LESSON : 1

MEANING, CHARACTERISTICS AND TYPES OF A COMPANY

STRUCTURE

1.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define a company and explain its features.

(b) Make a distribution between company and partnership firm.

(c) Explain the various types of companies.

1.1 INTRODUCTION

Industrial has revolution led to the emergence of large scale business organizations. These organization require big investments and the risk involved is very high. Limited resources and unlimited liability of partners are two important limitations of partnerships of partnerships in undertaking big business. Joint Stock Company form of business organization has become extremely popular as it provides a solution to overcome the limitations of partnership business. The Multinational companies like Coca-Cola and, General Motors have their investors and customers spread throughout the world. The giant Indian Companies may include the names like Reliance, Talco Bajaj Auto, Infosys Technologies, Hindustan Lever Ltd., Ranbaxy Laboratories Ltd., and Larsen and Tubro etc.

1.2 MEANING OF COMPANY

Section 3 (1) (i) of the Companies Act, 1956 defines a company as "a company formed and registered under this Act or an existing company". Section 3(1) (ii) Of the act states that "an existing company means a company formed and registered under any of the previous companies laws". This definition does not reveal the distinctive characteristics of a company . According to Chief Justice Marshall of USA, "A company is a person, artificial, invisible, intangible, and existing only in the contemplation of the law. Being a mere creature of law, it possesses only those properties which the character of its creation of its creation confers upon it either expressly or as incidental to its very existence".

Another comprehensive and clear definition of a company is given by Lord Justice Lindley, "A company is meant an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business, and who share the profit and loss (as the case may be) arising there from. The common stock 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 Haney, "Joint Stock Company is a voluntary association of individuals for profit, having a capital divided into transferable shares. The ownership of which is the condition of membership".

From the above definitions, it can be concluded that a company is registered association which is an artificial legal person, having an independent legal, entity with a perpetual succession, a common seal for its signatures, a common capital comprised of transferable shares and carrying limited liability.

1.3 CHARACTERISTICS OF A COMPANY

The main characteristics of a company are :

1. **Incorporated association.** A company is created when it is registered under the Companies Act. It comes into being from the date mentioned in the certificate of incorporation. It may be noted in this connection that Section 11 provides that an association of more than ten persons carrying on business in banking or an association or more than twenty persons carrying on any other type of business must be registered under the Companies Act and is deemed to be an illegal association, if it is not so registered.

For forming a public company at least seven persons and for a private company at least two persons are persons are required. These persons will subscribe their names to the Memorandum of association and also comply with other legal requirements of the Act in respect of registration to form and incorporate a company, with or without limited liability [Sec 12 (1)]

2. Artificial legal person. A company is an artificial person. Negatively speaking, it is not a natural person. It exists in the eyes of the law and cannot act on its own. It has to act through a board of directors elected by shareholders. It was rightly pointed out in Bates V Standard Land Co. that : "The board of directors are the brains and the only brains of the company, which is the body and the company can and does act only through them".

But for many purposes, a company is a legal person like a natural person. It has the right to acquire and dispose of the property, to enter into contract with third parties in its own name, and can sue and be sued in its own name.

However, it is not a citizen as it cannot enjoy the rights under the Constitution of India or Citizenship Act. In State Trading Corporation of India v C.T.O (1963 SCJ 705), it was held that neither the provisions of the Constitution nor the Citizenship Act apply to it. It should be noted that though a company does not possess fundamental rights, yet it is person in the eyes of law. It can enter into contracts with its Directors, its members, and outsiders.

Justice Hidayatullah once remarked that if all the members are citizens of India, the company does not become a citizen of India.

3. Separate Legal Entity : A company has a legal distinct entity and is independent of its members. The creditors of the company can recover their money only from the company and the property of the company. They cannot sue individual members. Similarly, the company is not in any way liable for the individual debts of its members. The property of the company is to be used for the benefit of the company and nor for the personal benefit of the shareholders. On the same grounds, a member cannot claim any ownership rights in the assets of the company either individually or jointly during the existence of the company or in its winding up. At the same time the members of the company can enter into contracts with the company in the same manner as any other individual can. Separate legal entity of the company is also recognized by the Income Tax Act. Where a company is required to pay Income-tax on its profits and when these profits are distributed to shareholders in the form of dividend, the shareholders have to pay income-tax on their dividend of income. This proves that a company that a company and its shareholders are two separate entities.

The principal of separate of legal entity was explained and emphasized in the famous case of Salomon v Salomon & Co. Ltd.

The facts of the case are as follows :

Mr. Saloman, the owner of a very prosperous shoe business, sold his business for the sum of $ 39,000 to Saloman and Co. Ltd. which consisted of Saloman himself, his wife, his daughter and his four sons. The purchase consideration was paid by the company by allotment of & 20,000 shares and $ 10,000 debentures and the balance in cash to Mr. Saloman. The debentures carried a floating charge on the assets of the company. One share of $ 1 each was subscribed by the remaining six members of his family. Saloman and his two sons became the directors of this company. Saloman was the managing Director.

After a short duration, the company went into liquidation. At that time the statement of affairs' was like this: Assets :$ 6000, liabilities; Saloman as debenture holder $ 10,000 and unsecured creditors $ 7,000. Thus its assets were running short of its liabilities b $11,000

The unsecured creditors claimed a priority over the debenture holder on the ground that company and Saloman were one and the same person. But the House of Lords held that the existence of a company is quite independent and distinct from its members and that the assets of the company must be utilized in payment of the debentures first in priority to unsecured creditors.

Saloman's case established beyond doubt that in law a registered company is an entity distinct from its members, even if the person hold all the shares in the company. There is no difference in principle between a company consisting of only two shareholders and a company consisting of two hundred members. In each case the company is a separate legal entity.

The principle established in Saloman's case also been applied in the following:

Lee V. Lee's Airforming Ltd. (1961) A.C. 12 Of the 3000 shares in Lee's Air Forming Ltd., Lee held 2999 shares. He voted himself the managing Director and also became Chief Pilot of the company on a salary. He died in an aircrash while working for the company. His wife was granted compensation for the husband in the course of employment. Court held that Lee was a separate person from the company he formed, and compensation was due to the widow. Thus, the rule of corporate personality enabled Lee to be the master and servant at the same time.

The principle of separate legal entity of a company has been, in fact recognized much earlier than in Saloman's case. In Re Kondoi Tea Co Ltd. (1886 ILR 13 Cal 43), it was held by Calcutta High Court that a company was a separate person, a separate body altogether from its Shareholders. In Re. Sheffield etc. Society - 22 OBD 470), it has been held that a corporation is a legal person, just as much in individual but with no physical existence.

The characteristic of separate corporate personality of a company was also emphasized by Chief Justice Marshall of USA when he defined a company “as a person, artificial, invisible, intangible and existing only in the eyes of the law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as accident to its very existence”. [Trustees of Darmouth College v woodward (1819) 17 US 518)

4. Perpetual Existence. A company is a stable form of business organization. Its life does not depend upon the death, insolvency or retirement of any or all shareholder (s) or director (s). Law creates it and law alone can dissolve it. Members may come and go but the company can go on for ever. “During the war all the member of one private company , while in general meeting, were killed by a bomb. But the company survived; not even a hydrogen bomb could have destroyed i”. The company may be compared with a flowing river where the water keeps on changing continuously, still the identity of the river remains the same. Thus, a company has a perpetual existence, irrespective of changes in its membership.

5. Common Seal. As was pointed out earlier, a company being an artificial person has no body similar to natural person and as such it cannot sign documents for itself. It acts through natural person who are called its directors. But having a legal personality, it can be bound by only those documents which bear its signature. Therefore, the law has provided for the use of common seal, with the name of the company engraved on it, as a substitute for its signature. Any document bearing the common seal of the company will be legally binding on the company. A company may have its own regulations in its Articles of Association for the manner of affixing the common seal to a document. If the Articles are silent, the provisions of Table-A (the model set of articles appended to the Companies Act) will apply. As per regulation 84 of Table-A the seal of the company shall not be affixed to any instrument except by the authority of a resolution of the Board or a Committee of the Board authorized by it in that behalf, and except in the presence of at least two directors and of the secretary or such other person as the Board may appoint for the purpose, and those two directors and the secretary or other person aforesaid shall sign every instrument to which the seal of the company is so affixed in their presence.

6. Limited Liability : A company may be company limited by shares or a company limited by guarantee. In company limited by shares, the liability of members is limited to the unpaid value of the shares. For example, if the face value of a share in a company is Rs. 10 and a member has already paid Rs. 7 per share, he can be called upon to pay not more than Rs. 3 per share during the lifetime of the company. In a company limited by guarantee the liability of members is limited to such amount as the member may undertake to contribute to the assets of the company in the event of its being wound up.

7. Transferable Shares. In a public company, the shares are freely transferable. The right to transfer shares is a statutory right and it cannot be taken away by a provision in the articles. However, the articles shall prescribe the manner in which such transfer of shares will be made and it may also contain bona fide and reasonable restrictions on the right of members to transfer their shares. But absolute restrictions on the rights of members to transfer their shares shall be ultra vires. However, in the case of a private company, the articles shall restrict the right of member to transfer their shares in companies with its statutory definition.

In order to make the right to transfer shares more effective, the shareholder can apply to the Central Government in case of refusal by the company to register a transfer of shares.

8. Separate Property : As a company is a legal person distinct from its members, it is capable of owning, enjoying and disposing of property in its own name. Although its capital and assets are contributed by its shareholders, they are not the private and joint owners of its property. The company is the real person in which all its property is vested and by which it is controlled, managed and disposed of.

9. Delegated Management : A joint stock company is an autonomous, self-governing and self-controlling organization. Since it has a large number of members, all of them cannot take part in the management of the affairs of the company. Actual control and management is, therefore, delegated by the shareholders to their elected representatives, know as directors. They look after the day-to-day working of the company. Moreover, since shareholders, by majority of votes, decide the general policy of the company, the management of the company is carried on democratic lines. Majority decision and centralized management compulsorily bring about unity of action.

1.4 DISTINCTION BETWEEN COMPANY AND PARTNERSHIP

The difference between a company and partnership is as follows:

		Company	Partnership
1.	Mode of creation	By Registration by Statute.	By Agreement
2.	Legal Statute	Legal entity distinct from members, perpetual succession.	Firm and partners are not separate; no separate entity; uncertain life
3.	Liability	Limited liability of members	Unlimited joint and several liability of partners
4.	Authority	Divorce between ownership and management Representative Management	Right to share mana gement, common and ownership and Management. Mutual agency - Implied authority.
5.	Transfer of shares	Public Co.-freely transferable; transferee gets all the rights of the transferor	Ordinarily no right of transfer of share by a partner-limited rights of transferee

6.	Number of members	Private Co-Minimum 2 and Maximum 50 public Co. Minimum7 and Maximum unlimited.	Minimum 2 Maximum 20.
7.	Resources	Large and unlimited resources	Personal resources of partners are limited.
8.	General powers	Memorandum defines and confines the scope of the company. alteration difficult.	Easy to change the agreement and so also the powers of the partners.
9.	Legal formalities	Statutory books, Audit, Publication Registration, filing, etc. lots of legal formalities	No legal formalities Registration not compulsory. No audit, no publication of accounts etc.
10.	Dissolution	Only according to the provisions of law-usually by an order of the court. Death of a share-holder does not affect the existence of a company.	Dissolution by agreement by notice, by court. Death of a partner may mean dissolution of partnership

1.5 TYPES OF COMPANY

Joint stock company can be of various types. The following are the important types of company:

1. Classification of Companies by Mode of Incorporation

Depending on the mode of incorporation, there are three classes of joint stock companies.

A. Chartered companies. These are incorporated under a special charter by a monarch. The East India Company and The Bank of England are examples of chartered incorporated in England. The powers and nature of business of a chartered company are defined by the charter which incorporates it. A chartered company has wide powers. It can deal with its property and bind itself to any contracts that any ordinary person can. In case the company deviates from its business as prescribed by the charted, the Sovereign can annul the latter and close the company. Such companies do not exist in India.

B. Statutory Companies. These companies are incorporated by a Special Act passed by the Central or State legislature. Reserve Bank of India, State Bank of India, Industrial Finance Corporation, Unit Trust of India, State Trading corporation and Life Insurance Corporation are some of the examples of statutory companies. Such companies do not have any memorandum or articles of association. They derive their powers from the Acts constituting them and enjoy certain powers that companies incorporated under the Companies Act have. Alternations in the powers of such companies can be brought about by legislative amendments.

The provisions of the Companies Act shall apply to these companies also except in so far as provisions of the Act are inconsistent with those of such Special Acts [Sec 616 (d)]

These companies are generally formed to meet social needs and not for the purpose of earning profits.

C. Registered or incorporated companies. These are formed under the Companies Act, 1956 or under the Companies Act passed earlier to this. Such companies come into existence only when they are registered under the Act and a certificate of incorporation has been issued by the Registrar of Companies. This is the most popular mode of incorporating a company. Registered companies may further be divided into three categories of the following.

i) Companies limited by Shares : These types of companies have a share capital and the liability of each member or the company is limited by the Memorandum to the extent of face value of share subscribed by him. In other words, during the existence of the company or in the event of winding up, a member can be called upon to pay the amount remaining unpaid on the shares subscribed by him. Such a company is called company limited by shares. A company limited by shares may be a public company or a private company. These are the most popular types of companies.

ii) Companies Limited by Guarantee : These types of companies may or may not have a share capital. Each member promises to pay a fixed sum of money specified in the Memorandum in the event of liquidation of the company for payment of the debts and liabilities of the company [Sec 13(3)] This amount promised by him is called

'Guarantee'. The Articles of Association of the company state the number of member with which the company is to be registered [Sec 27 (2)]. Such a company is called a company limited by guarantee. Such companies depend for their existence on entrance and subscription fees. They may or may not have a share capital. The liability of the member is limited to the extent of the guarantee and the face value of the shares subscribed by them, if the company has a share capital. If it has a share capital, it may be a public company or a private company.

The amount of guarantee of each member is in the nature of reserve capital. This amount cannot be called upon except in the event of winding up of a company. Non-

trading or non-profit companies formed to promote culture, art, science, religion, commerce, charity, sports etc. are generally formed as companies limited by guarantee.

iii) Unlimited Companies : Section 12 gives choice to the promoters to form a company with or without limited liability. A company not having any limit on the liability of its members is called an 'unlimited company' [Sec 12(c)]. An unlimited company may or may not have a share capital. If it has a share capital it may be a public company or a private company. If the company has a share capital, the article shall state the amount of share capital with which the company is to be registered [Sec 27 (1)]

The articles of an unlimited company shall state the number of member with which the company is to be registered.

II. On the Basis of Number of Members

On the basis of number of members, a company may be :

(1) Private Company, and (2) Public Company.

A. Private Company

According to Sec. 3(1) (iii) of the Indian Companies Act, 1956, a private company is that company which by its articles of association :

i) limits the number of its members to fifty, excluding employees who are members or ex-employees who were and continue to be members;

ii) restricts the right of transfer of shares, if any;

iii) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Where two or more persons hold share jointly, they are treated as a single member.

According to Sec 12 of the Companies Act, the minimum number of members to form a private company is two. A private company must use the word "Pvt" after its name.

Characteristics or Features of a Private Company. The main features of a private of a private company are as follows :

i) A private company restricts the right of transfer of its shares. The shares of a private company are not as freely transferable as those of public companies. The articles generally state that whenever a shareholder of a Private Company wants to transfer his shares, he must first offer them to the existing members of the existing members of the company. The price of the shares is determined by the directors. It is done so as to preserve the family nature of the company's shareholders.

ii) It limits the number of its members to fifty excluding members who are employees or ex-employees who were and continue to be the member. Where two or more persons hold share jointly they are treated as a single member. The minimum number of members to form a private company is two.

iii) A private company cannot invite the public to subscribe for its capital or shares of debentures. It has to make its own private arrangement.

B. Public company

According to Section 3 (1) (iv) of Indian Companies Act. 1956 “A public company which is not a Private Company”,

If we explain the definition of Indian Companies Act. 1956 in regard to the public company, we note the following :

i) The articles do not restrict the transfer of shares of the company

ii) It imposes no restriction no restriction on the maximum number of the members on the company.

iii) It invites the general public to purchase the shares and debentures of the companies

(Differences between a Public Company and a Private company)

1. **Minimum number :** The minimum number of persons required to form a public company is 7. It is 2 in case of a private company.

2. **Maximum number :** There is no restriction on maximum number of members in a public company, whereas the maximum number cannot exceed 50 in a private company.

3. **Number of directors.** A public company must have at least 3 directors whereas a private company must have at least 2 directors (Sec. 252)

4. **Restriction on appointment of directors.** In the case of a public company, the directors must file with the Register a consent to act as directors or sign an undertaking for their qualification shares. The directors or a private company need not do so (Sec 266)

5. **Restriction on invitation to subscribe for shares.** A public company invites the general public to subscribe for shares. A public company invites the general public to subscribe for the shares or the debentures of the company. A private company by its Articles prohibits invitation to public to subscribe for its shares.

6. **Name of the Company :** In a private company, the words "Private Limited" shall be added at the end of its name.

7. **Public subscription :** A private company cannot invite the public to purchase its shares or debentures. A public company may do so.

8. **Issue of prospectus :** Unlike a public company a private company is not expected to issue a prospectus or file a statement in lieu of prospectus with the Registrar before allotting shares.

9. **Transferability of Shares.** In a public company, the shares are freely transferable (Sec. 82). In a private company the right to transfer shares is restricted by Articles.

10. **Special Privileges.** A private company enjoys some special privileges. A public company enjoys no such privileges.

11. **Quorum.** If the Articles of a company do not provide for a larger quorum. 5 members personally present in the case of a public company are quorum for a meeting of the company. It is 2 in the case of a private company (Sec. 174)

12. **Managerial remuneration.** Total managerial remuneration in a public company cannot exceed 11 per cent of the net profits (Sec. 198). No such restriction applies to a private company.

13. **Commencement of business.** A private company may commence its business immediately after obtaining a certificate of incorporation. A public company cannot commence its business until it is granted a "Certificate of Commencement of business".

Special privileges of a Private Company

Unlike a private a public company is subject to a number of regulations and restrictions as per the requirements of Companies Act, 1956. It is done to safeguard the interests of investors/shareholders of the public company. These privileges can be studied as follows :

a) Special privileges of all companies. The following privileges are available to every private company, including a private company which is subsidiary of a public company or deemed to be a public company :

1. A private company may be formed with only two persons as member. [Sec.12(1)]
2. It may commence allotment of shares even before the minimum subscription is subscribed for or paid (Sec. 69).
3. It is not required to either issue a prospectus to the public of file statement in lieu of a prospectus. (Sec 70 (3)]
4. Restrictions imposed on public companies regarding further issue of capital do not apply on private companies. [Sec 81 (3)]

5. Provisions of Sections 114 and 115 relating to share warrants shall not apply to it. (Sec. 14)
6. It need not keep an index of members. (Sec. 115)
7. It can commence its business after obtaining a certificate of incorporation. A certificate of commencement of business is not required. [Sec. 149 (7)]
8. It need not hold statutory meeting or file a statutory report [Sec. 165 (10)]
9. Unless the articles provide for a larger number, only two persons personally present shall form the quorum in case of a private company, while at least five member personally present form the quorum in case of a public company (Sec. 174).
10. A director is not required to file consent to act as such with the Registrar. Similarly, the provisions of the Act regarding undertaking to take up qualification shares and pay for them are not applicable to directors of a private companies [Sec. 266 (5) (b)]
11. Provisions in Section 284 regarding removal of directors by the company in general meeting shall not apply to a life director appointed by a private company on or before 1st April 1952 [Sec. 284 (1)]
12. In case of a private company, poll can be demanded by one member if not more than seven members are present, and by two member if not more than seven member are present. In case of a public company, poll can be demanded by persons having not less than one-tenth of the total voting power in respect of the resolution or holding shares on which an aggregate sum of not less than fifty thousand rupees has been paid-up (Sec. 179).

13. It need not have more than two directors, while a public company must have at least three directors (Sec. 252)

b) Privileges available to an independent private company (i.e. one which is not a subsidiary of a public company)

An independent private company is one which is not a subsidiary of a public company. The following special privileges and exemptions are available to an independent private company.

1. It may give financial assistance for purchase of or subscription for shares in the company itself.
2. It need not, like a public company, offer rights shares to the equity shareholders of the company.
3. The provisions of Sec. 85 to 90 as to kinds of share capital, new issues of share capital, voting, issue of shares with disproportionate rights, and termination of disproportionately excessive rights, do not apply to an independent private company.
4. A transfer or transferee of shares in an independent private company has no right of appeal to the Central Government against refusal by the company to register a transfer of its shares.
5. Sections 171 to 186 relating to general meeting are not applicable to an independent private company if it makes its own provisions by the Articles. Some provisions of these Sections are, however made expressly applicable.
6. Many provisions relating to directors of a public company are not applicable to an independent private company, e.g.

a) it need not have more than 2 directors.

b) The provisions relating to the appointment, retirement, reappointment, etc. of directors who are to retire by rotation and the procedure relating, there to are not applicable to it.

c) The provisions requiring the giving of 14 days' notice by new candidates seeking election as directors, as also provisions requiring the Central Government's sanction for increasing the number of directors by amending the Articles or otherwise beyond the maximum fixed in the Articles, are not applicable to it.

d) The provisions relating to the manner of filing up casual vacancies among directors and the duration of the period of office of directors and the requirements that the appointment of directors should be voted on individually and that the consent of each candidate for directorship should be filed with the Registrar, do not apply to it.

e) The provisions requiring the holding of a share qualification by directors and fixing the time within which such qualification is to be acquired and filing with the Registrar of a declaration of share qualification by each director are also not applicable to it.

f) It may, by its Articles, Provide special disqualifications for appointment of directors.

g) It may provide special grounds for vacation of office of a director.

h) Sec. 295 prohibiting loans to directors does not apply to it.

i) An interested director may participate or vote in Board's proceedings relating to his concern of interest in any contract of arrangement.

7. The restrictions as to the number of companies of which a person may be appointed managing director and the prohibition of such appointment for more than 5 years at a time, do not apply to it

8. The provisions prohibiting the subscribing for, or purchasing of, shares or debentures of other companies in the same group do not apply to it.

9. The provisions of Section 409 conferring power on the Central Government to present change in the Board of directors of a company where in the opinion of the Central Government such change will be prejudicial to the interest of the company, do not apply to it.

When a Private company becomes a Public company

A private company shall become a public company in following cases :

i) By default : When it fails to comply with the essential requirements of a private company provided under Section 3 (1) (iii) Default in complying with the said three provisions shall disentitle a private company to enjoy certain privileges (Sec. 43).

ii) A private company which is a subsidiary of another public company shall be deemed to be a public company.

iii) By provisions of law - Section 43-A.

Section 43-A

a) Where not less than 25% of the paid-up share capital of a private company is held by one or more bodies" corporate such a private company shall become a public company from the data in which such 25% is held by body corporate [Sec. 43-A (1)]

b) Where the average annual turnover of a private company is not less than Rs. 10 crores during the relevant period, such a private company shall become a public company after the expiry of the period of three months from the last day of the relevant period when the accounts show the said average annual turnover [Sec. 43 A (1 A)].

c) When a private company holds not less than 25% of the paid up share capital of a public company the private company shall become a public company from the date on which the private company holds such 25% [Sec. 43A (IB)].

d) Where a private company accepts, after an invitation is made by an advertisement of receiving deposits from the public other than its members, directors or their relatives, such private company shall become a public company [Sec. 43A (IC)].

iv) By Conversion : When the private company converts itself into a public company by altering its Articles in such a manner that they no longer include essential requirements of a private company under Section 3 (1) (iii). On the data of such alternations, it shall cease to be private company. It shall comply with the procedure of converting itself into a public company [Sec. 44].

The Articles of Association of such a public company may continue to have the three restrictions and may continue to have two directors and less than seven members.

Within 3 months of such a conversion. Registrar of Companies shall be intimated. The Registrar shall delete the word ‘Private’ before the words ‘Limited’ in the name of the company and shall also make necessary alternations in the certificate of incorporation.

III. On the basis of Control

On the basis of control, a company may be classified into :

1. Holding companies, and
2. Subsidiary Company

1. Holding Company [Sec. 4(4)]. A company is known as the holding company of another company if it has control over the other company. According to Sec 4(4) a company is deemed to be the holding company of another if, but only if that other is its subsidiary.

A company may become a holding company of another company in either of the following three ways :-

a) by holding more than fifty per cent of the normal value of issued equity capital of the company; or

b) By holding more than fifty per cent of its voting rights; or

c) by securing to itself the right to appoint, the majority of the directors of the other company , directly or indirectly.

The other company in such a case is known as a “Subsidiary company”. Though the two companies remain separate legal entities, yet the affairs of both the companies are managed and controlled by the holding company. A holding company may have any number of subsidiaries. The annual accounts of the holding company are required to disclose full information about the subsidiaries.

2. Subsidiary Company. [Sec. 4 (I)]. A company is know as a subsidiary of another company when its control is exercised by the latter (called holding company) over the former called a subsidiary company. Where a company (company S) is subsidiary of another company (say Company H), the former (Company S) becomes the subsidiary of the controlling company (company H).

IV. On the basis of Ownership of companies

a) Government Companies. A Company of which not less than 51% of the paid up capital is held by the Central Government of by State Government or Government singly or jointly is known as a Government Company. It includes a company subsidiary to a government company. The share capital of a government company may be wholly or partly owned by the government, but it would not make it the agent of the government . The auditors of the government company are appointed by the government on the advice of the Comptroller and Auditor General of India. The Annual Report along with the auditor's report are placed before both the House of the parliament. Some of the examples of government companies are - Mahanagar Telephone Corporation Ltd., National Thermal Power Corporation Ltd., State Trading Corporation Ltd. Hydroelectric Power Corporation Ltd. Bharat Heavy Electricals Ltd. Hindustan Machine Tools Ltd. etc.

b) Non-Government Companies. All other companies, except the Government Companies, are called non-government companies. They do not satisfy the characteristics of a government company as given above.

V. On the basis of Nationality of the Company

a) Indian Companies : These companies are registered in India under the Companies Act. 1956 and have their registered office in India. Nationality of the members in their case is immaterial.

b) Foreign Companies : It means any company incorporated outside India which has an established place of business in India [Sec. 591 (I)]. A company has an established place of business in India if it has a specified place at which it carries on business such as an office, store house or other premises with some visible indication premises. Section 592 to 602 of Companies Act, 1956 contain provisions applicable to foreign companies functioning in India.

1.6 SUMMARY

Company may be defined as group of persons associated together to achieve some common objective. A company formed and registered under the Companies Act has certain special features, which reveal the nature of a company. These characteristics are also called he advantages of a company because as compared with other business organizations, these are in fact, beneficial for a company. Companies can be classified into five categories according to the mode of incorporation on the basis of number of members, on the basis of control, on the basis of ownership and on the basis of nationality of the company.

1.7 KEYWORDS

Company: A company means a body of individuals associated together for a common objective, which may be business for profit or for some charitable purposes.

Registered Company: A registered company is one which is formed and registered under the Indian Companies Act, 1956 or under any earlier Companies Act in force in India.

Public Company: A public company means a company which is not a private company. Any seven or more persons can join hands to form a public company.

Holding Company: A company shall be deemed to be the holding company to another if that other is its subsidiary.

Unlimited Company: A company not having any limit on the liability of its member is called an unlimited company.

1.8 SELF ASSESSMENT QUESTIONS

1. Define ‘Company’. What are its essential characteristics ?
2. Explain the special privileges of a private company as compared to a public company.
3. Bring out the difference between partnership and company form of organization.
4. Write notes on :
   a) Chartered Companies
   b) Government Companies
5. Classify company form of organization on the basis of liability of members.

1.9 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

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

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

LESSON : 2

INCORPORATION OF COMPANIES; MEMORANDUM OF ASSOCIATION AND ARTICLES OF ASSOCIATION

STRUCTURE

2.0 OBJECTIVE

After reading this lesson, you should be able to

(a) Describe the process of formation of a company.

(b) Explain the different clauses of memorandum of association and the alterations thereof.

(c) Discuss the contents of articles of association.

(d) highlight the importance of constructive notice of memorandum and articles of association.

2.1 INTRODUCTION

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

2.2 INCORPORATION OF COMPANIES

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

2.2.1 Promotion

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

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

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

Promoter's Remuneration

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

Promoter's Liability

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

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

Promoter's Contracts

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

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

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

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

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

2.2.2 Incorporation

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

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

ii) To get a letter of Intent under Industries (Development and Regulation) Act, 1951, if the company's business comes within the purview of the Act.

iii) To get necessary documents i.e. Memorandum and Articles of Association prepared and printed.

iv) to prepare preliminary contracts and a prospectus or statement in lieu of a prospectus.

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

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

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

The certificate of incorporation is the birth certificate of a company. The company comes into existence from the date mentioned in the certificate of incorporation and the date appearing in it is conclusive, even if wrong. Further, the certificate is ‘conclusive evidence that all the requirements of this Act in respect of registration and matters precedent and related thereto have been fulfilled and that the association is a company authorized to be registered and duly registered under this Act.

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

2.2.3 Capital Subscription

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

If the capital has to be said through a public offer of shares, the directors of the public company will first file a copy of the prospectus with the Registrar of Companies. On the scheduled date the prospectus will be issued to the public. Investors are required to forward their applications for shares along with application money to the company’s bankers mentioned in the prospectus. The bankers will then forward all applications to the company and the directors will consider the allotment of shares. If the subscribed capital is at least equal to 90 percent of the capital issue, and other requirements of a valid allotment are fulfilled the directors pass a formal resolution of allotment. However, if the company does not receive applications which can cover the minimum subscription within 120 days of the issue of prospectus, no allotment can be made and all money received will be refunded.

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

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

2.2.4 Commencement of Business

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

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

The certificate to commence business granted by the Registrar is a conclusive evidence of the fact that the company has complied with all legal formalities and it is legally entitled to commence business. It may also be noted that the court has the power to wind up a company, if it fails to commence business within a year of its incorporation [Sec. 433 (3)]

2.3 MEMORANDUM OF ASSOCIATION

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

1. Memorandum of Association
2. Articles of Association

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

Form of Memorandum (Sec. 14)

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

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

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

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

Printing and signing of Memorandum (Sec. 15).

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

Contents of Memorandum

1. Name clause

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

i) There is no other company registered under the same or under an identical name;

ii) The name should not be considered undesirable and prohibited by the Central Government (Sec. 20). A name which misrepresents the public is prohibited by the Government under the Emblems & Names (Prevention of Improper use) Act, 1950 for example, Indian National Flag, name pictorial representation of Mahatma Gandhi and the Prime Minister of India, name and emblems of the U.N.O., and W.H.O., the official seal and Emblems of the Central Government and State Governments.

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

iii) Once the name has been approved and the company has been registered, then

a) the name of the company with registered office shall be affixed on outside of the business premises;

b) if the liability of the members is limited the words “Limited” or “Private Limited” as the case may be, shall be added to the name; [Sec 13(1) (1)]:

Omission of the word ‘Limited’ makes the name incorrect. Where the word’ Limited” forms part of a company’s name, omission of this word shall make the name incorrect. If the company makes a contract without the use of the word “Limited”, the officers of the company who make the contract would be deemed to be personally liable [Atkins & Co v Wardle, (1889) 61 LT 23]

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

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

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

In Osborn v The Bank of U. A. E., [9 Wheat (22 US), 738]; it was held that the name of a company is the symbol of its personal existence. The name should be properly and correctly mentioned. The Central Government may allow a company to drop the word "Limited" from its name.

2. Registered Office Clause

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

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

3. Object Clause

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

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

i) **Main Objects** : This sub-clause has to state the main objects to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of main objects.

ii) **Other objects**: This sub-clause shall state other objects which are not included in the above clause.

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

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

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

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

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

i) The objects of the company must not be illegal, e.g. to carry on lottery business.

ii) The objects of the company must not be against the provisions of the Companies Act such as buying its own shares (Sec. 77), declaring dividend out of capital etc.

iii) The objects must not be against public, e.g. to carry on trade with an enemy country.

iv) The objects must be stated clearly and definitely. An ambiguous statement like "Company may take up any work which it deems profitable" is meaningless.

v) The objects must be quite elaborate also. Note only the main objects but the subsidiary or incidental objects too should be stated.

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

4. Capital Clause

In case of a company having a share capital unless the company is an unlimited company, Memorandum shall also state the amount of share capital with which the company is to be registered and division there of into shares of a fixed amount [Sec. 13 (4)]. The capital with which the company is registered is called the authorized or nominal share capital. The nominal capital is divided into classes of shares and their values are mentioned in the clause. The amount of nominal or authorized capital of the company would be normally, that which shall be required for the attainment of the main objects of the company. IN case of companies limited by guarantee, the amount promised by each member to be contributed by them in case of the winding up of the company is to be mentioned. No subscriber to the memorandum shall take less than one share. Each subscriber of the Memorandum shall write against his name the number of shares he takes.

5. Liability Clause

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

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

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

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

6. Association or Subscription Clause

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

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

Alteration of Memorandum of Association

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

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

1. Change of name

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

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

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

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

2. Change of Registered Office

This may involve :

a) Change of registered office from one place to another place in the same city, town or village. In this case, a notices is to be give within 30 days after the date of change to the Registrar who shall record the same.

b) Change of registered office from one town to another town in the same State. In this case, a special resolution is required to be passed at a general meeting of the shareholders and a copy of it is to be filed with the Registrar within 30 days. The within 30 days of the removal of the office. A notice has to be given to the Registrar of the new location of the office.

c) Change of Registered Office from one State to another State to another State.

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

Special Resolution

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

Confirmation by Central Government

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

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

3. Alteration of the Object Clause

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

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

Limits of alteration of the Object Clause

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

i) to enable the company to carry on its business more economically or more effectively;

ii) to enable the company to attain its main purpose by new or improved means;

iii) to enlarge or change the local area of the company's operation;

iv) to carry on some business which under existing circumstances may conveniently or advantageously be combined with the business of the company;

v) to restrict or abandon any of the objects specified in the memorandum

vi) to sell or dispose of the whole, or any part of the undertaking of the company;

vii) to amalgamate with any other company or body of persons.

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

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

Effect of non Registration with Registrar

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

4. Alteration of Capital Clause

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

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

5. Alteration of Liability Clause

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

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

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

2.4 ARTICLES OF ASSOCIATION

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

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

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

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

Contents of Articles of Association

Articles generally contain provision relating to the following matters; (1) the exclusion, whole or in part of Table A; (ii) share capital different classes of shares of shareholders and variations of these rights (iii) execution or adoption of preliminary agreements, if any; (iv) allotment of shares; (v) lien on shares (vi) calls on shares; (vii) forfeiture of shares; (viii) issue of share certificates; (ix) issue of share warrants; (x) transfer of shares; (xi) transmission of shares; (xii) alteration of share capital; (xiii) borrowing power of the company; (xiv) rules regarding meetings; (xv) voting rights of members; (xvi) notice to members; (xvii) dividends and reserves; (xviii) accounts and audit; (xix) arbitration provision, if any; (xx) directors, their appointment and remuneration; (xxi) the appointment and reappointment of the managing director, manager and secretary; (xxii) fixing limits of the number of directors (xxiii) payment of interest out of capital; (xxiv) common seal; and (xxv) winding up.

Model form of Articles

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

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

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

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

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

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

A Public Company may have its own Article of Association. If it does not have its own Articles, it may adopt Table A given in Schedule I to the Act.

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

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

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

Alteration of Articles

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

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

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

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

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

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

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

2.5 DISTINCTION BETWEEN ARTICLES OF ASSOCIATION AND MEMORANDUM OF ASSOCIATION

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

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

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

2.6 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES OF ASSOCIATION

The Memorandum and Articles of a company are registered with the Registrar. These are the public documents and open to public inspection,. Every person contracting with the company must acquaint himself with their contents and must make sure that his contract is in accordance with them, otherwise he cannot sue the company.

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

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

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

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

2.7 SUMMARY

The whole process of formation of a company can be divided into four distinct stages namely promotion incorporation, capital subscription and commencement of business. However, a private company can start business as soon as it obtains the certificate of information. The memorandum of Association of a company tells us the objects of the company's formation and the utmost possible scope of its operations beyond which its actions cannot go. The memorandum of association of every clause, objects clause, liability clause, Memorandum of association cannot be altered by the sweet will of the members of the company. It can be altered only by following the procedure prescribed in the Companies Act. Articles of association contain the rules and regulations which are granted for the internal management of the company. The company may alter its articles of association any time by following the procedure as prescribed in the Companies Act. Every person dealing with the company is presumed to have read the memorandum and articles of association and understood them in their time perspective. This is known as doctrine of constructive notice.

2.8 KEYWORDS

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

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

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

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

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

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

2.9 SELF ASSESSMENT QUESTIONS

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

2.10 SUGGESTED READINGS

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

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

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

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

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

LESSON : 3

PROSPECTUS AND COMMENCEMENT OF BUSINESS

STRUCTURE

3.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define a prospectus and explain the requirement regarding issue of prospectus.

(b) Describe the contents of the prospectus.

(c) Explain the civil and criminal liabilities for mis-statement in prospectus.

(d) Discuss the conditions to be fulfilled by a public company to get certificate of commencement of business.

3.1 INTRODUCTION

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

3.2 DEFINITION OF PROSPECTUS

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

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

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

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

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

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

I. There must be an invitation offering to the public;

II. The invitation must be or on behalf of the company or in relation to an intended company;

III. The invitation must be to subscribe or purchase.

IV. The invitation must relate to shares or debentures.

3.3 OBJECTS OF PROSPECTUS

The main objects of a prospectus are as follows :

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

2. To preserve an authentic record of the terms of allotment on which the public have been invited to but its shares or debentures.

3. The secure that the directors of the company accept responsibility of the statement in the prospectus.

3.4 REQUIREMENTS REGARDING ISSUE OF PROSPECTUS

The relevant requirements regarding issue of prospectus are given below:

1. Issue after Incorporation

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

a) by a person interested or engaged in the formation company or

b) through an offer for sale by a person to whom the company has allotted shares.

2. Dating of Prospectus

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

3. Registration of Prospectus

A copy of every prospectus must be delivered to the Registrar for registration before it is issued to the public. Registration must be made on or before the date of its publication. The copy sent for registration must be signed by every person who is named in the prospectus as a director or proposed director of the company or by his agent authorized in writing. Where the prospectus is issued in more than one language, a copy of its as issued in each language should be delivered to the registrar. This copy must be accompanied with the following documents:

a) If the report of an expert is to be published, his written consent to such publication;

b) a copy of every contract relating to the appointment and remuneration of managerial personnel;

c) a copy of every material contract unless it is entered in the ordinary course of business or two years before the date of the issue of prospectus;

d) a written statement relating to adjustments; if any, made by the auditors or accountants in their reports relating to profits and losses, assets and liabilities or the rates of dividends, etc.; and

e) written consent of auditors, legal advisers, attorney, solicitor, banker or broker of the company to act in that capacity.

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

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

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

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

5. Terms of the contract not to be varied

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

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

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

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

7. Personation for Acquisition etc. of Shares

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

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

8. Contents as per Schedule II

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

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

3.5 CONTENTS OF PROSPECTUS

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

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

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

Part I of Schedule II

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

particulars as regards their redemption.

4. The number of shares fixed by the articles of company as the qualification of a director.

5. The names, addresses, description and occupation of directors, managing director or manager or any of those proposed person.

6. Any provisions in the articles or any contract relating to appointment, remuneration and compensation for loss of office of directors, managing director or manager.

7. The amount of minimum subscription.

8. The time of the opening of the subscription list cannot be earlier than the beginning of the fifth day after the publication of prospectus.

9. Amount payable on application and allotment on each share shall be stated. If any allotment was previously made within two preceding years, the details of the shares allotted and the amount; if any, paid thereon.

10. Particulars about any option or preferential right to be given to any person to subscribe for shares or debentures of the company.

11. The number, description and amount of shares and debentures which, within the last two years, have been issued or agreed to be issued as fully or partly paid up than in cash.

12. The amount paid or payable as a premium, if any, on such share issued within two years preceding the date of the prospectus or is to be issued

stating the necessary particulars.

13. The names of the underwriters of shares or debentures, if any, and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations.

14. The names or addresses description and occupations of the vendors from whom the property has been purchased or is to be purchased, and the amount paid or payable in cash, shares or debentures respectively.

15. The amount of underwriting commission paid within two preceding years or payable to any person for subscribing or procuring subscription for any shares or debentures of the company.

16. Any benefit given to any promoter or officer in preceding two years and the consideration for giving of the benefit.

17. Particulars as to the date, parties and general nature of every contract appointing or fixing the remuneration of managing director or manager, whenever entered into.

18. Particulars of every material contract not entered into in the ordinary course of business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of the prospectus.

19. Names and addresses of the auditors of the company.

20. Full particulars of the nature and extent of interested of the directors or promoter in the promotion of the company or in the property acquired by

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

21. If the share capital of the company is divided into different classes of shares, the rights of voting at meeting of the company and the rights in respect of capital and the dividends attached to several classes of shares respectively.

22. Where the articles of the company impose any restriction upon the members of the company in respect of the rights to attend, speak or vote at meetings of the company or the rights to transfer shares or on the directors of the company in respect of their powers of management, the nature and extent of these restrictions.

23. Where the company carries on business, the length of time during which it has been carried on. If the company proposes to acquire a business which has been carried on for less than three years, the length of time during which the business had been conducted.

24. If any reserves or profits of the company or any of its subsidiaries have been capitalized, particulars of the capitalization and particulars of the surplus arising from any revaluation on the assets of the company.

25. A reasonable time and place at which copies of all balance sheets and profits and loss accounts, if any, on which the report of the auditors under part II below is based, may be inspected.

Part II of Schedule II

I General Information

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

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

2. Consent of Directors, Auditors, Solicitors/Advocates, Managers to issue, Registrar of Issue, Bankers to the company, Bankers to the issue and Experts.

3. Expert's opinion obtained, if any.

4. Change, if any, in directors and auditors during the last 3 years, and reasons thereof.

5. Authority for the issue and details of resolution passed for the issue.

6. Procedure and time schedule for allotment and issue of certificates.

II. Financial Information

1. Report by the Auditors

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

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

2. Reports by the Accountants

(a) A report by the accountants on the profits or losses of the business for the preceding 5 financial years, and on the assets and liabilities of the business on a date which shall not be more than 120 days before the date of the issue of the prospectus. This report is required to be given, if the proceeds of the issue of the shares or debentures are to be applied directly on the purchase of any business.

(b) A similar report on the account of a body corporate by an accountant if the proceeds of the issue are to be applied in the purchase of shares of a body corporate so that body corporate becomes a subsidiary of the acquiring company.

(c) Principal terms of loans and assets charged as security.

3. Statutory and other Information

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

Part III of Schedule II

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

A. Every person shall, for the purpose of this schedule, be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase of any property to be acquired by the company, in any case where (a) the purchase money is not fully paid at the date of the issue of the prospectus (b) the purchase money is to be paid or satisfied, wholly or in part, out of the proceeds of the issue offered for subscription by the prospectus; (c) the contract depends for its validity or fulfillment on the result of that issue.

B. In the case of a company which has been carrying on business for less than 5 financial years, reference to 5 financial years means reference to that number of financial years for which business has been carried on.

C. Reasonable time and place at which copies of all balance sheets and profit and loss accounts on which the report of the auditors is based, and material contracts and other documents may be respected.

"Term year" wherever used herein earlier means financial year.

Declaration

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

Statement by Experts

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

to a statement made by him.

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

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

3.6 MIS-STATEMENT IN THE PROSPECTUS

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

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

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

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

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

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

1. Civil Liability
2. Criminal Liability

1. Civil Liability

A person who has induced to subscribe for shares (or debentures) on the faith of a misleading prospects has remedies against the company, directors, promoters, and experts. Every person who is a director and promoter of the company, and who has authorized the issue of the prospectus [Section (2)].

a) Compensation

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

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

b) Recession of the Contract for Misrepresentation

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

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

1) The statement must b a material misrepresentation of fact

2) It must have induced the shareholder to take the shares.

3) The deceived shareholder is an allottee and he must have relied on the statement in the prospectus.

4) The omission of material fact must be misleading before recession is granted.

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

c) Damages for Deceit as Fraud

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

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

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

d) Liability for non-compliance

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

e) Damages for Fraud under General Law

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

f) Penalty for Contravening Section 57 & 58

If any prospectus is issued is contravention of Section 57, (experts to be unconnected with formation or management of company), or Section 58 (expert's consent to issue of prospectus containing statement by him) the company and every person who is knowingly party to the issue thereof, shall be punishable

with fine which may extend to Rs. 5,000/-.

g) Penalty for issuing the Prospectus without Registration

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

Defence against Civil Liability

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

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

II. The prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forth with gave reasonable public notice that it was issued without his knowledge or consent.

III. After the issue of prospectus, and before allotment thereunder he, on becoming aware of any untrue statement therein withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal.

IV. If a director, etc., has reasonable ground to believe that the statement was true and he, in fact, believed it to be true up to the time of allotment, he is not liable. But it is not enough for a director to say that he was honest, he has to show that his honest belief was based on reasonable grounds.

V. If statement is a correct and fair representation or extract or copy of the statement made by an expert who is competent to make it and had given his consent and had not withdrawn it, the director, etc., is not liable. Likewise, if the statement is a correct and fair representation or extract or copy of an official document or is based on the authority of an official person, no liability attaches to the director etc.

2. Criminal Liability

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

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

Any person who either knowingly or recklessly makes any statement, promises or forecast which is false, deceptive or misleading or by any dishonest concealment of material facts, induces or attempts to induce another person to enter into;

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

Defence against Criminal Liability

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

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

3.7 STATEMENT IN LIEU OF PROSPECTUS (SECTION 70)

A company having a share capital which does not issue a prospectus or which has issued a prospectus but has not proceeded to allot any of the shares offered to the public for subscription, shall not allot any of its shares or debentures, unless at least three days before the allotment of shares or debentures, this has been delivered to the Registrar for registration a 'statement in lieu of prospectus' signed by every person who is named therein as a director or a proposed director of the company or by his agent authorized in writing, in the form and containing the particulars set out in Part I of Schedule III and setting out the reports specified in Part II of Schedule III subject to the provisions contained in Part III of that Schedule (Section 70).

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

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

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

3.8 MINIMUM SUBSCRIPTION (SECTION 69)

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

3.9 COMMENCEMENT OF BUSINESS

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

1. Public Company Issuing a Prospectus

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

a) At least minimum subscription has been raised;

b) every director of the company has paid to the company, on each of the shares taken by him or agree to be taken by him the amount payable by him on application and allotment of the shares;

c) Obtain or apply for permission for dealing of the shares or debentures on the recognized stock exchange so that no money is repayable to application for an shares of debentures offered for public subscription by reason of any failure to apply for, or to obtain stock exchange permission;

d) A duly verified declaration has been filed with the Registrar by one of the director or the secretary or of the secretary in whole time practice that the above provisions have been complied with [Section 149(1)].

2. Public Company Not Issuing a Prospectus

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

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

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

Any contract made by a public company after incorporation but before the date on which it is entitled to commence business shall be provisional only and shall not be binding on the company until the certificates is obtained [Section 149(4)].

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

3. Failure to Commence business

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

3.10 SUMMARY

A prospectus means any invitation issued to the public inviting it to deposit money with the company or to take share or debentures of the company such invitation may be in the form of a document or a notice, circular, advertisement etc. Section 55 states that every prospectus must be dated, and that date is deemed to be the date of publications of the prospectus, prospectus should neither contain any mis-statement i.e. untrue or misleading nor omit to disclose any material fact. It there is any mis-statement or omission of material facts, then the directions promoters, the persons responsible for the issue of prospectus, and the company incur a liability for the same. The company can also allot shares or debentures without issuing the prospectus. However, in such a case, a statement known as 'Statement in lieu of Prospectus' is required to be prepared and field with the Registrar of Companies.

3.11 KEYWORDS

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

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

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

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

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

3.12 SELF ASSESSMENT QUESTIONS

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

4. Write short notes on the following:

    A) Minimum subscription

    B) Statement in lieu of prospectus

5. Explain the conditions that a public company is required to fulfil in order to obtain a certificate of commencement of business.

3.13 SUGGESTED READINGS

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

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

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

Nirmal Singh, Business Law, Deep and Deep Publication Pvt. Ltd., New Delhi.

M.C. Kuchhal, Mercentile Law, Vikas Publishing House Pvt. Ltd., New Delhi.

LESSON -4
ALLOTMENT OF SHARES AND DEBENTURES; TRANSFER AND TRANSMISSION OF SHARES; SHARE WARRANT AND SHARE CERTIFICATE

STRUCTURE

4.0 OBJECTIVE

After reading this lesson, you will be conversant with

a) General principles regarding allotment.

b) Rules of allotment of shares and debentures.

c) Procedure for transfer of shares and powers of directors to refuse transfer.

d) Transmission of shares.

e) Procedure for issuing share warrant and share certificate.

4.1 INTRODUCTION

When a company issue a prospectus inviting the public to subscribe for the shares of a company, it is merely an invitation rather than an offer. An application for shares is an offer by the prospective shareholders to take the shares of the company. Such offers are made on application forms supplied by the company. When an application is accepted, it is called allotment. Allotment is the acceptance by the company of the offer made by the applicant. Allotment results in a binding contract between the parties. The term allotment has not been defined in the Companies Act.

In *Sri Gopal Jalan & Co. v. Calcutta Stock Exchange Association Ltd., (1963),* allotment of shares was explained by the Supreme Court as "the appropriation, out of the previously unappropriated capital of the company, of a certain number of shares to a person. It is only after allotment that shares come into existence. Reissue of forfeited shares is not an allotment'.

4.2 GENERAL PRINCIPLES REGARDING ALLOTMENT

The provisions of the law of contract regarding the acceptance of an offer apply to the allotment of shares by a company. The general principles relating to the allotment of shares are as follows :

1. **Proper Authority**

Allotment must be made by a resolution of the Board of Directors or by a committee authorised to allot shares on behalf of the Board if permitted by the articles.

2. **Absolute and unconditional**

The allotment must be absolute and unconditional. If an application for shares in made subject to a condition, then that condition has to be fulfilled in order to make the allotment effective. In case that condition is not fulfilled, the applicant is not bound to take the shares.

3. **Within a reasonable time**

The allotment must be made within a reasonable time after the receipt of the application. Otherwise the applicant shall not be bound to accept it.

In *Ramasgate Victoria Hotel Co. v. Monterfiore*, Monterfiore applied for shares on June 28. But allotment was made on November 23 and he refused to take the shares. In this case it was held that the offer had lapsed and the applicant was not liable to pay for the allotment.

4. **Must be communicated**

The allotment must be communicated to the person making the application so that it is legally complete. Communication need not be in a particular form unless the articles of the company provide otherwise. Whatever is the mode of communication, it must be made to the applicant or his agent who is duly authorised to receive it. In case of postal communication, allotment is complete as soon as the letter of allotment is posted even though it is never received (Household Fire Insurance Co. v. Grant).

5. **Revocation of the offer**

An offer to take shares can be revoked at any time before the allotment is communicated.

H applied for shares in a company which were allotted to him. The letter of allotment was sent by the company's agent to be delivered by hand to H. Before the delivery of the letter of allotment, H withdrew his application. It was held that H was not a shareholder of the company. [*Re National Savings Bank Association (1867) L.R. 4E9.9]*

In the same way, the allotment can be withdrawn by the company before it is communicated completely to the applicant.

4.3 RULES OF ALLOTMENT

The Companies Act, 1956 does not prescribe any restriction as to the allotment of shares and debentures when issued by private companies. However, the Companies Act prescribes certain restrictions regarding the allotment of shares and debentures by public companies. Such restriction may be discussed under the following two heads :

(A) When no public offer is made.

(B) When public offer is made.

(A) When no public offer is made

A public company having share capital, which does not issue a prospectus or has issued a prospectus but has not proceeded to allot any of the shares offered to the public for subscription, shall not allot any of its shares or debentures unless a statement in lieu of prospectus has been delivered to the Registrar at least three days before the first allotment of shares or debentures. The statement must be signed by every person who is a director or proposed director of the company or by his agent authorised in writing. (Section 70 (1)]

If the company contravenes the above provision, the allotment shall be irregular and voidable at the option of the allottee. Further, the company, and every director of the company who willfully authorises or permits the contravention, shall be punishable with fine which may extend to Rs. 1000. [Section 70(4)]

(B) When public offer is made

In the case of public company offering shares or debentures to the public for subscription, the provisions relating to allotment may be discussed under the following three heads :

1. First allotment of shares.
2. Subsequent allotment of shares.
3. Allotment of debentures.

1. First allotment of shares

The Companies Act, 1956 imposes the following restrictions which must be complied with by a public company which offers shares to the public for the first time :

(i) Registration of prospectus : The company must deliver a copy of the prospectus to the Registrar for registration on or before the date of its publication. It must be signed by every director or proposed director of the company or by his agent authorised in writing. [Sec. 60(1)]

(ii) Minimum subscription : No allotment shall be made of any share capital of the company offered to the public for subscription unless the amount stated in the prospectus as the minimum amount has been subscribed and the sum payable on application for such amount has been paid to or received by the company. [Sec.69(1)]

The amount stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in cash. [Sec.69(2)]

A company making any rights or public issue of shares, debentures etc. must receive a minimum of 90 per cent subscription against the entire issue before making an allotment of shares or debentures to the public. If the amount of minimum subscription is not received within 120 days of the issue of the prospectus, all amounts received from the applicants shall be refunded to them immediately without interest. However, if the refund is not made within 130 days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay the money with interest @ 6% p.a. for the delayed period.

(iii) Application money : The amount payable on application for each share shall not be less than 5% of the nominal amount of the share [Sec.69(3)]. SEBI guidelines prescribe that in the case of mega issues (exceeding Rs. 500 crore), the amount payable with the application on allotment or any one call should not exceed 25% of the value of shares.

All moneys received from the applicants for shares shall be deposited and kept deposited in a scheduled bank :

(a) until the certificate of commencement of business is obtained, or

(b) where such certificate has already been obtained, until the entire amount payable on application for shares in respect of the minimum subscription has been received by the company. [Sec. 69 (4)]

If the conditions aforesaid have not been complied with, all moneys received from the applicants for shares shall be forthwith repaid to them without interest. If any such money is not so repaid within one hundred and thirty days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of 6% p.a. from the expiry of 130 days. A director shall not be liable if he proves that default in the repayment of the money was not due to any misconduct or negligence on his part. [Sec. 69 (4)]

Any condition which requires or binds any applicant for shares not to comply with any requirement of Section 69 shall be void. [Sec. 69(6]

(iv) Subscription list : No allotment shall be made until the beginning of the 5th day after a date on which the prospectus is issued or such later time as may be specified in the prospectus. This day is known as the 'opening of the subscription list'.

Where after the issue of the prospectus, a public notice is given by some responsible person, disclaiming his responsibility for the issue of the prospectus, no allotment shall be made until the beginning of the fifth day after that on which such public notice is first given [Sec. 72(1)]

A company may proceed to allot shares soon after the opening of the subscription list. In case of listed shares, however, the subscription list must be kept open for at least 3 days under the rules of recognised stock exchanges. The prospectus generally states the time when the subscription lists will be closed. The allotment of shares in contravention of these provisions is valid. But the company and every officer who is in default shall be liable to a fine upto Rs. 5,000 [Section 72(3)].

An application for shares shall not be revocable until after the expiry of the fifth day after the opening of the subscription list. [Section 72 (5)]. The object of these provisions is to discourage the activities of stags.

(v) Shares and debentures to be dealt on a stock exchange : Where a prospectus states that an application has been, or will be, made for permission for the shares or debentures offered thereby to be dealt in one or more recognised stock exchanges, the allotment made under such prospectus be void :

(i) if the permission has not been applied for before the 10th day after the issue of the prospectus, or

(ii) if permission has not been granted by the stock exchange, as the case may be, before the expiry of 10 weeks from the date of the closing of the subscription list.

If the allotment becomes void, the company must forthwith repay without interest all moneys received from applicants in pursuance of the prospectus and if any such money is not repaid within 8 days after the company becomes liable to repay it, the directors shall be jointly and severally liable to repay that money with interest between 4 to 15% per annum from the expiry of the eighth day [Sec. 73(2)].

Return of excess money where permission is granted

Where permission has been granted by the recognised stock exchange or stock exchanges for dealing in any shares or debentures and moneys received from the applicants for shares or debentures are in excess of the aggregate of the application moneys relating to the shares or debentures in respect of which allotments have been made, the company shall repay the moneys to the extent of such excess forthwith without interest. If such money is not repaid within eight days from the day the company becomes liable to repay it, the company and every director of the company who is an officer in default shall, on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at such rate, not less than 4% and not more than 15%, as may be prescribed, having regard to the length of the period of delay in making the repayment of such money. [Sec. 73(2A)]

If default is made in complying with the provisions of Section 73(2A), the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 5000 and where the repayment is not made within 6 months from the expiry of the eight day, also with imprisonment for a term which may extend to one year. [73(2B)]

All moneys to be kept in a separate bank account in a scheduled bank

Where a prospectus states that an application has been made to stock exchange for permission for the shares to be dealt in on the stock exchange, all moneys received shall be kept in a separate bank account maintained with a Scheduled Bank until the permission has been granted and where an appeal has been preferred against the refusal to grant such permission, until the disposal of the appeal. Where the permission has not been applied for or has not been granted, the moneys shall be repaid within the time and in the manner specified in Section 73(2). If default is made in complying with this Section, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs. 5000. [Sec. 73(3)]

2. Subsequent allotment of shares

In case of subsequent allotment of shares all the 'statutory provisions' regarding 'first allotment of shares' apply equally, except :

(a) minimum subscription [Sec. 69 (1)]; and

(b) application money must be deposited in a scheduled bank. [Sec 69(4)]

3. Allotment of debentures

In case of issue of debentures all the statutory provisions regarding 'first allotment of shares' apply equally, except :

(a) minimum subscription [Sec. 69(1)];

(b) the amount payable on application; [Sec.69(3)] and

(c) application money must be deposited in a scheduled bank. [Sec.69(4)]

4.4 TRANSFER AND TRANSMISSION OF SHARES

A. Transfer of Shares

The shares in a company are movable property and they can be transferred in the manner provided by the articles of the company. A private company with a share capital, by its very nature as provided by Section 3(1)(iii) of the Act restricts the right of transfer in shares by its articles. Transfer of shares is less strict in a public company.

In a public company, every shareholder has right to transfer his shares to any person without the consent of other shareholders subject to such express restrictions as are found in the articles of the company. A restriction on transfer of shares which is not specified in the articles is not binding on the company or the shareholders. A transfer of share is valid if it is not forbidden under the articles of the company, even if it has been made with the object of escaping liability on the shares.

Procedure for Transfer of Shares

Ordinarily, shares can be transferred by a person whose name appears in the register of members and who is the holder thereof. As per Section 109, a legal representative of a deceased member, although not a member at the time of transfer, can also transfer shares.

Shares may be transferred by executing an instrument of transfer (called the 'transfer deed'). The instrument of transfer must be in the prescribed form. Before it is signed by or on behalf of the transferor and before any entry is made therein, it shall be presented to the prescribed authority which shall stamp or otherwise endorse on it the date of presentation.

The instrument of transfer shall then be executed by the transferor and the transferee and completed in all respects. Thereafter, it shall be presented to the company for registration within the following time limits :

(i) Where the shares of the company are listed/dealt in/quoted on a recognised stock exchange, the instrument of transfer must be presented for registration at any time before the register of members is closed for the first time after the date of presentation of the instrument to the prescribed authority or within 12 months thereof, whichever is later.

(ii) In any other case, the instrument of transfer shall be presented to the company within 2 months of the date of presentation to the prescribed authority. [Section 108 (1A)]

The Central Government may, however, on application extend the period by such further time as it may think fit to avoid any hardship [Section 108 (1-D)]

When a duly executed and stamped transfer deed is delivered to the company within the prescribed time, the transfer is complete irrespective of whether the company registers it or not. But the transferee becomes a member only when the transfer is registered. Pending registration, the transferor is a trustee of the shares for the transferee. The transferor continues to be the holder of the shares until his name is struck off the register and that of the transferee substituted in its place. The transferor must pay over to the transferee any dividends or other rights which he may receive from the company after the date of the transfer deed.

The application for transfer of shares may be made either by the transferor or the transferee. In case any application is made by the transferor and relates to partly paid shares, the transfer shall not be registered unless the company gives notice of application to the transferee and the later raises no objection to the transfer within two weeks from the receipt of such notice. No such notice needs to be given where fully paid shares are transferred or where the application for the registration of transfer is made by the transferee.

In case a company refuses to register the transfer of shares, it must give notice to the transferor and the transferee within 2 months from the date of which the instrument of transfer was delivered, giving reasons for such refusal.

The transferor or the transferee may prefer an appeal to the Central Government within 2 months of the receipt of such notice of refusal. In case the notice of refusal has not been given by the company, the appeal must be filed within 4 months from the date on which the instrument of transfer was delivered to the company. On its appeal, the Central Government must give an opportunity to the company, the transferor and the transferee to make their representation before issuing any order. If the refusal of the company seems to be unjustified, the Central Government may issue an order to the company to register the transfer.

Issue of new share certificate (Sec. 113)

On the approval of the transfer, the company shall cancel the old share certificate and issue a new one made out in the name of the transferee. Normally, it is done by making an endorsement on the back of the share certificate.

The transfer when registered has retrospective effect from the time when the transfer was first made. It should be noted that the seller of the shares is not bound to procure registration. He will simply hand over to the transferee a duly executed transfer form and the share certificate or the letter of allotment.

Power of Directors to refuse transfer

Where the articles do not contain any clause, allowing the directors to reject the transfer, the shareholder may freely transfer his share and can compel the directors for registering of shares. On the other hand, if the articles contain a clause empowering the directors to reject the transfer, the directors can reject such transfer but subject to the following conditions :

(a) Power must be exercised by the directors in the interest of the company as a whole and not in the interest of a section of shareholders.

(b) For rejection, the conditions given in the articles must be followed.

(c) Refusal must be exercised within a reasonable time.

(d) Refusal must be exercised by the board and not by one of the directors.

(e) The court cannot compel the directors to supply the reasons of rejection but if supplied can examine and if inadequate can reject the order of the directors.

The following are the grounds on which the board may refuse registration of transfer :

(a) If partly paid up shares are being transferred and transferee is known to be financially incapable of paying balance calls.

(b) Where partly paid up shares are being transferred to a minor incapable of entering into a contract.

(c) When the transferor is a debtor of the company and the company has lien on such shares.

(d) When the transferor has not paid the due call money.

(e) Where the instrument of transfer is incomplete, irregular and defective and not properly stamped.

(f) On any other reasons which are just and equitable and are in the general interest of the company.

Grounds on which the company may refuse to register transfer in the case of the listed companies

The Companies Act does not specify the grounds on which the board of directors may refuse to register a transfer of shares. But after the insertion of Section 22-A in the Securities Contract (Regulation) Act, 1956, the Board of Directors of a company, the shares of which are listed on a stock exchange, can refuse to register a transfer on only one or more of the four grounds provided for in Section 22-A (3).

Thus in the case of listed securities, the absolute powers with the directors to refuse registration of transfer are no longer available. There are now only four grounds (and no other) on which transfer can be refused in the case of listed shares. The four grounds under Sec. 22-A (3) are :

(a) Where there are defects or deficiencies in the transfer deed, i.e., instrument of transfer is not proper or the certificate relating to the securities has not been delivered to the company or that any other requirement under the law relating to registration of such transfer has not been complied with. This is a technical ground on which transfer of shares can be refused.

(b) The transfer of shares is likely to result in such a change in the composition of the Board of Directors as would be prejudicial to the interests of the company or to the public interest.

(c) The transfer of shares is in contravention of any law.

(d) The transfer of shares is prohibited by any court, tribunal or other authority under any law for the time being in force.

Certification of transfer

Where a person purchases a number of shares, only one certificate of shares is issued in respect of the whole lot of shares so that when he desires to transfer a part of his shares, he is required to produce before the company his certificate of shares along with the instrument of transfer for the purpose of certification. The company then endorses on the instrument of the transfer the fact of the certificate having been lodged with the company. The company will cancel the old certificate and prepare two new share certificates to be delivered to the transferor and the transferee. This is known as the certification of transfer and is provided for in Section 112 of the Companies Act.

The certification of shares amounts to a representation by the company that the document which evidences the title to the transferor has been produced to the company. It gives neither warranty of the transferor's title nor any guarantee on the part of the company.

Forged Transfer

A forged document never has any legal effect. If a forged transfer is lodged with the company for registration, the position of the parties affected is as follows :

(i) If the true owner has been removed from the register, he can compel the company to replace him.

(ii) If the company has issued a new certificate to the so called transferee, it can not deny his title to the shares, the certificate stops it (the company) from doing so.

(iii) The person lodging the transfer must indemnify the company against loss by forgery.

Companies normally notify the transferor of the transfer so that he can object if he wishes. The transferor is, however, under no legal obligation to reply and therefore no estoppel can be raised against the owner on his failure to reply.

Blank Transfer

A blank transfer is an instrument of transfer signed by the transferor in which the name of the transferee is not filled.

Since the name of the transferee is not filled, the shares in such cases may further be transferred merely by delivering the blank instrument of transfer. Thus, stamp duty and registration fee is saved. Only the last transferee has to bear these expenses. The results are :

(i) this helps in avoiding or reducing liability of tax thereon; and

(ii) these may act as clear security for creditors.

But blank transfer does not confer the ownership of shares on the transferee. If he wants to retain the shares, he can fill in his name and date in the transfer deed and get himself registered as shareholder. Until such registration, the original transferor continues to be the owner and remains liable for any amount remaining unpaid on the shares. Morally, he is a trustee for the dividends declared and received. But it does not confer any right on the transferee to prefer any claim against the company in the event of the transferor's failure to pay him the dividends etc.

A blank transfer, however, can remain in circulation only for 12 months after its signing by the prescribed authority or up to the time of closure of the register of members by the company, whichever is later. This provision has been made to curb the abuse of this system.

B. Transmission of shares

When a registered shareholder dies or becomes bankrupt his share are transmitted to his legal representative or the Official Assignee or Receiver, This is called transmission of shares. It takes place when a registered shareholder (a) dies or (b) becomes bankrupt.

Transmission of death : When a registered shareholder dies, his shares vest in his legal representative. If they wish, they may ask the company to register them as the holder of these shares and for this purpose no instrument of transfer is required and the company is bound to accept the probate of will or letters of administration as sufficient evidence of the title to those shares. When they are registered as the holder of these shares and their names are put on the company's register of members, they become personally liable on the shares. Thus if the shares are not fully paid, they will be liable to pay the unpaid value of the shares.

However, if the legal representatives do not wish to be registered as the holder of the shares, they may transfer them without being so registered. Section 109 enables the legal representative to transfer the shares even if he is not himself a member of the company. Thus the transfer of shares of a deceased member made by his legal representative, although the legal representative does not get himself registered as the holder of these shares, (i.e., the member of the company) is perfectly valid and the transferee acquires a good title to the shares.

Transmission on bankruptcy : If a registered shareholder is adjudged an insolvent, his shares vest in the Official Assignee or Receiver who may either get himself registered as the holder of the these shares or transfer them to another person. The Official Assignee or Receiver can also disclaim the shares if they contain liability. Usually the articles of the company contain provisions relating to the transmission of shares. Clauses 25 to 28 of Table A in Schedule I contain regulation governing the transmission of shares. If the transmission is not accepted by the company, the same remedies are available against the company as in the case of the refusal of a transfer of shares.

Distinction Between Transfer And Transmission of Shares

The following are the points of difference between transfer and transmission of shares :

(a) A transfer is a deliberate act of the holder, while transmission results by operation of law.

(b) A transfer requires an execution of an instrument of transfer, while transmission requires evidence showing the entitlement of the transferee.

(c) For the execution of transfer, stamp duty is payable, while no stamp duty is payable in case of transmission.

(d) The company charges for registering a transfer, while no charges are levied for registering a transmission.

(e) In case of transfer, the liability of the transferor ceases as soon as the transfer is complete, while in transmission, the shares continue to be subject to original liabilities.

4.5 SHARE WARRANT AND SHARE CERTIFICATE

A. Share Warrants

A public company limited by shares may issue share warrants under its common seal in the following circumstances :

(i) if it is authroised by its articles ;

(ii) shares are fully paid up ; and

(iii) previous approval of the Central Government is obtained.

A share warrant is a document which shows that the bearer of the warrant is entitled to the shares specified therein. It is a substitute for the share certificate. A shares warrant may have coupons attached to it to provide for the payment of future dividends on the shares specified in the warrant. A shares warrant shall entitle the bearer thereof to the shares specified therein. The shares may be transferred by delivery of the warrant.

On issue of a share warrant, the company shall strike out of its register the name of the member then entered therein as holding the shares specified in the warrant as if he had ceased to be a member. The following particulars shall be entered in the register :

(i) the fact of the issue of the warrant ;

(ii) a statement of the shares specified in the warrant, distinguishing each share by its number ; and

(iii) the date of the issue of the warrant.

The bearer of a share warrant shall subject to the articles of the company be entitled to have his name entered as a member in the register of members on surrendering the warrant for cancellation and paying such fee to the company as the Board of Directors may from time to time determine.

The bearer of the share warrant may, if the articles of the company so provide, be deemed to be a member of the company.

B. Share Certificate

The holder of share or shares is issued a share certificate by the company. A certificate under the common seal of the company, signed by one or more of directors, specifying shares held by the member and the amount paid up on the shares shall be prima facie evidence of the title of the member to such share or shares.

Every company shall deliver the certificates to the allottee within three months from the date of allotment and to the transferee within two months of making of the application for the registration of the transfer of shares, debentures or debenture stock.

If default is made, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs. 5,000/- for every day during which the default continues. The person may make an application to the court if default is not made good by the company within 10 days after the service of the notice. The court may order the company and any officer of the company to make good the default.

Objects and Advantages : Since a share certificate is prima facie evidence of title, a shareholder is able to show his title to the shares by producing his share certificate. Thus it is very easy for a shareholder to sell his shares in the market by producing a share certificate showing his title to these shares. Besides it would be very easy for a lender to lend money to the shareholder taking the possession of his share certificate by way of security.

Duplicate Certificate

Section 84(2) provides that a company may renew or issue a duplicate certificate if it is proved to have been lost or destroyed or having been defaced, mutilated or torn; is surrendered to the company. The articles may provide other terms and conditions like requiring the allottee to give an indemnity bond (Clause 89 Table A).

If a company with the intent to defraud renews a certificate or issues a duplicate thereof, the company shall be punishable with fine which may extend to Rs. 10,000 and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to Rs. 10000 or with both [Sec.84(3)].

The Central Government may prescribe rules regarding the issue or renewal of certificates and duplicates, fees, etc. (Sec. 84(4)). The rules so made override the provisions in the articles.

4.6 DIFFERENCE BETWEEN A SHARE CERTIFICATE AND A SHARE WARRANT

1. The holder of a share certificate is a registered member of the company whereas the bearer of a share warrant is not. The bearer of a share warrant can be a member only when the Articles so provide and only for the purposes defined in the Articles.

2. A share certificate may be issued in respect of partly or fully paid shares, whereas a share warrant can be issued only when shares are fully paid up.

3. Only public companies are authorised to issue share warrants but share certificates are issued by both public and private companies.

4. A share warrant is transferable by delivery only and no transfer deed and registration of transfer with the company is required. But a share certificate is transferred only in pursuance of a transfer deed along

with the delivery of the share certificate. The transfer of a share certificate must be registered with the company.

5. A share warrant is a negotiable instrument as it is transferable by delivery only. But a share certificate is not a negotiable instrument.

6. Stamp duty is payable for the transfer of a share certificate but no stamp duty is payable in the case of transfer of a share warrant.

7. The permission of the Central Government is not necessary for the issue of share certificates but share warrants can be issued only if allowed by the Articles and with the prior permission of the Central Government.

8. The holder of a share warrant does not qualify to become a director of the company (where qualification share are required for directorship). But the holder of a share certificate is so qualified.

9. The petition for the winding up of the company can be presented by the holders of share certificates only. Holders of shares warrants cannot do so.

10. Payment of dividend on a share warrant is made by way of coupons attached with it. But in the case of share certificates, the company issues dividend warrants to the holders by name.

4.7 SUMMARY

Allotment means and implies a division of the share capital into defined shares of a particular value or of different classes and assignment of such shares of different persons. An allotment is the acceptance of an offer in purchase relating to valid acceptance of an offer must be followed. The shares can be transferred by any person who is the holder of shares and whose name appears in the Register of Members or by anyone with his authority. However, the legal representative of a deceased member can validly transfer the shares even if he is not the member. The transmission of shares takes place on the death or insolvency of the shareholder. Every person whose name is entered as a member in the register of members, is entitled to receive share certificate from the company. A share warrant is a document specifying certain shares and stating that the bearer of the document is entitled to the shares specified in it.

4.8 KEYWORDS

Share Warrant: Share warrant is a document which shows that the bearer of the warrant is entitled to the shares specified therein.

Share Certificate: As soon as a shareholder is allotted shares, he must be issued a share certificate by the company within the specified time.

Allotment: Allotment is the acceptance by the company of the offer made by the applicant.

Application Money: The amount payable on application for each share is known as application money.

Transmission of Shares: When a registered shareholder dies or becomes bankrupt, his shares are transmitted to his legal representative or the official assignee or receivers, and this is called transmission of shares.

4.9 SELF ASSESSMENT QUESTIONS

1. What restrictions have been imposed by the Companies Act, 1956 on the allotment of shares ? What is the effect of irregular allotment?

2. What is a share certificate ? What is the object and effect of the share certificate ? When can a company renew a share certificate or issue a duplicate ?

3. What is a share warrant ? Distinguish between a share certificate and a share warrant. What legal formalities are to be complied with for the issue of a share warrant ?

4. How is the transfer of shares effected ? What course is open to a transferee if the company refuses to register a transfer ?

5. What is a forged transfer ? If a forged document is lodged with a company, what is the position of the affected parties ?

4.10 SUGGESTED READINGS

Nirmal Singh, Business Law, Deep and Deep Publication Pvt. Ltd., New Delhi.

M.C. Kuchhal, Mercentile Law, Vikas Publishing House Pvt. Ltd., New Delhi.

Avtar Singh, The Priciples of Mercantile Law, Eastern Book Co., Lucknow.

M.C. Shukla, A Manual of Mercantile Law, S. Chand & Co., New Delhi.

R.S.N. Pillai and Bagavathi, Business Law, S. Chand & Co., New Delhi.

LESSON : 5

MEMBERSHIP OF COMPANIES; BORROWING POWERS

STRUCTURE

5.0 OBJECTIVE

By reading this lesson, you would know about

(a) Who is a member and who may become member ?

(b) Modes of acquiring membership.

(c) Rights, duties and liabilities of members.

(d) The borrowing powers of Board of Directors and their limitations

(e) Lender's rights when borrowing is ultra vires the company

(f) Charges requiring registration and effect of non-registration

5.1 INTRODUCTION

A company is composed of certain persons who constitute it as a corporate body. However, the identity of the company is different from the persons composing it. The persons composing the company are the 'members' or 'shareholders' of the company. A member is a person who has signed company's memorandum of association. Any other person who agrees in writing to become a member and whose name is entered in company's register of members is also a member of the company [Section 41].

It is important to note here that the terms 'member' and 'shareholder' are used inter-changeably in the Companies Act. A shareholder means a person who holds the shares of the company. A part from a few exceptional cases, the terms member and shareholder are synonymous. In these exceptional cases, a person may be a member but not a shareholder, or he may be a shareholder but not a member. In the following cases, a person is a member, but not a shareholder:

(a) A person who signs company's memorandum of association, immediately becomes the member on registration of the memorandum before any shares are allotted to him.

(b) A person who transfers his shares, continues to be the member of the company until his name is replaced by the name of the transferee. But he is no more a shareholder.

(c) A person who has ceased to be a shareholder by reason of forfeiture, surrender or transfer of shares, may be held liable as member, for the payment of unpaid amount on shares in case of default by the present shareholder.

(d) A company limited by guarantee or an unlimited company having no share capital will have only members but no shareholders.

In the following cases, a person is a shareholder, but not a member:

1. A person having a share warrant is a shareholder but he is not a member [Section 115 (1)]. However, he may be treated as member for specific purpose if company's articles so provide.

2. A legal representative of a deceased shareholder is the shareholder even if his name is not entered in the register of members. He becomes a member only when his name is entered in the register.

Note: The Depositories Act, 1996 has further widened the definition of a member by inserting a new Sub-section 41 (3). This sub-section provides that every person holding equity share capital of the company and whose name is entered as beneficial owner in the record of the depository, shall be deemed to be a member of the company.

5.2 DIFFERENCE BETWEEN MEMBERS AND SHAREHOLDERS

The terms 'member' and 'shareholder' have been used interchangeably in the Companies Act. The word 'shareholder' is used in relation to a company having a share capital and there can be no membership except through the medium of shareholding. A holder of shares becomes a member only when his name is entered on the register of members. But the term 'member' is wider in scope and may be used in relation to all types of company. A person may become a member of a company without holding any shares. Companies limited by guarantee or unlimited companies having no share capital can have no shareholders but do have members.

The following are the points of distinction between members and shareholders :

1. A holder of a share warrant is a shareholder but not a member as his name is struck off the register of members immediately after the issue of such share warrant.

2. Every registered shareholder is a member but every registered member may not be a shareholder because the company may or may not have share capital.

3. The transferor or the deceased person is a member so long as his name is on the register of members whereas he cannot be termed as shareholder.

4. Similarly, a shareholder by transfer is not a member until his name is entered in the company's register of members.

5. A person who mispresents himself to be a member is estopped from denying his position subsequently. He is said to have become a member by estoppel.

6. A person may become a member by an order or decree of a court.

5.3 CAPACITY OF A MEMBER

We know that the capacity means the competency of a person to enter into a contract. A contract to purchase shares in a company is like any other contract. Therefore, the membership of a company is open to any person who is competent to enter into a valid contract. The Companies Act does not prescribe any qualifications for becoming a member of a company. However, only such a person who is competent to contract as per the Indian Contract Act, 1872 may become a member. This is, however, subject to the provisions of the memorandum and articles of the company. The articles may provide that certain persons cannot become members of the company. The membership rights of certain persons and organisations are discussed hereunder :

1. **Minor**

Under the English Law, a minor can be a member of the company because a contract with a minor is voidable and not void. But under the Indian Law, a minor being incompetent to contract can not become a member of a company because a contract with a minor is absolutely void here. A minor in India may apply for and receive an allotment of shares subject to a right to repudiate liability on them before or within a reasonable time after attaining full age.

In the case of *Palaniappa Mudliar v. Official Liquidator, Pasupathi Bank Ltd., A.I.R. (1942) Mad. 470.,* an application for shares in a company was made by a father as a guardian of his minor daughter. The company allotted the shares in the name of the daughter described as a minor. Subsequently, the company went into liquidation and the liquidator placed the father's name in the list of contributories. It was held that the transaction was void ab-initio and neither the minor nor her guardian could be placed on the list of contributories.

2. **Company**

Since a company is a legal person, it can become a member of another company, provided it is so authorised by its memorandum, by investing in the shares of that company.

3. **Partnership Firm**

Since a partnership firm has no legal personality, it cannot purchase shares in a company in its own name.

4. **Person taking shares in fictitious names**

A person who takes shares in the name of a fictitious person will be liable as a member in respect of those shares and his name shall be entered in the register of members. Besides, such a person can be punished for impersonation under Section 68-A.

5. Hindu Undivided Family

It can have shares in the name of its karta.

6. Foreigners/Non-Residents

Foreigners can become members of companies registered in India but permission of the Reserve Bank of India under FERA, 1973 has to be obtained for this purpose. This right of the foreigner as a member will be suspended if he becomes an alien enemy.

7. Insolvent

An insolvent being incompetent to contract can not become a member of a company. But if a person is a member of a company and afterwards he is declared insolvent, he will be regarded as a member so long as his name appears in the register of members and he will be entitled to vote but the beneficial interest in the shares will be vested in the official assignee or receiver and any dividend on shares will be received by the assignee.

8. Pawnee

In case of a pledge, the ownership remains with the pawner and the possession with the pawnee. So the pawnee does not become the member of the company. The pawner continues to be the member and he can exercise the rights of a member.

5.4 MODES OF ACQUIRING MEMBERSHIP

A person may become a member in a company in any of the following ways :

1. Membership by Subscribing to Memorandum (Section 41)

All the subscribers to the memorandum are deemed to have agreed to become members of the company and on the registration of the company their names are automatically entered as members in the company's register of members. Thus, the signatories to the memorandum become members of the company simply by reason of their having signed the memorandum. Neither an application form nor allotment of shares is necessary for becoming a member in their case. A person who signs the memorandum enters into a contract with the company to take the number of shares written opposite his name and be cannot repudiate his contract on the ground of misrepresentation.

In the case of *Metal Constituents Co., (1902) 1.Ch. 707,* a subscriber agreed to take 350 shares. Then, he wanted to rescind the contract on the ground of misrepresentation on the part of the promoters. Held that the subscriber by signing the Memorandum becomes liable to other members in the company brought into existence by his own act. So he can not rescind the contract.

2. Membership by Qualification shares

Before a person can be appointed a director of a public company, he must take, or sign an undertaking to take and pay for the qualification shares. He thus becomes a member and is in the same position as a subscriber to the memorandum of the company is.

3. Membership by Application and Allotment

A person may become a member of a company by an application for shares subject to formal acceptance by the company. The ordinary law of contracts applies to the agreement to take shares in a company. An application for shares may be absolute or conditional. If it is absolute, a simple allotment and notice thereof to the applicant will constitute the agreement. If it is conditional, the allotment must be made on the basis of the conditions specified. Where there is a conditional application for shares and an unconditional allotment, there is no contract constituted.

R agreed to take shares in a company provided he was appointed local manager of the company. Shares were allotted to him but he was not given the appointment. R refused to take the shares. It was held that R was not a member as his application was conditional and allotment was unconditional. [Roger's case (1868) L.R. 3Ch. 633].

4. Membership by Transfer

Where a transfer of share is made and the transfer is registered with the company, the transferee becomes entitled to be placed on the company's register of members in the place of the transferor in respect of the shares so transferred.

5. Membership by Transmission

On the death of a member his shares rest with his legal representative. The legal representative is entitled to be registered as the holder of the shares and to get his name entered as member in the register of members provided there is no provision in the articles of the company and for the purpose no instrument of transfer is required to be delivered by him to the company.

If a company unduly refuses to accept a transmission, the same remedies are available to the legal representative as in the case of transfer.

In the case of *Indian Chemical Products V. State of Orissa, AIR (1967) SC 253*, by devolution, the state of Orissa had become entitled to the shares of the Maharajas. But the company refused to register the shares in the name of state's representative. It was held that the company was bound to register the shares in favour of the state's representative because it was a case of transmission. And the state became entitled to the shares due to the operation of law.

6. Membership by Estoppel

If a person holds himself out in writing or allows his name to be on the register of members, he is deemed to be a member of the company. Thus if a persons's name is improperly placed on the register of members, and he knows and assents to it, he cannot afterwards say that he is not a member. Estoppel is simply a rule of evidence which prevents a person from denying the legal implications of his conduct.

5.5 CESSATION OF MEMBERSHIP

A person may cease to be a member of a company :

(a) if he transfers his shares to another person.

(b) by the sale of his shares by the company in exercise of right of lien over his shares.

(c) by forfeiture of his shares;

(d) by a valid surrender of his shares.

(e) by the death of a member. The estate of the deceased remains liable until the shares are registered in the name of his legal representative.

(f) by his insolvency.

(g) by his rescission of contract to take shares on the ground of misrepresentation or fraud.

(h) by the winding-up of the company, of course he remains liable as a contributory.

(i) by redemption of redeemable preference shares.

(j) by issue of share warrants to him in exchange of fully paid shares.

5.6 DUTIES AND LIABILITIES OF MEMBERS

Duties

It is the duty of a shareholder :

(a) as a subscriber of the memorandum, to take the share written opposite his name direct from the company and pay for them ;

(b) to take shares when they are duly allotted to him and pay for them according to the terms of issue of the shares ;

(c) to pay all valid calls as and when they are made;

(d) to abide by the decisions of the majority of members unless the majority acts vindictively, oppressively, mala fide or fraudulently;

(e) to contribute to the asset of the company when it goes into liquidation.

Liability

The liability of the members of a company depends upon the nature of the company.

Company limited by shares. In the case of a company limited by shares, the liability of a member of company is the amount, if any unpaid on his shares. If his shares are fully paid, his liability is nil for all purposes.

Company limited by guarantee. The liability of the members of a company limited by guarantee is limited to the amount they undertook to contribute to the assets of the company in the event of winding up.

*Company with unlimited liability***.** Every member of an unlimited company is liable in full for all debts contracted by the company during the period he was a member.

5.7 RIGHTS OF MEMBERS

When a person becomes a member of a company he is entitled to exercise all the rights of a member until he ceases to be a member in accordance with the provisions of the Act. The rights of a member can be classified under the following heads :

(A) Statutory Rights

Statutory rights are those which are given to the members by the statute, i.e. the Companies Act, 1956. No document of the company can take away or modify such rights. Such rights, for example, are :

1. Right to receive copies of the Balance Sheet and Profit and Loss Account of the company along with the auditor's report.
2. Right to obtain a copy of the contract for the appointment of managing directors/managers of the company.
3. Right to receive notice of the general meetings of the company.
4. Right to get the copies of the Memorandum and the Articles of the company on payment of the prescribed fees.
5. Right to inspect the register of members, and debentureholders and index registers, annual returns etc. and get copies thereof on payment of the prescribed fee.
6. Right to inspect the debenture trust deed and get copies thereof on payment of the prescribed fees.

7. Right to inspect the register of charges and get copies thereof on payment of the prescribed fees.
8. Right to receive a copy of the statutory report.
9. Right to apply to the Central Government to call the annual general meeting when default is made by the company in holding annual general meeting (AGM).
10. Right to attend the AGM.
11. Right to appoint a proxy to attend the AGM and vote in his place and right to inspect the proxy register.
12. Right to receive a share certificate in respect of his share holding and a certificate of stock within a prescribed time.
13. Right to transfer shares.
14. Right to receive dividend when declared by the company.
15. Preemptive right i.e. right to have the rights shares on any further issue of shares.
16. Right of participation in the appointment the directors who are to retire by rotation by taking part in the AGM.
17. Right of participation in appointing the auditors and fixing their remuneration.
18. Right to have a share in the surplus of assets, if any, on the winding up of the company.
19. Right of dissident shareholders to apply to the court to have any variation of their rights cancelled.

20. Right to have notice of any resolution requiring a special notice in the meeting.

21. Right to inspect the shareholders' minutes book and get copies thereof on payment of the prescribed fees.

(B) Documentary Rights

There rights are the rights given by the two basic documents i.e. memorandum of association and articles of association. The company may also give certain rights to its members by expressly providing for them in the memorandum or the articles of the company.

(C) Legal Rights

These rights are given to members under general law. For example, a person who has taken shares of a company on the faith of a misleading prospectus can avoid the contract and claim damages under the general law.

5.8 REGISTER OF MEMBERS (SEC. 150)

It is the statutory obligation of every company to maintain a register of its members containing the following particulars :

(a) The name and address and the occupation, if any, of each member ;

(b) In the case of a company having share capital, the shares held by each member and the amount paid or agreed to be considered as paid on those shares;

(c) The date on which each person was entered in the register as a member;

(d) The date on which any person ceased to be a member.

(e) Where the company has converted any of its shares into stock and given notice of conversion to the Registrar, the register shall show the amount of the stock held by each of the members concerned instead of the shares so converted which were previously held by him.

If default is made in complying with these provisions, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to fifty rupees for every day during which the default continues.

5.9 INDEX OF MEMBERS (SEC. 151)

Every company having more than fifty members must keep an index of members, unless the register is already in the form of an index. Any alteration in the register of members must be noted in the index within 14 days of alteration. The index must, in respect of each member, contain a sufficient indication to enable the entries relating to that member in the register to be readily found. The index must always be kept at the same place as the register of members.

Inspection : The register of members and the index must be open for inspection, except when closed under the provisions of the Act, by members and debenture-holders free and by other persons on payment of such sum as may be prescribed. The company is also bound to supply a copy of the register on demand on payment.

Closure of Register of Members : As per Sec. 154, a company may, after giving not less than seven days' previous notice by advertisement in a local daily, close the register of members, for a period not exceeding 45 days in a year, but not exceeding 30 days at any one time.

The closure of the register of members is necessary whenever any general meeting of the shareholders is to be held or interim dividend is to be declared or a call is made. During the period of closure, no transfer of shares can take place and therefore, the company may determine its membership and may send notices of general meetings and calls made and also the dividend warrants to is members.

5.10 ANNUAL RETURNS

Every company is required to file with the Registrar an annual return containing certain particulars relating to the company. The object of filing the annual return is to enable the Registrar to record the changes that have occurred in the constitution of the company during the years. The particulars to be stated in the annual return are different for the companies having a share capital, and for the companies having no share capital. The returns for these companies, are, therefore, discussed separately:

I) **By Company having a Share Capital (Sec.159)**

Every company having a share capital shall within 60 days from the day on which each of the annual general meetings is held, prepare and file with the Registrar a return containing the particulars specified in parts I and II of Schedule V, as they stood on that day regarding its :

1. Registered office.
2. Register of members.
3. Register of debenture-holders.
4. Shares and debentures.
5. Indebtedness.
6. Members and debenture-holders, past and present; and
7. Its directors, managing directors, managers and secretary, past and present.

8. Names and addresses of and number of equity shares held by each of the following, namely :

   (a) Foreign holdings;

   (b) Government-sponsored financial institutions;

   (c) Bodies corporates (not covered under (a) and (b) above);

   (d) Directors and their relatives, their shareholdings and directorships ;

II) **By Company not having Share Capital (Sec. 160)**

Every company not having a share capital shall within 60 days from the day on which each of the annual general meetings is held, prepare and file with the Registrar a return stating the following particulars as they stood on that day :

(a) Registered office.

(b) Name of members and respective dates on which they became members.

(c) Names of persons who ceased to be members since the date of the annual general meeting of the immediately preceding year, and the dates on which they so ceased.

(d) Particulars regarding its directors, managers and its secretary.

Other provisions regarding annual return (Sec.161)

The copy of the annual return filed with the Registrar under Section 159 or 160 shall be signed both by a director and by the manager or secretary of the company. Where there is no manager or secretary, it shall be signed by two directors of the company, one of whom shall be the managing director, where there is one. The annual return is also required to be signed by a secretary in whole time practice, in the case of a company whose shares are listed on a recognised stock exchange.

Penalty: In case of non compliance with any of the provisions contained in Sections 159, 160 or 161 the company and every officer who is in default shall be punishable with fine upto Rs. 50 for every day during which the default continues. (Section 162).

5.11 BORROWING POWERS

Capital is necessary for the establishment and development of a business and borrowing is one of the most important source of the capital, but unfortunately there is no express provision in the Companies Act as to the borrowing powers of the company. Every trading company, unless prohibited by its memorandum or articles, has an implied power to borrow money for the purpose of its business, and to give security for the loan by creating a mortgage or charge on its property even though such power is not expressed in the memorandum of the company. On the other hand, a non-trading company has no implied power to borrow money and, therefore, it cannot borrow unless such power is expressly provided in the memorandum. If the memorandum does not contain such a power, the memorandum have to be amended before the company can exercise its borrowing powers. Again a public company having a share capital cannot exercise the borrowing powers unless a certificate of commencement of business has been obtained by it (Section 149).

In General Auction Estate and Monetary Co. v. Smith (1891) 3ch. 432 case the company had among its objects the sale and purchase of estates and property, loans on deposits of securities and discounting of bills. The Memorandum of the company did not expressly give it any power to borrow money. The company borrowed money from one of the directors on the security of some of its estates to pay off some depositors and creditors. The company was wound up within six months. The liquidator wanted to set aside the security as it was beyond the powers of the company. Held, being a trading company, it had an implied power to borrow money for its business and to give security to the person making the advance (loan). Where a company has express or implied power to borrow it can raise, borrow or secure the payment of any sum of money for the purposes of business subject to the limits set by its Memorandum or Articles.

The Board's Powers

The borrowing power is exercised by the board of directors subject to the provisions in the memorandum and articles of the company. The memorandum or articles generally specify the maximum limit of borrowing power allowed to the Board of Directors and may impose restrictions upon the exercise of such power. Section 293(1)(d) also limits the directors' power to borrow. It provides that the Board of Directors of a public company or of a private company which is a subsidiary of a public company, shall not except with the consent of such public company or its subsidiary in a general meeting borrow moneys, where the moneys to be borrowed together with the moneys already borrowed by the company (apart from the temporary loans obtained from the company's bankers in the ordinary course of business) will exceed the aggregate of paid-up capital of the company and its free reserves (that is to say, reserves not set apart for any specific purpose). Thus, the power of directors to borrow is subject to two main limitation :

1. Statutory limitations and
2. Limitations enumerated in the memorandum and articles.

5.12 ULTRA VIRES BORROWINGS

Ultra vires borrowings mean borrowings which are beyond the powers of the company or the directors. Borrowing by a company may be :

1. Ultra vires of the company, or
2. Intra vires of the company but ultra vires of the directors.

1. Borrowing which is ultra vires of the company

Where a company borrows money in excess of its powers, the borrowing would be ultra vires the company. In such a case, the contract is void and the lender cannot sue the company for the return of the loan. The securities given for such ultra vires borrowings are also void and inoperative, and no ratification can render the debt valid.

In the case of *Introduction Ltd. v. National Provincial Bank Ltd. (1970) Ch. 199,* a company was formed with the main object of providing information and facilities to the overseas visitors to the Festival of Britain in 1950. The company later engaged in pig breeding as its sole activity. For this purpose, it borrowed money from a bank which took debentures as a security. The bank was given a copy of the Memorandum and it knew that the only business being carried on by the company was pig breeding. Held, the loan was for a purpose known to be ultra vires and therefore, the debentures were sold.

The lender has, however, the following remedies :

(a) Injunction

If the money lent to the company has not been spent, the lender can get an injunction to prevent the company from parting with it.

(b) Subrogation

If the money borrowed has been used by company in paying off its lawful debts, the lender will rank as a creditor upto the amount so used, and can recover it from the company. He can sue the company by virtue of principle of subrogation. But the lender will have no priority over other creditors even though the debts paid off had priority.

Example : A company had exhausted its borrowing powers by issuing three different series of debentures A, B and C. A had priority over B and B had priority over C. The company took a loan from the plaintiff to pay interest on A debentures. The borrowing by the company was ultra vires. It was held that plaintiff was a legal creditor of the company to the extent his loan was used to pay-off legal debts, but he was not entitled to the priority of A debentures. (Re Wrexham Mold C. Ltd. (1899) 1 Ch. 440).

(c) Tracing

If the lender is in a position to trace the property purchased with his money, he can get a tracing order from the court and follow the property. If traced, the company will be deemed as a trustee for the property on behalf of the lender.

In the case of *Sinclair v. Broughham, (1914) A.c. 398,* the Memorandum of a building society empowered it to borrow or to lend on the security of land. But the building society also developed a large banking business which was ultravires of the society. The company was wound up and the company's assets were composed partly of the shareholder's money (i.e. the money of the members of the society) and partly of the depositors money (i.e. the money of the ultravires lenders). The company had to pay the outside creditors, the shareholders of the society (i.e. members) and the depositors of money. The outside creditors were paid in-full with the consent of the shareholders and the depositors. The remaining assets were not capable of being identified; nor were they sufficient to pay both the shareholders and the depositors in full. Held the remainder of the assets should be apportioned between the shareholders and the ultravires depositors in proportion to the amount paid by them.

(d) Recovery of damages

The ultra vires lender has a right to sue the directors for the breach of warranty of authority and recover the damages. e.g. if the directors knowingly misrepresent their authority, the lender can claim the money back from them.

Example : Under the authority of an investment trust company, its managing director borrowed large sums of money. He utilised large sums of such borrowed money for the purpose of gambling in shares differences and also misappropriated some money. It was held that the company was liable. [V.K.R.S.T. Firm v. Oriental Investment Trust Ltd. AIR 1944 Mad 532]

2. Borrowing intra vires of the company but ultra vires of the directors

In this case, the borrowings is within the powers of the company but restrictions have been placed on the authority of the directors to borrow. Borrowing ultra vires the directors, but within the power conferred by the memorandum, is voidable only and may be ratified by the company. If the borrowing is ratified, the company becomes liable to repay the money. Whereas such borrowing is not ratified by the company, the remedies available to lender are :

(i) Doctrine of indoor management. By relying on the rule of indoor management he can recover the amount of loan from the company provided the borrowing was due to non-compliance with some internal regulations of the company.

(ii) No notice for unauthorised business. A lender is deemed to have notice of the limitations imposed by the memorandum and articles on the borrowing powers of the directors. A company can avoid the liability on the ground that borrowing was known or deemed to be known to be ultra vires. But if restrictions on the director's authority are secret or not obvious from these documents, or otherwise the lender does not know of it from some other source, the company will be bound.

Further, the company shall not be liable for the unauthorised borrowings of its directors if it can establish that the borrowing was neither necessary not 'bonafide' or for the benefit of the company but if a loan has not been taken in the name of the company it will not be liable even if it has received some benefit.

In Equity Insurance Co. Ltd v. Dinshaw & Co., AIR 1940 outh 202 case, it was held- "Where the managing agent of a company who is not authorised to borrow has borrowed money which is not necessary, neither bonafide, nor for the benefit of the company, the company is not liable for the amount borrowed.".

But if a loan has not been obtained in the name of the company, it will not be liable even though such amount has been used for the benefit of the company.

5.13 CHARGES SECURING DEBENTURES

A company can issue debentures either secured or unsecured by a charge on its property. Such charge may :

1. Fixed charge (or specific charge)
2. Floating charge

Fixed charge

A fixed charge or specific charge is one which is created on some ascertained and definite property of the company such as building or machinery, etc.

The effect of such a charge is that the company cannot deal with such property freely, i.e. it cannot sell without the consent of the holder. Again in the winding up of the company, the holder of a debenture secured by a fixed charge ranks as a secured creditor in respect of debt due to him on the debenture.

Floating charge

When a charge is created on property which is not fixed but changing or unstable, it is known as floating charge. For example, where a debenture is secured by creating a charge on stock-in-trade, the charge will be valid as a floating charge.

Lord Macnaghten remarks, "A floating charge is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying conditions in which it happens to be from time to time. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern or until the person in whose favour the charge is created intervenes. [*Government Stock Investment Co. Ltd. v. Manila Rly Company Ltd.(1897) A.C.]*

The chief characteristics of a floating charge have been summed up by Justice Romer in Re *Uorkshire Woolcomber's Association Lt.* His Lordship said that mortgage or charge will be treated as a floating charge, if :

1. It is a charge upon a class of assets both present and future.

2. The class of assets upon which the charge has been created must be one which in the ordinary course of the business of the company would be changing from time to time, and

3. It has been contemplated by the charge that until some step is taken by the mortgagee, the company can use the assets comprised in the charge in the ordinary course of business.

Crystallisation of a Floating Charge

Crystallisation is the conversion of a floating charge into a fixed charge on the assets in the class charged at the moment of crystallisation A floating charge crystallises and becomes fixed in the circumstances given below :

1. When the company goes into liquidation, or

2. When the company ceases to carry on business, or

3. When the debenture-holders take steps to enforce their security, e.g. by appointing a receiver.

Effects

In the case of floating charge

1. The company has a free hand to deal with the property charged in the ordinary course of business in any way authorised by its memorandum or articles so long as the company remains a going concern or so long as the charge does not become a fixed charge.

2. Unless otherwise agreed, a floating charge leaves the company at liberty to create a specific mortgage on the property subject to the floating charge ranking in priority in such floating charge.

3. The company can sell the whole of its undertaking if that is one of its objects specified in the memorandum, in spite of a floating charge on the undertaking.

Invalidity of Floating Charge

A floating charge created within 12 months of the commencement of the winding up of a company will be invalid unless it is proved that the company immediately after the creation of the charge was solvent. Even a charge created within twelve months of the commencement of the winding up of the company is valid to the extent of the cash paid or to be paid to the company in consideration for such charge, together with interest on that amount at the rate of 5% per annum or such other rate as may for the time being be notified by the Central Government in this behalf in the official Gazette (Sec. 534).

5.14 CHARGES REQUIRING REGISTRATION

All charges are not required to be registered. Only nine types of charges need compulsory registration under Section 125 with the Registrar of Companies within 30 days of their creation. They are :

1. A charge for the purpose of securing any issue of debentures
2. A charge on uncalled share capital of the company
3. A charge on any immovable property
4. A charge on any book debts of the company
5. A charge not being a pledge on any movable property of the company
6. A floating charge on the undertaking or any property of the company including stock in trade.

7. A charge on calls made but not paid

8. A charge on a ship or any share in a ship

9. A charge on goodwill, on a patent or a licence under a patent, on a trade mark, or on a copyright or a licence under a copyright

It is the duty of the company to send the above particulars to the Registrar within 30 days of charge or extended period which cannot be more than seven days, but registration may also be effected on the application of the creditor. The creditor may in such a case recover the registration fee from the company (Sec.134).

5.15 CONSEQUENCES OF NON -REGISTRATION OF CHARGES

If any charge which is required to be registered under Sec. 125 is not registered, the consequences will be as follows :

1. The charge becomes void as against the liquidators (if the company goes into liquidation) and against the creditors.

2. The charge is good against the company and may be enforced until the company goes into liquidation.

3. Money secured by the charge becomes immediately payable.

4. A subsequent registered charge will have priority over a prior unregistered charge even if the subsequent creditor has notice of the prior mortgage or charge.

5. The holder of an equitable charge whose charge is void for non-registration, has no lien on the title deeds or documents deposited with him as they are only ancillary to the void charge.

6. At the time of liquidation of the company, the creditor having an unregistered charge becomes an unsecured creditor of the company

as the charge is void against the liquidator and the creditors.

7. If default is made in filing the particulars of charges, the company and every officer of the company or any other person who is in default shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues. A further fine of upto Rs. 1000 may be imposed on the company and every officer of the company for other defaults relating to the registration of charges (Sec. 142).

The Company's Register of Charges (Sec. 143)

Every company has to keep at its registered office a register of charges and enter therein all charges specifically affecting property of the company and all floating charges on the undertaking or on any property of the company, giving in each case :

(a) a short description of the property charged ;

(b) the amount of charge ; and

(c) the names of the persons entitled to charge.

If any officer of the company knowingly omits or wilfully authorises or permits the omission of any of the above entries, he shall be punishable with fine which may extend to Rs. 500.

Further, under Sec. 136, every company must keep at its registered office a copy of every instrument creating any charge requiring registration. But in the case of a series of uniform debentures , a copy of only one debenture of the series is sufficient. The register of charges and the documents must be open for inspection by any person.

Register of Charges to be kept by the Registrar (Sec. 130)

The Registrar must also keep, with respect to each company, a register of all the charges requiring registration. He must, on payment of the prescribed fee, enter in the register, with respect to every charge, the following particulars :

(a) the date of the creation of the charge (if the charge is a charge created by the company), or the date of the acquisition of the property (if the charge was a charge existing on property acquired by the company);

(b) the amount secured by the charge ;

(c) short particulars of the property charged ; and

(d) the persons entitled to the charge

5.16 SUMMARY

There are two important elements which must be present to make one a member of a company (a) these must be an agreement to become a member and (b) the name must be entered in the register of member of the company. Companies Act does not prescribe any qualifications for the members of a company but as regards the competency of a member, the provisions of the Indian Contract Act shall apply. There are different modes of acquiring membership- Companies Act confers a number of rights on the members of a company. The liability of the members of the company depends upon the nature of company. Every company is bound to keep the register of its members. But when the number of company's members is more than fifty, it must also keep an index of the names of its member.

Every trading company, unless prohibited by its memorandum or articles, has an implied power to borrow money for the purpose of its business, and to give security for the loan by creating a mortgage or charge on its property even though such power is not expressed in the memorandum of the company, whom borrowings are beyond the powers of the company or the directors, it is ultra vires borrowings. In case of borrowing which is ultra vires of the company, the lender has no right for the recovery of his loan, yet he has the right of injunction, subrogation, identification and tracing, and recovery of damages against the company. The charges which a company may create on its assets are of two kinds namely fixed charge and floating charge. The effect of non-registration of a charge is that the security created by the charge becomes void as against the liquidator and other creditors.

5.17 KEYWORDS

Member: Member refers to a person whose name appears on the register of members.

Shareholders: The term shareholder as refers to the person who holds the share in a company.

Insolvent: An insolvent is a person who has been declared by the court as unable to pay his debts.

Ultra Vires Borrowing: Where a company borrows money in excess of its powers, the borrowing would be ultra-vires the company.

Injuction: Injuction means a court order restraining a person from doing a particular thing.

Subrogation: Subrogation means the substitution of one person for another.

Fixed Charge: It is the charge which is created on the definite and ascertained assets of the company.

Floating Charge: It is the charge which is created on the class of property which is constantly changing.

5.18 SELF ASSESSMENT QUESTIONS

1. 'Members include shareholders while shareholders does not include members'. Comment.
2. Who may become a member of a company ? How to become member of a company? What are the ways of cessation of membership ? Discuss in detail.
3. What are the duties and liabilities of members ? Discuss.
4. Discuss the borrowing powers of a company. What are the restrictions on its borrowing powers ?
5. Define a floating charge and distinguish it from a fixed charge. When does a floating charge become a fixed charge ?
6. Enumerate the charges that require registration. Discuss the consequences of non-registration.

5.19 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

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

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

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

LESSON : 6

MEETINGS; MANAGERIAL REMUNERATION

STRUCTURE

6.0 OBJECTIVE

After reading this lesson, you should be able to-

(a) Define a meeting and explain the kinds of meeting.

(b) Discuss the statutory provision regarding the various types of meeting of shareholders.

(c) Explain the requisites of a valid meeting.

(d) Describe the provisions regarding voting and poll, proxies and resolutions.

(e) Discuss the statutory provisions regarding payment of management remuneration.

6.1 INTRODUCTION

The company is an artificial person created by law having a separate entity distinct from its members. Being an artificial person, it cannot take decisions on its own. It has to take decisions on matters relating to its well being by way of resolutions passed at properly constituted and convened meetings of its shareholders or directors. The decisions about a company's management are taken by the directors in their meetings and they are to be ratified in the general meetings of the company by the shareholders.

There in an old proverb that "Two heads are always better than one". When two or more than two persons come together to discuss matters of common interest, there is said to be a meeting. It follows that to constitute a meeting there must be two or more persons. Generally, the purpose of a meeting is to consider issues of common interests to its attendants.

6.2 KINDS OF MEETINGS

The meetings of a company are of three kinds :

1. Meetings of the shareholders
   - (i) General meetings
   - (ii) Class meetings
2. Meetings of the Directors
3. Meetings of the Creditors

Meetings

- Shareholders
  - General meetings
    - Statutory meeting
    - Annual general meeting
    - Extraordinary general meeting
  - Class meetings
- Directors
  - Board meetings
  - Committee meetings
- Creditors
  - Meeting of Debenture-holders
  - Meetings of creditors and contributories at the time of liquidation of the company

In this lesson, the discussion will be confined to the meetings of the shareholders.

6.3 STATUTORY MEETING

Every public company limited by shares and every company limited by guarantee and having a share capital, shall, within a period of not less than one month nor more than six months from the date on which the company is entitled to commence business hold a general meeting of the members of the company. This meeting is called 'the statutory meeting'. [Sec. 165 (1)]

A meeting held prior to the statutory period of one month from the date of entitlement of a company to commence business can not be called the statutory meeting. The notice for such a meeting should state it to be statutory. The statutory meeting is held only once in the life time of a company.

Private companies, public companies limited by guarantee and not having a share capital and unlimited companies are not required to hold the statutory meeting. However, a private company which becomes a public company by the application of Sec. 43 will have to comply with the provisions of the Act which are applicable to public limited companies from the date of its becoming a public limited company. A private company can commence business on the date of its incorporation. If the date of its becoming a public company is within 6 months of its incorporation, it must hold a statutory meeting in accordance with the provision of Section 165 (1). If it becomes a public company after 6 months of its incorporation, it is not required to hold the statutory meeting.

Notice

The company must give notice to its members 21 days before the holding of the statutory meeting. The notice convening the statutory meeting must specifically state that the meeting is the statutory meeting. The time, date and place of the meeting must be mentioned in the notice. However, a shorter notice may be sufficient if consent is accorded by the members of the company :

(a) If the company has a share capital, holding not less than 95% of such part of the paid up share capital of the company as gives a right to vote at the meeting.

(b) If the company has no share capital, holding not less than 95% of the total voting power exercisable at the meeting.

Statutory Report

The Board of Directors is required to prepare a report which is known as the 'statutory report" and must send this report to the members at least 21 days before the day on which the meeting is to be held [Section 165(2)]. If the report is sent later than is required, it will be deemed to have been duly forwarded if it is so agreed to by all the members entitled to attend and vote at the meeting. Thus the delay in sending the report can be condoned by unanimous consent of all the members present at the meeting. The statutory report is required to be certified as correct by at least two directors of the company, one of whom must be a Managing Director, if there is any. Thereafter the auditor must certify the report to be correct in so far as it relates to the shares allotted by the company, the cash received in respect of such shares and the receipts and payments of the company [Section 165(4)]. A copy of the report must be sent to the Registrar also [Section 165(5)].

Contents of Statutory Report

The statutory report shall set out :

(a) The total number of shares allotted, distinguishing those allotted as fully or partly paid-up otherwise than in cash, the extent to which they are partly paid up and the consideration for which they have been allotted.

(b) The total amount of cash received by the company in respect of all the shares allotted.

(c) An abstract of the receipts and payments made thereout up to a date within 7 days of the date of the report.

(d) The name, address and occupations of the directors of the company and of its auditors and also if there be any, of its manager and secretary.

(e) The particulars of any contract which , or the modification or the proposed modification of which is to be submitted to the meeting for its approval.

(f) The extent to which each underwriting contract (if any) has not been carried out and the reason therefor.

(g) The arrears due on cash from every director and from the manager.

(h) Particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares or debentures to any director.

Procedure at the meeting

A list showing the names, addresses and occupation of the members of the company and the number of shares held by them must be produced by the Board of Directors at the commencement of the statutory meeting. The list is to remain open and accessible to any member of the company during the continuance of the meeting [Section 165 (6)].

It is to be noted that the members of the company present at the meeting are at liberty to discuss any matter relating to the formation of the company or arising out of the statutory report, whether previous notice has been given or not but one resolution may be passed of which notice has not been given in accordance with the provisions of Companies Act. [Sec. 165 (7)]

Adjournment of Statutory Meeting

The meeting may adjourn from time to time and at any adjourned meeting any resolution of which notice has been given in accordance with the provisions of the Companies Act may be passed and the adjourned meeting will have the same power as an original meeting. [Sec. 165(8)]

Penalty

If any default is made in complying with the above provisions, every director or other officer of the company who is in default shall be liable to a fine which may extend to Rs. 500. Besides, if default is made in delivering the statutory report to the Registrar or in holding the statutory meeting, the Court may order the compulsory winding up of the company. [Sec. 433 (b)]

Objects

The obvious purpose of the statutory meeting with its preliminary report is to put the shareholders of the company as early as possible in possession of all the important facts relating to the new company what shares have been taken up, what moneys received, what contracts entered into, what sums spent on preliminary expenses, etc. Furnished with these particulars the shareholders are to have an opportunity of meeting and discussing the whole situation in the management methods and prospects of the company. If the shareholders fails to do so, they have only themselves to blame.

6.4 ANNUAL GENERAL MEETING

Every company must in each year hold in addition to any other meeting a general meeting, as its annual general meeting and must specify the meeting as such in the notices calling it [Section 166 (1)]. The annual general meeting is to be held in addition to any other general meeting that might have been held in a year. It appears that holding of an annual general meeting in every calender year is a statutory necessity. Calender year is to be calculated from Ist January to 31st December and not twelve months from the date of incorporation of the company.

First annual general meeting

A company must hold its first annual general meeting within a period of not more than 18 months from the date of its incorporation and if such general meeting is held within that period, it shall not be necessary for the company to hold any annual general meeting in the year of its incorporation or in the following year [Section 166(1)]. For example a company is incorporated in October 1994. Its first annual general meeting is required to be held within 18 months from the incorporation, i.e. up to March 1996 and if such a meeting is held within this period, no other meeting will be necessary either for 1995 or 1996.

Subsequent annual general meeting

As already discussed a company is required to hold an annual general meeting in each year. Where a meeting called and held on a day in one year is adjourned to a date in the next year and held on that date, the meeting held on the latter date is not a different meeting and does not comply with the requirements of Section 166. However, the gap between one annual general meting and the next should not be more than fifteen months.

In the case of Shree Meenakshi Mills Company Limited v. Astt. Registrar of Joint Stock Companies Madurai AIR 1938 Mad. 640, the annual general meeting of a company called in December 1934 was adjourned and held in March 1935. The next annual general meeting was held in January, 1936, no other meting being held in 1935. The company was prosecuted for failure to call the annual general meeting in 1935. It was held that there should be one meeting per year and as many meetings as there are years.

The Registrar can, for any special reason, extend the time within which any annual general meeting is required to be held by a period not exceeding 3 months but the time for holding the first annual general meeting cannot be so extended. [Sec. 166(1)]

Power to convene an annual general meeting

The proper authority to convene an annual general meeting is the Board of Directors, and if the managing director, manager, secretary or other officer calls a meting without such authority, it will not be effectual unless the Board ratifies the act before the meeting is held.

Notice

A public company must give at least 21 days notice for convening any general meeting including annual general meeting. Annual general meeting may be called after giving a shorter notice than 21 days if it is so agreed by all the members entitled to vote in the meeting (Section 171). In calculating 21 days, the date on which the notice is served and the day of the meeting are excluded.

Date, time and place of holding the annual general meeting

Every annual general meeting shall be called at any time during the business hours, on a day that is not a public holiday. It shall be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situated [Section 166(2)]. The Central Government may exempt any class of companies from the provisions of Sec. 166 subject to such conditions as it may impose.

(a) A public company or a private company which is a subsidiary of a public company, may by its Articles fix the time for its annual general meetings and may also by a resolution passed in preceding annual general meeting fix the time for its subsequent annual general meetings and

(b) A private company which is not a subsidiary of a public company may in like manner and also by a resolution agreed to by all the members thereof, fix the time as well as the place for its annual general meetings [Sec. 166(2)]

Adjournment

Where an annual general meeting is held but adjourned, the adjourned meeting is nothing but continuance of the earlier meeting and therefore if in the adjourned meeting the Balance Sheet and the Profit and Loss Account of the company are laid and adopted and thereafter sent to the Registrar, Section 220(I) is not violated.

Holding of annual general meeting where the annual accounts are not ready

According to Central Government instructions, in case the annual accounts are not ready for laying at the appropriate annual general meeting, the company must hold the annual general meeting within the time limit, transact all business other than the consideration of the accounts, announce when the accounts are expected to be ready for laying and pass a suitable resolution adjourning the said annual general meeting to a specific date or to a date to be specified later on. Thus the company cannot take the plea that the annual general meeting was not held because the accounts were not ready.

Power of Central Government to call annual general meeting

The Central Government may, on the application of any member of the company, call or direct the calling of a general meeting of the company. However, it is to be noted that the Court has no power to call such meeting. A general meeting held in pursuance of this order will be deemed to be an annual general meeting of the company.

The Central Government may direct that only one member of the company present in person or by proxy shall be deemed to constitute a meeting. [Section 167]

Penalty

If a default is made in holding an annual general meeting in accordance with the above provisions or in complying with the directions given by the Central Government, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 5000 and in the case of a continuing default, with a further fine which may extend to Rs. 250 for every day after the first during which the default continues. (Section 168)

Importance

It is the annual general meeting at which the shareholders can exercise control over the affairs of the company. At this meeting some directors retire and come up for re-election and thereby the shareholders find an opportunity to refuse to re-elect a director of whose action and policy they disapprove. Appointment of auditors is also made at this meeting.

Annual accounts are presented at this meeting for the consideration of the shareholders and the shareholders can ask any question relating to the account. It is at this meeting that dividends are declared. At this meeting the shareholders can discuss any other matters relating to the company's business.

6.5 EXTRAORDINARY GENERAL MEETING

Regulation 47 of the Table A provides that all general meetings other than annual general meetings shall be called extraordinary general meetings. An extraordinary general meeting is called to consider those transactions or business which cannot be postponed till the next annual general meeting. Hence, it is a meeting of a company which is held between two consecutive annual general meetings for transacting some urgent or special business. An extraordinary general meeting may be convened :

1. By the Board of Directors on its own or on the resolution of members; or
2. By the requisitionists themselves on the failure of the Board to call the meeting ; or
3. By the Central Government.

1 Extraordinary meeting convened by the Board of Directors

(A) On its own

Regulation 48(1) of Table A provides that the board may, whenever it thinks fit, call an extraordinary general meeting. An extraordinary general meeting may be convened by the Board of Directors if some business of special importance requires the approval of the members and which in the opinion of the Board of Directors can not be postponed till the next annual general meeting. The directors can call an extraordinary general meeting by passing a resolution in a properly convened board meeting or by a circular resolution. Regulation 48(2) of Table A provides that "If at any time, they are not present within India, the number of directors capable of acting and forming a quorum, any director or any two members of the company may call an extraordinary general meeting in the same manner, as nearly as possible, as that in which such a meeting may be called by the Board".

(B) On the requisition of members

The directors are bound to call an extraordinary general meeting of the company if the requisition is made :

(i) in the case of a company having a share capital, by the holders of at least one-tenth paid up capital having the right to vote on the matter of requisition ; or

(ii) in the case of a company not having a share capital, by members representing not less than one-tenth of the total voting power in regard to the matter of requisition.

The Board of Directors is under a legal obligation to proceed within 21 days of the deposit of the requisition to call a meeting. The meeting shall be held within 45 days of such deposit of the requisition with the company [Sec. 169(6)]. On receipt of the requisition, the Board shall send out notices for the meeting giving not less that 21 days' time.

3. Extraordinary meeting covered by the Central Government

If due to any reason it is impracticable to call or conduct an extraordinary general meeting, the Central Government may, either on its own or on the application of any director or any member who would be entitled to vote, order a meeting to be called, held and conducted in such manner as the Central Government thinks fit and may give such directions as it thinks expedient, including a direction that one member present in person or by proxy shall be deemed to constitute a meeting.

Any meeting called, held and conducted in accordance with any such order of the Central Government will, for all purposes, be deemed to be a meeting of the company duly called, held and conducted.

The word 'impracticable' may be taken to mean impossible to hold a peaceful or useful meeting. It has been held that the word 'impracticable' should be taken to mean impractical from a reasonable point of view.

In Opera Photographic Ltd. Re; 1989 BCL [763 (1989)] case, there were only two directors and one of them who was holding 51% of the shares wanted to remove his fellow director. The Articles required the quorum of two. The fellow director did not attend the meeting to frustrate him. The Central Government ordered a meeting to be called with the presence of one as a sufficient quorum.

6.6 CLASS MEETINGS

Class meetings are the meetings of the shareholders and the creditors. Class meetings are held to pass resolutions which will bind only the members of the particular class concerned. According to regulation 3(1), if the rights attached to any class of shares are to be varied, it can be done with the consent of the holders of 3/4 of the issued shares of that class in a separate meeting of that class of holders. Similarly, under Sec. 394, where a scheme of arrangement or compromise is proposed, the meetings of several classes of shareholders and creditors are required to be held. Class meetings can only be attended by the members of that class. Whenever it is necessary to alter or change the rights or privileges of a class as provided by the Articles, a class meeting must be called.

6.7 REQUISITES OF A VALID MEETING

A meeting to be in order must fulfil certain requirements.

1. Proper Authority

The Board of Directors is the proper authority to convene a general meeting of a company and for this purpose the board should pass a resolution at a duly convened meeting of the board. However, if the board fails to call a general meeting of the company, the members or the Central Government or the Central Government may call such a meeting. Some defects in appointment or qualification of the directors present at the meeting of the board will not necessarily be fatal to the validity of the resolution passed at the meeting provided the board has acted bonafide.

2. Notice of Meetings (Sec. 171)

A proper notice of the meetings must be given to the members of the company. The notice must be given 21 days before the date of the meeting. The period of 21 days excludes the day of service of the notice and also the day on which the meeting is to be held.

The length of the notice may be waived :

(a) in the case of an annual general meeting by the consent of all members;

(b) in the case of any other meeting by the consent of the holders of not less than 95% of the paid-up share capital or the total voting power where the company has no share capital.

Notice to whom (Sec. 172)

The notice is required to be given to

(a) all the members of the company who are entitled to vote on the matters which are proposed to be dealt with at the meeting ;

(b) all the persons who are entitled to a share in consequences of the death and insolvency of a member ;

(c) the auditor or auditors of the company. Deliberate omission to give notice of the meeting to members or to a single member will make the meeting invalid, but an accidental omission to give notice to or the non-receipt of notice by any member will not invalidate the proceedings at the meeting [Sec. 172 (3)].

Contents of Notice

Every notice of a meeting is required to specify the place and the day and hours of the meeting and must contain a statement of the business to be transacted at the meeting. If the time of holding meeting and other essential particulars are not specified in the notice, the meeting will be invalid and all resolutions passed at the meeting will be of no effect.

The notice of general meeting must contain a statement of the business to be transacted at the general meeting of the company. The business to be transacted at a meeting may be general business or special business.

Section 173 provides (a) in the case of an annual general meeting, all business to be transacted at the meeting will be deemed special except the business relating to the consideration of accounts, Balance Sheet and reports of the Board of Directors and auditors, the declaration of dividends, the appointment of directors in the place of those retiring and the appointment of and the fixing of the remuneration of the auditors and (b) in the case of any other meeting, all business will be deemed special.

If any special business is to be transacted at an annual general meeting a statement to that effect must be annexed to the notice of the meeting. The statement must set out all material facts concerning each item of business including in particular the nature of the concern or interest therein of every director or other managerial personnel. Thus every notice calling a meeting is required to specify the business to be transacted at the meeting.

A notice of meeting must give a sufficiently full and frank disclosure to the members of the fact upon which they are asked to vote otherwise the resolution passed at the meeting will be invalid.

In Kaye v. Croydon Tramways Co., there was a provisional agreement between two companies for the sale of the undertaking of the one company to the other. Under the agreement the buying company agreed to pay, in addition to the sum payable to the selling company, certain amount to the directors of the selling company as compensation for the loss of office. The notice calling the meeting of the shareholders to consider the agreement for sale of the undertaking did not disclose that there was a provision in the agreement for the payment of compensation to the directors. The Court held that the notice could not make the full and fair disclosure of all the material facts to the considered and voted upon at the meeting and therefore the resolutions passed at the meting were invalid and ineffective.

3. Quorum

Quorum means the minimum number of members that must be present at the meeting. The quorum is generally fixed by the company's article. Unless the articles provide for a large number, five members personally present in the case of a public company (other than a public company which has become such by virtue of Section 43-A) and two members personally present in the case of any other company will be the quorum for a meeting of the company. If within half an hour from the time appointed for holding a meeting of the company, a quorum is not present, the meeting will stand dissolved if it was called upon the requisition of members but in any other case it stands adjourned to the same day in the next week, at the same time and place or to such other day as the Board may determine. If at a adjourn meeting also the quorum is not present within half an hour from time appointed for holding the meeting the members present sufficient will be quorum [Section 174(5)].

Section 174 clearly indicate that the meeting must be attended by more than one member so as to constitute it as a meeting. But a few exceptions to this general rule may also be noted :

(a) Under Section 167, the Central Government may, on the application of any member of the company, call a general meeting of the company and may direct that even one member of the company present in person or by proxy shall be deemed to constitute a meeting.

(b) Under Section 186, the Central Government may call a meeting of the company other than an annual general meeting and may give direction that even one member of the company present in person or by proxy shall be deemed to constitute a meeting.

(c) In *East v. Bennet Bros. Ltd.*, one shareholder held all these preference shares in the company. A meeting of preference shareholders attended by him only was held to be a valid meeting.

4. Chairman of meeting

Before a meeting of a company can start its business, it is required to have a Chairman. It is the Chairman who is to preside at the meeting of the company. He is to conduct the meeting and to maintain the order. It is the Chairman who is to put up the resolution, count the votes and declare the result. Usually the articles provide for the appointment of a Chairman but if there is no provision in the articles to this effect, the members present in the meeting shall elect one of themselves to be the Chairman of such meeting on a show of hands [Section 175(1)]. If a poll is demanded on the election of the Chairman, it shall be taken forthwith [Section 175(2)] and in such a case the Chairman elected on the show of hands will exercise all the powers of the Chairman. If some other person is elected Chairman as a result of the poll, he will be the Chairman for the rest of the meeting [Section 175(3)]. He can adjourn the meeting in the event of disorder but he should do so only as a last resort, if his attempts to restore order have failed.

A Chairman is not entitled to close the meeting prematurely and if he does so, a new Chairman may be elected and the meeting of the company may be continued. However, it is to be noted that where a meeting is called but it is not held due to pandemonium and confusion and a note to this effect is made in the minute book by the Chairman, the shareholders cannot elect a new Chairman because in such a case no meeting has actually been commenced and consequently no question of dissolving the meeting permanently by the Chairman arises.

Duties of the Chairman

(a) He must take care that the minority is not oppressed in any way.

(b) He must give the members who are present a reasonable opportunity to discuss any proposed resolution and it must be ensured that all the views are adequately aired. But at the expiry of a reasonable time, if he thinks fit, he should stop the discussion on any resolution.

(c) He must see that the meting is properly convened and constituted i.e. proper notice was given to every person entitled to attend the meeting and his own appointment is in order. It is the Chairman who is to see whether a quorum is present before proceeding with the business.

(d) The Chairman must conduct the proceedings in accordance with the provisions of the Act, the companies Articles of Association or Table A or in the absence thereof, the common law relating to the meetings.

(e) He should adjourn the meeting when it is impossible, by reason of disorder or other like cause, to conduct the meeting and complete its business. He must not use this power in a malafide manner.

(f) He must take care that the opinion of the meeting is properly ascertained with regard to the questions before it. He must do so by putting the resolution in a proper form before the members and then declaring the result.

(g) He must keep order in the meeting. He must decide all questions which arise at the meeting and which require decision at the time.

(h) He should exercise his casting vote, if any, provided by the articles for the benefit of the company.

(i) The minutes of the meeting should be properly recorded and signed by the chairman.

5. Minutes of the meeting :

Every company must keep a record of all proceedings of every general meeting and of all proceedings of every meeting of its Board of Directors and of every committee of the board.

These records are known as minutes and the books in which these records are written are called 'minute books'.

Rules of Keeping Minutes (Sec. 193-196)

(a) Within 30 days of every such meeting, entries of the proceedings must be made in the books kept for that purpose. [Sec. 193 (1-A)]

(b) Each page of minutes book which records proceedings of a board meeting must be initialled or signed by the Chairman of the same meeting or the next succeeding meeting. In the case of minutes of proceedings of a general meeting, each page of the minute book must be initialled or signed by the Chairman of the same meeting.

(c) The minutes of each meeting must contain a fair and correct summary of the proceedings at the meeting.

(d) All the appointments of officers made at any of the meetings aforesaid must be included in the minutes. In the case of a meeting of the Board of Directors or of a committee of the board, the minutes must contain the names of the directors present at the meeting and the names of the directors dissenting from or not concurring in the resolution passed at the meeting [Sec. 193 (4)].

(e) The Chairman may exclude from the minutes, matters which are defamatory of any person, irrelevant or immaterial to the proceedings or which are detrimental to the interests of the company. Minutes of meetings kept in accordance with the above provisions are evidence of the proceedings recorded therein.

(f) The minutes books must be kept (i) at the registered office of the company; and (ii) be open during business hours to the inspection of any member without charge subject to reasonable restrictions but at least two hours each day must be allowed for inspection.

Penalty

If default is made in complying with the provision of Section 193 in respect of any meeting, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 50.

6.8 VOTING AND ROLL

A vote is the formal expression of the will of the members of the house either for or against a proposal. The matters proposed and duly recommended in a general meeting of the company are decided by the voting of the members of the company.

The procedure of voting is regulated by the Articles subject to the provisions of the Act. Members holding any share capital of the company have the right to vote on every motion placed before the company. However, the members holding preference shares can vote only on those motions which affect the rights attached to their capital. Share warrant holders, executors of a deceased member, receiver of an insolvent member can not exercise any voting right unless registered as members. The voting rights of an equity shareholder at a poll are in proportion to his share of the paid up equity capital.

Voting may take place in either of the following two ways :

1. Voting by a show of hands

At any general meeting, unless the Articles otherwise provide, a resolution put to the vote is in the first instance decided by a show of hands except when a poll is demanded [Sec. 177]. While voting by a show of hands, one member has one vote irrespective of the shares held by him. Proxies can not be counted unless the Articles otherwise provide. The

Chairman will count the hands raised and will declare the result accordingly. Chairman's declaration of the result of voting by the show of hands to be conclusive evidence [Sec. 178].

2. Voting by poll [Sec. 179]

If there is dissatisfaction among the members about the result of voting by the show of hands, they can demand a poll. 'Poll' means counting the number of votes cast for and against a motion. The voting rights of a member on a poll shall be in proportion to his share of the paid-up equity capital of the company. Before or on the declaration of the result of voting on any resolution by a show of hands, a poll may be ordered to be taken by the Chairman of the meeting of his own motion, and shall be ordered to be taken by him on a demand made in that behalf by the person or persons specified below :

(a) In the case of a public company having a share capital, by any member or members present in person or by proxy and holding shares in the company:

  (i) which confer a power to vote on the resolution not being less than one tenth of the total voting power in respect of the resolution, or

  (ii) on which an aggregate sum of not less than fifty thousand rupees has been paid-up,

(b) In the case of a private company having a share capital, by one member having the right to vote on the resolution and present in person or by proxy if not more than seven such members are personally present, and by two such members present in person or by proxy, if more than seven such members are personally present,

(c) In the case of any other company, by any member or members present in person or by proxy and having not less than one tenth of the total voting power in respect of the resolution [Sec. 179(1)].

The demand for a poll may be withdrawn at any time by the person or persons who made the demand. [Sec. 179(2)]. The provisions of Section 179 apply to a private company, which is not a subsidiary of a public company unless the articles provide otherwise.

A poll demanded on the question of adjournment or the election of the Chairman shall be taken forth with. A poll demanded on any other question shall be taken at such time not being later than forty eight hours from the time when the demand was made, as the Chairman may direct. Where a poll is taken, the meeting will be deemed to continue until the ascertainment of the result of the poll. Even a voter who was not present at the meeting when the poll was demanded to be taken, may vote personally in a poll held on the next day.

The Chairman of the meeting shall have the power to regulate the manner in which a poll shall be taken [Sec. 185(1)]. Where a poll is to be taken, the Chairman of the meeting shall appoint two scrutiniser to scrutinise the votes given on the poll and to report thereon to him [Sec. 184 (1)]. Of the two scrutiniser, one shall always be a member present at the meeting, provided such a member is available and willing to the appointed [Sec.184 (3)].

The Articles of a company may provide that no member shall exercise any voting right in respect of any shares registered in his name on which calls or other sums presently payable by him have not been paid (Sec. 181).

Proxies

A meeting has right to vote either in person or by proxy. Any member of a company who is entitled to attend and vote at a meeting of the company can appoint another person (whether a member or not) as his proxy to attend and vote instead of himself but a proxy so appointed will have no right to speak at the meeting. Unless the articles otherwise provide, a proxy will not be allowed to vote except on a poll. A member of a private company, unless the articles provide otherwise is not entitled to appoint more than one proxy to attend on the same occasion. Besides unless the articles provide otherwise a member of a company not having a share capital is not entitled to appoint a proxy. The instrument appointing a proxy is required to be in writing and signed by the appointor or his attorney duly authorised in writing. A proxy is revocable but it should be revoked before the proxy has voted. If the member who has appointed a proxy personally attends and votes at the meeting, the proxy is revoked by such conduct of the member [Section 189]. Death of the member who has appointed a proxy revokes the authority of his proxy but if the company has no notice of such death, then the vote given by the proxy will be valid.

6.9 RESOLUTIONS

The decisions of a meeting take the form of resolutions carried by a majority of votes. A question on which a vote is proposed to be taken is called a 'motion'. Once a 'motion' has been put to the members and they have opted in favour of it, it becomes a resolution. A resolution may, thus, be defined as the formal decision of a meeting on a particular proposal before it.

Types of Resolutions

Resolutions are of the following types :

1. Ordinary Resolutions ;
2. Special Resolutions ; and
3. Resolutions requiring special notice.

Ordinary Resolution

At a general meeting of which notice has been given, if votes cast in favour of the resolution by members exceed the votes, if any, cast against the resolution by members, the resolution so passed is an ordinary resolution [Sec. 189(1)]

Unless the Companies Act or the memorandum or the articles expressly require a special resolution or resolution requiring special notice, an ordinary resolution is sufficient to carry out any matter.

Transactions where ordinary resolution is required

Important maters for which an ordinary resolution is enough are as follows :

(i) Issue of shares at a discount (Sec. 79)

(ii) Alteration of the share capital (Sec. 94)

(iii) Approval of the statutory report (Sec.165)

(iv) The consideration of accounts, the Balance Sheet and the report of the Board of Directors and of the auditors (Sec. 210)

(v) Appointment of auditors and fixation of their remuneration [Sec. 224(1)].

(vi) Appointment of the first directors who are to retire by rotation [Sec. 255(1)].

(vii) Increase or decrease in the number of directors within the limits prescribed by the Articles [Sec. 258].

(viii) Adoption of the appointment of sole selling agents [Sec. 294].

(ix) Removal of a director and appointment of another director in his place [Sec. 284(1)].

(x) Declaration of dividend [Sec. 205].

(xi) Appointment of liquidator in case of voluntary winding up and fixing his remuneration [Sec. 490(1)].

(xii) To rectify the name of company [Sec. 22].

(xiii) To cancel or redeem debentures [Sec. 21].

(xiv) To cancel directors by rotation [Sec. 256].

(xv) To approve the remuneration of directors [Sec. 309].

(xvi) To fill the vacancy in the office of Liquidator [Sec. 492].

Special Resolution

The resolution is a special resolution, if

(i) the intention to propose the resolution as a special resolution has been duly specified in the notice calling the general meeting ;

(ii) the notice required has been duly given of the general meeting; and

(iii) the votes cast in favour of the resolution by members are three times the number of the votes, if any, cast against the resolution by the members [Sec. 189 (2)].

A copy of the special resolution must be filed with the Registrar within 30 days of its passing.

Special Resolution Matters

In addition to the matters given in the articles of the company, the Companies Act specifies certain matters for which a special resolution must be passed ; for example,

(i) to alter the memorandum of the company [Sec. 17];

(ii) to alter the articles of the company [Sec. 31];

(iii) to issue further shares without pre-emptive rights [Sec. 81];

(iv) for creation of a reserve capital [Sec. 99];

(v) to reduce the share capital [Sec. 100];

(vi) to pay interest out of the capital to members [Sec. 208],

(vii) for authorising a director to hold an office or place of profit [Sec. 314];

(viii) for voluntary winding-up of a company [Sec. 484].

Resolutions Requiring Special Notice

A resolution requiring special notice is not an independent class of resolutions. It is a kind of ordinary resolution, with the only difference that here the mover of the proposed resolution is required to give a special notice of 14 days to the company before moving the resolution, and the company shall then immediately give its members notice of the resolution in the same manner as it gives notice of the meeting. If that is not practicable, the company shall give not less than seven days notice before the meeting either by advertisement in a newspaper or in any other mode allowed by the articles (Sec. 190).

In addition to the purposes enumerated in the articles requiring special notice, under the Act, special notice has to be given for the following matters :

(a) for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor and for a resolution providing expressly that a retiring auditor shall not be re-appointed (Sec. 225).

(b) for certain persons who shall not be eligible for appointment as directors whose period of office is liable to determination by retirement of directors by rotation (Sec. 261).

(c) for removing a director before the expiry of his period of office; and

(d) of any resolution to appoint a director in place of a director so removed (Sec. 284).

6.10 MANAGERIAL REMUNERATION

Directors have no right to claim remuneration for their services unless there is a specific provision to that effect in the Articles or the company resolves for the same in a general meeting as per the provisions of Section 309. The resolution may be ordinary or special as the Articles may require.

As per Section 198, the total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company, to its directors and its managing agent, secretaries and treasurer or manager in respect of any financial year shall not exceed 11% of the net profit of that company for that financial year. This percentage shall be exclusive of the fees payable to the directors under Section 309.

If in any financial year, a company has no profits or its profits are inadequate, the company shall not pay any remuneration to its directors except with the previous approval of the Central Government. The word remuneration shall include the following :

(i) any expenditure incurred on providing free accommodation and other amenities connected therewith ;

(ii) any expenditure incurred on providing any other amenity either absolutely free or at a concessional rate ;

(iii) any expenditure incurred in providing any obligation or service which in the absence of provision by the company would have to be borne by that person ;

(iv) any expenditure incurred in providing life insurance, pension, annuity or gratuity to such person or his spouse or child.

According to Section 249, in computing the net profits of a company in any financial year for the purpose of Section 348, credit shall be given for bounties and subsidies received from any government, or any public authority constituted or authorised in this behalf, by any government, unless and except in so far as the Central Government otherwise directs.

However credit shall not be given for the following sums :

(i) Profits, by way of premium, on the shares or debentures of the company, which are issued or sold by the company,

(ii) Profits on the sales by the company of the forfeited shares;

(iii) Profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof ;

(iv) Profits from the sales of any immovable property or fixed assets of a capital nature comprising in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets.

In making the aforesaid computation, the following sums shall be deducted :

(i) all the usual working charges ;

(ii) director's remunerations ;

(iii) bonus or commission paid or payable to any employees of the company whether on a whole time or on a part time basis ;

(iv) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;

(v) any tax on business profits imposed for special reasons or in special circumstances;

(vi) interest on debentures issued by the company ;

(vii) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets ;

(viii) interest on unsecured loans and advances ;

(ix) expenses on repairs to immovable or movable property provided the repairs are not of a capital nature ;

(x) contributions to charitable and other funds ;

(xi) depreciation to the extent specified in Section 350;

(xii) past losses arising after Ist April, 1956 to the extent not already deducted in any year preceding that in which net profits have to be ascertained ;

(xiii) any compensation or damages under a legal liability or arising from breach of contract ;

(xiv) any sum paid by way of insurance against the risk of meeting any liability as specified in clause (iii) above ; and

(xv) bad debts written off or adjusted during the year of account.

The following sums shall not be deducted in computing the profits :

(i) Income tax and super tax payable by the company or any other tax on the income of the company not falling under clauses (d) and (e) of Section 399 (4);

(ii) any compensation, damages or payments made voluntarily ; and

(iii) loss of a capital nature.

It is pertinent to note that according to Section 309, a whole time director or managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company, or partly by one way and partly by the other. Except with the approval of the Central Government, such remuneration shall not exceed 5 per cent of the net profits for one such director, or 10 per cent for all of them in case there are more than one such director.

A part time director may be paid remuneration either by way of a monthly, quarterly, or annual payment with the approval of the Central Government, or by way of commission if the company by a special resolution authorises such payment with the approval of the Central Government, or by a special resolution authorises such payment.

The remuneration paid to part time directors shall not exceed per cent of the net profits of the company if the company has a managing or whole time director or a manager and 3 per cent of the profits in any other case. However, the company in a general meeting may, with the approval of the Central Government, increase these rates of remuneration.

6.11 SUMMARY

A meeting is a gathering or assembly of a number of persons for transacting any lawful business. But every gathering of persons does not constitute a meeting. A meeting would be valid if it is held by following the prescribed rules and regulations. The meetings of a company are of three kinds namely meetings of shareholders directors and creditors. Statutory meeting is the first meeting of the members of the company after its incorporations and must be held within six months from the date at which the company is entitled to start business. Annual general meeting is the regular meeting of the members of the company and the purpose of this meeting is to provide an opportunity to the members of the company express their views on the management of company's affairs. Any meeting other than the statutory and the annual general meeting of the company is known as extra-ordinary general meeting, class meeting is the meeting of a particular class of shareholders. The business of the meeting is conducted in the form of resolutions passed at the meeting and the resolutions proposed in the meeting are decided on the votes of the members of the company. The remuneration payable to directors is determined by the articles of association of the company, or by a resolution of the company passed in its general meeting. The overall maximum limit of management remuneration in fixed by Section 198 of the Companies Act.

6.11 KEYWORDS

Meeting: A meeting may be defined as gathering or assembly of a number of persons for transacting any lawful business.

Statutory Meeting: Every public company limited by shares and every company limited by guarantee and having a share capital, shall, within a period of not less than one month nor more than six months from the date on which the company is entitled to commence business hold a general meeting of the members of the company. This meeting is called the statutory meeting.

Annual General Meeting: Every company must in each year hold in addition to any other meeting, a general meeting as its annual general meeting.

Extra Ordinary General Meeting: Any meeting other than a statutory and an annual general meeting is called an Extra Ordinary General Meeting.

Class Meeting: Class meetings are separate meetings of holders of different classes of shares. They are held in cases where their rights are sought to be affected.

Quorum: It means the minimum number of members that must be present at the meeting.

Vote: A vote is the formal expression of the will of the members of the house either for or against a proposal.

Ordinary Resolution: It is the resolution which is passed, at a valid meeting by simple majority of the members, i.e., where the votes cast in favour of resolution exceed the votes cast against it.

Managerial Remuneration: The total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company to its directors, managing agent, secretaries and treasurer or manager in respect of any financial year shall not exceed 11% of the net profit of that company for that financial year.

6.13 SELF ASSESSMENT QUESTIONS

1. What is a statutory meeting ? When and how is it held ? What are the objects of such a meeting ? What business is transacted at such meetings ?
2. What are the statutory provisions regarding the holding of an annual general meeting ? What types of business are transacted in such meetings ?
3. What are the requisites of a valid meeting ? Discuss in detail
4. What is a quorum ? What happens if there is no quorum at a meeting?
5. What are different types of resolutions which must be passed in the meeting of shareholders ?
6. Discuss the statutory provisions relating to payment of managerial remuneration of a public limited company.

6.14 SUGGESTED READINGS

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

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

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

Nirmal Singh, Business Law, Deep and Deep Publication Pvt. Ltd., New Delhi.

LESSON : 7

WINDING UP OF A COMPANY

STRUCTURE

7.0 OBJECTIVE

This lesson is intended to familiarize you with

a) The concept of winding up.

b) Different modes of winding up of a public company.

c) Persons entitled to apply for winding up.

d) Consequences of winding up.

7.1 INTRODUCTION

Winding up (which is more commonly called liquidation in Scotland) is proceeding for the realisation of the assets, the payment of creditors, and the distribution of the surplus, if any, among the shareholders, so that the company may be finally dissolved. Professor Gover in his book *Principles of Modern Company Law* has described the winding up of a company in the following words :

‘‘Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator called a liquidator is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights.’’

Thus winding up is the last stage in the life of a company. It means a proceeding by which a company is dissolved.

Winding up should not be taken as if it is dissolution of a company. The winding up of a company precedes its dissolution. Prior to dissolution and after winding up, the legal entity of the company remains and it can be sued in a Court of law. On dissolution the company ceases to exist, its name is actually struck off from the Register of Companies by the Registrar and the fact is published in the official Gazette.

7.2 MODES OF WINDING UP

A company can be wound up in three ways :

1. Compulsory winding up by the Court;
2. Voluntary winding up : (i) Members' voluntary winding up; (ii) Creditors' voluntary winding up;

3. Voluntary winding up subject to the supervision of the Court [Sec. 425].

7.3 WINDING UP BY THE COURT

A company may be wound up by an order of the Court. This is called compulsory winding up or winding up by the Court. Section 433 lays down the following grounds where a company may be wound up by the Court.

A petition for winding up may be presented to the Court on any of the grounds stated below :

1. Special resolution

A company may be wound up by the Court if it has, by a special resolution, resolved that it be wound up by the Court. But it is to be noted that the Court is not bound to order for winding up merely because the company by a special resolution has so resolved. Even in such a case it is the discretion of the Court to order for winding up or not.

2. Default in filing statutory report or holding statutory meeting

If a company has made a default in delivering the statutory report to the Registrar or in holding the statutory meeting, a petition for winding up of the company may be presented to the Court. A petition on this ground may be presented to the Court by a member or Registrar (with the previous sanction of the Central Government) or a creditor. The power of the Court is discretionary and generally it does not order for winding up in first instance. The Court may, instead of making an order for winding up, direct the company to file the statutory report or to hold the statutory meeting but if the company fails to comply with the order, the Court will wind up the company.

3. Failure to commence business within one year or suspension of business for a whole year

Where a company does not commence its business within one year from its incorporation or suspends its business for a whole year, a winding up petition may be presented to the Court. Even if the business is suspended for a whole year, this by itself does not entitle the petitioner to get the company wound up as a matter of right but the question whether the company should be wound up or not in such a circumstances entirely in the discretion of the Court depending upon the facts and circumstances of each case. Even if the work of all the units of the company has been suspended then too it will still be open to the Court to examine as to whether it will be possible for the company to continue its business. Before the order of winding up on this ground the Court is required to see what are the possibilities of resumption of the business of the company. The suspension of the business, for this purpose, must be the entire business of the company and not a part of it.

The Court will not order for winding up on the grounds, if :

(a) suspension of business is due to temporary causes ; and

(b) there are reasonable prospects for starting of business within a reasonable time.

4. Reduction of membership below the minimum

When the number of members is reduced, in the case of a public company, below 7 and in the case of a private company, below 2, a petition for winding up of the company may be presented to the Court.

5. Company's inability to pay its debts

A winding up petition may be presented if the company is unable to pay its debt. 'Debt' means definite sum of money payable immediately or at future date. A company will be deemed to be unable to pay its loan in the following conditions (Section 434) :

(a) a creditor of more than Rs. 500 has served, on the company at its registered office, a demand under his hand requiring payment and the company has for three weeks thereafter neglected to pay or secure or compound the sum to the reasonable satisfaction of the creditor ; or

(b) execution or other process issued on a judgement or order in favour of a creditor of the company is returned unsatisfied in whole or in part ; or

(c) it is proved to the satisfaction of the Court that the company is unable to pay its debts, taking into account its contingent and prospective liabilities, i.e. whether its assets are sufficient to meet its liabilities.

6. Just and Equitable [Sec. 433(f)]

The Court may also order to wind up of a company if it is of opinion that it has just and equitable that the company should be wound up. What is 'just and equitable' depends on the facts of each case. The words 'just and equitable' are of wide connotation and it is entirely discretionary on the part of the Court to order winding up or not on this ground.

Thus the Court itself works out the principles on which the order for winding up under the section is to be made.

Winding up by the Court on 'just and equitable' grounds may be ordered in the cases given below :

(a) When the substratum of the company has gone : In the words of Shah, J. in *Seth Moham Lal v. Grain Chambers Ltd.* the "substratum of the company is said to have disappeared when the object for which it was incorporated has substantially failed, or when it is impossible to carry on the business of the company except at a loss, or the existing and possible assets are insufficient to meet the existing liabilities.

The substratum of a company will be deemed to have gone when (i) The object for which it was incorporated has substantially failed or has become impossible or (ii) it is impossible to carry on business except at a loss or (iii) the existing and possible assets are insufficient to meet the existing liabilities of the company.

(b) When there is oppression by the majority shareholders on the minority, or there is mismanagement.

(c) When the company is formed for fraudulent or illegal objects or when the business of the company becomes illegal.

(d) When there is a deadlock in the management of the company. When there is a complete deadlock in the management of the company, it will be wound up even if it is making good profits. In *Re Yenidjee Tobacco Co. Ltd.* A and B the only sharehodlers and directors of a private limited company became so hostile to each other that neither of them would speak to the other except through the secretary. Held, there was a complete deadlock and consequently the company be wound up.

(e) When the company is a 'bubble', i.e. it never had any real business.

7.4 PERSONS ENTITLED TO APPLY FOR WINDING UP

The Court does not choose to wind up a company at its own motion. It has to be petitioned. Section 439 of the Companies Act enumerates the persons those can file a petition to the Court for the winding up of a company. The petition for winding up may be brought by any one of the following :

1. Petition by Company

A company can make a petition only when it has passed a special resolution to that effect. However, it has been held that where the company is found by the directors to be insolvent due to circumstances which ought to be investigated by the Court, the directors may apply to the Court for an order of winding up of the company even without obtaining the sanction of the general meeting of the company.

2. Petition by Creditors

The word 'creditor' includes secured creditor, debentureholder and a trustee for debentureholder. A contingent or prospective creditor (such as the holder of a bill of exchange not yet matured or of debentures not yet payable) is also entitled to petition for a winding up of the company.

Before a petition for winding up of a company presented by a contingent or prospective creditors is admitted, the leave of the Court must be obtained for the admission of the petition. Such leave is not granted (a) unless, in the opinion of the Court, there is a prima facie case for winding up the company; and (b) until reasonable security for costs has been given.

Notice that a creditor has a right to winding up order if he can prove that he claims an undisputed debt and that the company has failed to discharge it. When a creditors' petition is opposed by other creditors, the Court may ascertain the wishes of the majority of creditors.

3. Contributory Petition

The term 'contributory' means every person who is liable to contribute to the assets of the company in the event of its being wound up.

Section 428 makes it clear that it includes the holder of fully-paid shares. A fully-paid shareholder will not, however, be placed on the list of contributors, as he is not liable to pay any contribution to the assets, except in cases where surplus assets are likely to be available for distribution.

A contributory is entitled to present a petition for winding up a company if :

(a) the number is reduced, in the case of a public company below seven and in the case of private company below two; and

(b) the shares in respects of which he is a contributory either were originally allotted to him or have been held by him; and

(c) the shares have been registered in his name, for at least six months during the period of 18 months immediately before the commencement of the winding up; and

(d) the shares have been devolved on him during the death of a former holder [Sec. 439(4)].

4. Registrar's Petition

The Registrar can present a petition for winding up a company only on the following grounds, viz.,

(a) if a default is made in delivering the statutory report to the Registrar or in holding the statutory meeting;

(b) if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year ;

(c) if the number of members is reduced, in the case of a public company below seven and in the case of a private company below two ;

(d) if the company is unable to pay its debts; and

(e) if the Court is of opinion that it is just and equitable that the company should be wound up.

Note that the Registrar can file a petition for winding up only with prior approval of the Central Government. The Central Government before sanctioning approval must give an opportunity to the company for making its represent actions, if any.

Again a petition on the ground of default in delivering the statutory report or holding the statutory meeting cannot be presented before the expiration of 14 days after the last day on which the statutory meeting ought to have been held.

5. Petition by any Person Authorised by the Central Government

If it appears to the Central Government from any report of the inspectors appointed to investigate the affairs of the company, that it is expedient to wind up the company because its business is being conducted with intent to defraud creditors, members or any other person, or its business is being conducted for a fraudulent or unlawful purpose, or the management is guilty of fraud, misfeasance or other misconduct, the Central Government may authorise any person to present to the Court a petition for winding up of the company that is just and equitable that the company should be wound up.

7.5 COMMENCEMENT OF WINDING UP (SECTION 441)

Where before the presentation of a petition for the winding up of a company by the Court, a resolution has been passed by the company for voluntary winding up, the winding up of the company will be deemed to have commenced from the date of the resolution. In all other cases (i.e. where the company has not previously passed a resolution for voluntary winding up), the winding up will be deemed to commence from the time of the presentation of the petition for the winding up.

The Court may dismiss or allow the petition for winding up and also can adjourn its hearing or pass conditional order of winding up. In the case of *Misrilal Dharamchand Ltd. v. B. Patnaik Mines Ltd. (1978)* the Court ordered for winding up but stayed the operation of the order for six months so as to enable the company to pay the petitioner, if it could do so within this period and in case of failure the order was to come in force.

Powers of the Court

On hearing a winding up petition, the Court may dismiss it or adjourn the hearing or make interim orders or make an order for winding up the company, with or without costs or any other order that it thinks fit (Section 443).

Consequences of winding up

(i) Where the Court makes an order for winding up of company, the Court must forthwith cause intimation thereof to be sent to the Official Liquidators and the Registrar (Section 444).

(ii) On the making of a winding up order it is the duty of the petitioner in the winding up proceedings and of the company to file with the Registrar a copy of the order of the Court within 30 days from the date of the making of the order [Section 445(1)].

(iii) The winding up order is deemed to be notice of discharge to the officers and employees of the company, except when the business of the company is continued [Section 445(3)].

(iv) When a winding up order has been made, no suit or other legal proceedings can be commenced against the company except with the leave of the Court. Suits pending at the date of the winding up order cannot be further proceeded without the leave of the Court. According to sub-section (2) of Section 446 the Court which is winding up the company has jurisdiction to entertain or dispose of (a) any suit or proceeding by or against the company; (b) any claim made by or against the company; (c) any application made under Section 391 by or in respect of the company ; (d) any question of priorities or any other question whatsoever which may relate to or arise in course of the winding up of the company.

(v) An order for winding up operates in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of a contributory (Section 447).

(vi) According to Section 536 any disposition of the property (including actionable claims) of the company, any transfer of shares in the company or alteration in the status of its members, made after the commencement of the winding up shall be void, unless the Court otherwise orders.

Thus the Court can direct that any such disposition of property or actionable claims or transfer of shares or alteration of status of the members will be valid. But unless the Court so directs, such disposition, transfer or alteration will be void.

(vii) Section 537 declares that any attachment and sale of the estate or effects of the company, after the commencement of the winding up, will be void. In the case of winding up by the Court any attachment, distress or execution put in force, without leave of the Court, against the estate or effects of the company after the commencement of the winding up will be void. Similarly any sale held , without leave of the

Court, of any of the properties or effects of the company after the commencement of the winding up will be void. With leave of the Court, attachment and sale of the properties of the company will be valid even if such attachment and sale are made after the commencement of the winding up of the company. Besides this section does not apply to any proceedings for the recovery of any tax imposed or any dues payable to the Government. Thus I.T.O. can commence assessment proceedings without leave of the Court.

(viii) It is to be noted that winding up order does not bring the business of the company to an end. The corporate existence of the company continues through winding up till the company is dissolved. Thus the company continues to have corporate personality during winding up. Its corporate existence come to an end only when it is dissolved.

(ix) An order for winding up operates in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of contributory.

(x) On a winding up order being made in respect of a company, the Official Liquidator, by virtue of the office, becomes the liquidator of the company (Section 449).

7.6 OFFICIAL LIQUIDATORS

Under the present Act, the only person who is competent to act as the liquidator in a winding up is the official liquidator. For the purpose of winding up, there shall be attached to each high Court an official liquidator appointed by the Central Government, who may be either a whole time or part time officer depending upon the volume of work. In district courts the official receiver will be the official liquidator. The Central

Government may appoint one or more deputy or assistant official liquidators to assist the official liquidator in the discharge of his functions. There is no provision in the Act, for the removal of the official liquidator [Sec. 448(1) & (1-A)].

Liquidator

On a winding up order being made, the official liquidator, by virtue of his office, becomes the liquidator of the company (Sec. 449). Where the official liquidator becomes or acts as liquidator, there shall be paid to the Central Government out of the assets of the company such fees as may be prescribed.

A liquidator shall be described by the style of "The official liquidator" of the particular company in respect of which he acts and not by individual name [Sec. 452].

Provisional Liquidator

The Court may appoint the official liquidator to be the liquidator provisionally at any time after the presentation of the petition for winding up and before making winding up order [Sec. 450 (1)]. Before making such an appointment notice must be given to the company and a reasonable opportunity must be given to it to make representation. The Court may dispense with such notice where there are special reasons. Such reasons must be recorded in writing. A provisional liquidator is as much liquidator as a liquidator in the winding up of a company. But where a provisional liquidator is appointed by the Court, the Court may limit and restrict his powers. On a winding up order being made, the official liquidator shall cease to be provisional liquidator and shall become liquidator of the company.

General provisions for liquidators

The liquidator shall conduct the proceedings in winding up the company and perform such duties as the Court may impose. The official liquidator gets his remuneration from the Central Government and as such he is not entitled to any further remuneration. For the services rendered by the official liquidator to the company, the Central Government shall pay such fees out of the assets of the company as may be prescribed.

The acts of a liquidator shall be valid, notwithstanding any defect that may afterwards be discovered in his appointment or qualification. But his acts shall not be valid if they are done after it has been shown that his appointment was invalid [Sec. 451].

Statement of Affairs [Sec. 454]

The company must make out and submit to the official liquidator a statement as to the affairs of the company in the prescribed form verified by an affidavit and containing the following particulars :

(a) The assets of the company, stating separately the cash balance in hand and at the bank and the negotiable securities held by the company;

(b) Its debts and liabilities;

(c) Names, residences and occupation of its creditors, stating separately the amount of secured and unsecured debts;

(d) In the case of secured debts, particulars of securities given, their value and the dates on which they were given ;

(e) The debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realised on account thereof; and

(f) Such further or other information as may be prescribed or as the official liquidator may require.

Note that the statement must be submitted and verified by one or more of the directors and by the manager, secretary or other chief officer of the company and it must be submitted within 21 days from the relevant date or within such extended time not exceeding three months [Sec. 454 (3)].

Duties of the Liquidator

They may be summarised as under :

(i) He must conduct equitably and impartially all proceedings in the winding up according to the provisions of the law.

(ii) He must submit a preliminary report to the Court as to :

(a) the amount of capital issued, subscribed and paid up and the estimated amount of assets and liabilities, giving separately, under the heading of assets such as (i) cash and negotiable securities; (ii) debts due from contributories; (iii) debts due to the company and securities, if any available in respect thereof ; (iv) immovable and movable properties belonging to the company; and (v) unpaid calls.

(b) if the company has failed, as to the causes of the failure; and

(c) whether in his opinion further inquiry is desirable as to any matter relating to the promotion, formation or failure of the company or the conduct of the business thereof.

Note that the Court may extend the period of six months for the submission of the above report by the official liquidator. The Court may also order that no such statement need be submitted.

(iii) The official liquidator may, if he thinks fit, make further reports, stating the manner in which the company was promoted or formed. He may state in the reports whether in his opinion any fraud has been committed by any person in its promotion or formation, or since the formation thereof. He may also state any other matters which, in his opinion, it is desirable to bring to the notice of the Court [Sec. 455(2)].

(iv) He must take into his custody and control the property of the company.

Notice that so long as there is no liquidator, all the property and effects of the company are deemed to be in the custody of the Court [Sec. 456(2)].

(v) Control of powers : The liquidator must in the administration of the assets of the company and the distribution thereof among its creditors have regard to any directions which may be given by a resolution of the creditors or contributories at any general meeting or by the committee of inspection [Sec. 460(1)]. Any directions given by the creditors or contributories at any general meeting override any directions given by the committee of inspection.

(vi) To Summon Meetings of Creditors and Contributories : He may summon general meetings of the creditors or contributories for the purpose of ascertaining their wishes. But he shall be bound to summon such meetings, at such times, as the creditors or contributories may, by resolution, direct, or whenever requested in writing to do so by not less than one tenth in value of the creditors or contributories, as the case may be [Sec. 460 (3)].

(vii) Proper Books : The liquidator must keep proper books for making entries or recording minutes of proceedings at meetings and of such other matters as may be prescribed. Any creditor or contributory may, subject to the control of the Court, inspect any such books, personally or through his agent [Sec. 461].

(viii) He must, at least twice in each year, present to the Court an account of his receipts and payments as liquidator. The account must be in the prescribed form and must be made in duplicate. The Court gets the account audited, keeps one copy thereof in its records and delivers the other copy to the Registrar for filling. Each copy shall, however, be open to the inspection of any creditor, contributory or person interested. The liquidator must also send a printed copy of the accounts so audited by post to every creditor and to every contributory.

(ix) Within two months from the date of the direction of the Court, the liquidator must call a meeting of the creditors for determining the persons who are to be members of the committee of inspection, if such committee is to be appointed. Within 14 days of the meeting of the creditors, the liquidator must call a meeting of the contributories to consider the decision of the creditors.

(x) Within two months of the expiry of each year from the commencement of winding up, the liquidator must file a statement duly audited, by a qualified auditor with respect to the proceedings in, and position of, the liquidation.

The statement must be filed :

(a) in the case of a winding up by or subject to the supervision of the Court, in the Court ; and

(b) in the case of voluntary winding up, with the Registrar.

Note that when the statement is filed in the Court, a copy must simultaneously be filed with the Registrar and must be kept by him along with the other records of the company [Sec. 551].

Powers of The Liquidator

A liquidator has two types of powers under the Act :

(a) Powers exercisable with the sanction of the Court ; and

(b) Powers exercisable without the sanction of the Court.

Powers with the Sanction of the Court

(a) to institute or defend any suit, prosecution or other legal proceedings, civil or criminal, on behalf of the company ;

(b) to carry on the business of the company for the beneficial winding up of the company ;

(c) to sell the immovable and movable property and actionable claims of the company by public auction or private contract ;

(d) to raise any money required on the security of the assets of the company ;

(e) to appoint an advocate, attorney or pleader to assist him in the performance of his duties ;

(f) to do all such other things as may be necessary for winding up the affairs of the company and distributing its assets.

Note that the Court may by order provide that the liquidator may exercise any of the above powers without the sanction of the Court [Sec. 458).

Powers Without the Sanction of the Court

The liquidator may exercise the following powers without the sanction of the Court, namely, powers :

(a) to execute documents and deeds on behalf of the company and use, when necessary, the company's seal ;

(b) to inspect the records and returns of the company or the files of the Registrar without payment of any fee ;

(c) to draw, accept, make and endorse any bills of exchange, hundis or promissory notes with the same effect as if drawn, accepted, made, or endorsed by the company in the course of its business ;

(d) to prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends in respect thereof;

(e) to take out, in his official name, letters of administration to any deceased contributory ;

(f) to appoint an agent to do any business which he is unable to do himself [Sec. 457(2)]. For example, he can appoint any advocate, attorney or pleader entitled to appear before the Court to assist him in the performance of his duties [Sec. 459], but with the sanction of the Court.

Supervision and control over liquidators

1 Control by contributories and creditors

The contributories and creditors exercise control over the liquidator in the performance of his duties through the medium of the meetings which it is his duty to call from time to time. Any creditor or contributory may, subject to the control of the Court inspect the books which are maintained by the liquidator. The liquidator is also required to print and send a copy of the audited accounts to each creditor and contributory.

2. Control by Court

The liquidator shall apply to the Court for directions in relation to any matter arising in the winding up. The Court has the power to confirm, reserve or modify any act or decision of the liquidator if complained by any aggrieved person. The Court has the power to cause the accounts of the liquidator to be audited in such manner as it thinks fit.

3. Supervision by committee of inspection

The committee of inspection can inspect the accounts of the liquidator at all reasonable times. The liquidator is under an obligation to have directions from the committee of inspection.

4. Control by Central Government

Section 463 seeks to bring the conduct of the liquidators of companies under the control and scrutiny of the Central Government. Where a liquidator does not faithfully perform his duties and duly observe all the requirements imposed upon him by the Act or the rules thereunder with respect to the performance of his duties, or if any complaint is made to the Central Government by any creditor or contributory in regard thereto, the Central Government shall enquire into the matter, and take such action thereon as it may think fit . The power includes the power to remove the liquidator from office.

The Central Government may at any time require any liquidator of a company which is being wound up by the Court to answer any inquiry in relation to any winding up in which he is engaged. It may also, if it thinks fit, apply to the Court to examine him or any other person on oath concerning the winding up. The Central Government may also direct a local investigation to be made of the books and vouchers of the liquidator.

The provisions of this section do not apply where the winding up has been completed after dissolution.

Committee of Inspection (Sections 464, 465)

The Court may, at the time of making an order for the winding up or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator. Where such a direction is given by the Court, the liquidator is required to convene, within 2 months from the date of the direction, a meeting of the creditors to determine who are to be the members of the committee, within 14 days from the date of the creditors' meeting, the liquidator must call a meeting of the contributories to consider the creditors' decision with respect to the membership of the committee. Contributories may accept the decision of the creditors with or without modification or reject it. If the contributories at their meeting do not accept the creditors' decision in its entirely, the liquidator shall apply to the Court for directions as to what the composition of the committee should be and who shall be its members. The committee shall consist of not more than 12 members, being creditors or contributories of the company in such proportion as may be agreed on by the meetings of the creditors and contributories and in case of difference of opinion, as may be determined by the Court. The Committee may inspect the accounts of the liquidator at all reasonable time.

The committee will meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary. The quorum for a meeting of the committee will be one-third of the total number of the members or two, whichever is higher. The committee may act by a majority of its members present at a meeting but shall not act unless a quorum is present. A member may resign by notice in writing signed by him and deliver to the liquidator. If a member of the committee is adjudged as insolvent or compounds or arranges with his creditor or is absent from five consecutive meetings of the committee without leave of those members, who together with himself, represent the creditors or contributories, his office shall become vacant. A member of the committee may be removed at a meeting of the creditors, if he represents creditors, or at a meeting of contributories if he, represents contributories, by an ordinary resolution of which seven days' notice has been given stating the objects of the meeting. When any vacancy has occurred in the committee, the liquidator will call a meeting of the creditors or contributories, as the case may be, and the meeting may reappoint the same person or appoint some other person in the vacancy. However, the liquidator may apply to the Court that the vacancy need not be filled in and if the Court is satisfied that in the circumstances of the case the vacancy need not be filled, it may make an order accordingly.

Dissolution of Company in Winding up by the Court

The Court may make an order for the dissolution of a company in the following conditions : (a) When the affairs of the company have been completely wound up ; or (b) when the Court is of opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason and it is just and equitable in the circumstances of the case that an order of dissolution of the company should be made. Where such an order is made by the Court, the company will be dissolved from the date of the order of the Court. Within 30 days from the date of the order, the liquidator must send a copy of the order to the Registrar. On the dissolution, the corporate existence of the company comes to an end.

Company in liquidation exists as juristic personality until order of dissolution is based by the Court. After the order of dissolution, the legal personality of the company come to an end. The Court may declare the dissolution void within 2 years from the date of the dissolution.

7.7 VOLUNTARY WINDING UP

Winding up by the creditors or members without any intervention of the Court is called 'voluntary winding up'. In voluntary winding up, the company and its creditors are left free to settle their affairs without going to the Court, although they may apply to the Court for directions or orders if and when necessary.

A company may be wound up voluntarily under the circumstances given hereunder :

1. when the period fixed for the duration of the company by the articles has expired or the event has occurred on the occurrence of which the articles provide that the company is to be dissolved and the company in a general meeting has passed a special resolution to wind up voluntarily; or

2. the company has passed a special resolution to wind up voluntarily. Thus a company may be wound up voluntarily at any time and for any reason if a special resolution to this effect is passed in its general meeting.

When a company has passed a resolution for voluntary winding up, it must within 14 days of the passing of the resolution gives notice of the resolution by advertisement in the official Gazette and also in some newspaper circulating in the district where the registered office of the company is situated.

Commencement of Voluntary Winding up

A voluntary winding up is deemed to commence at the time when the resolution for winding up is passed [Sec. 486]. The date of the commencement of the winding up is important for several matters such as liability of past members and fraudulent preferences, etc..

Consequences of Voluntary Winding up

The consequences of voluntary winding up are :

1. From the commencement of voluntary winding up, the company ceases to carry on its business, except so far as may be required for the beneficial winding up thereof [Sec. 487].

2. The possession of the assets of the company vests in the liquidator for realisation and distribution among the creditors. The corporate state and powers of the company shall, however, continue until it is dissolved (Sec 456 and 487).

3. On the appointment of a liquidator, all the powers of the board of directors cease and the liquidator may exercise the powers mentioned in Sec. 512 including the power to do such things as may be necessary for winding up the affairs of the company and distributing its assets. The liquidator appointed in a members' voluntary winding up is merely an agent of the company to administer the property of the company for purposes prescribed by the statue.

Kinds of Voluntary Winding up

Voluntary winding up may be :

(a) A members' voluntary winding up; or

(b) A creditors' voluntary winding -up.

7.7.1 Members' voluntary winding up

A members' voluntary winding up takes place only when the company is solvent. It is initiated by the members and is entirely managed by them. The liquidator is appointed by the members. No meeting of creditors is held and no committee of inspection is appointed. To obtain the benefit of this form of winding up, a declaration of solvency must be filed.

Declaration of solvency

Section 488 provides that where it is proposed to wind up the company voluntarily the directors or a majority of them, may, at a meeting of the board, make a declaration verified by an affidavit that the company has no debts or that it will be able to pay its debts in full within a period not exceeding 3 years from the commencement of winding up as may be specified in the declaration. Such declaration shall be made within five weeks immediately preceding the date of the passing of the resolution for winding up and shall be delivered to the Registrar before that date. It shall also be accompanied by a copy of the auditors on the Profit and Loss Account and the Balance Sheet of the company prepared upto the date of the declaration and must embody a statement of the company's assets and liabilities as on that date.

Where such a declaration is duly made and delivered, the winding up following shall be called members' voluntary winding up. Where the same is not duly made, it shall be called creditors' voluntary winding up.

Sections 490-98 of the Act deal with provisions applicable to members' voluntary winding up. They are as follows :

1. Appointment and Remuneration of Liquidator

On the passing of the resolution for winding up, the company must in a general meeting appoint one or more liquidators and fix his or their remuneration. Any such remuneration cannot be increased at all, not even with the sanction of the Court and the liquidator cannot take charge of his office unless the remuneration is so fixed [Sec. 490].

2. Powers of the Board on Appointment of Liquidator

On the appointment of a liquidator, all the powers of the board and of a managing or whole-time director, and manager, if there be any of these, shall cease, except for the purpose of giving notice of such appointment to the Registrar or in so far as the company in a general meeting or the liquidator may sanction the continuance thereof [Sec. 491].

3. Office of the Liquidator Falling Vacant

If a vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in a general meeting may fill the vacancy [Sec. 492].

4. Notice of Appointment to Registrar

The company must, within 10 days of the appointment of the liquidator, or the filling up of the vacancy, as the case may be, give notice to the Registrar of the event. Default renders the company and every officer (or liquidator) who is in default liable to fine upto Rs. 100 for every day of default [Sec. 493].

5. Calling Meeting of Creditors

If the liquidator at any time is of opinion that the company is insolvent, he must summon a meeting of the creditors, and lay before the meeting a statement of the assets and liabilities of the company [Sec. 495]. Thereafter the winding up proceeds as if it were a creditors' voluntary winding up and not a members' voluntary winding up [Sec. 498].

6. Calling General Meeting at the End of one Year

In the event of the winding up continuing for more than one year, the liquidator must call a general meeting of the company at the end of the first year from the commencement of the winding up at the end of each succeeding year, or at the first convenient date within three months from the end of the year or such longer period as the Central Government may allow, and must lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year [Sec. 496].

7. Final Meeting and Dissolution

As soon as the affairs of the company are fully wound up, the liquidator makes up an account of winding up, showing how the winding up has been conducted and how the property of the company has been disposed of. He then calls a general meeting, of the company and lays before it accounts showing how the winding up has been conducted. This is called the final meeting of the company.

The meeting must be called by advertisement :

(a) specifying the time, place and object of the meeting ; and

(b) published not less than one month before the meeting in the official Gazette, and also in some newspaper circulating in the district where the registered office of the company is situated.

Within one week after the meeting, the liquidator is required to send to the Registrar and the official liquidator a copy of the accounts. He must also make a report to each of them of the holding of the meeting and of the date thereof. If at the final meeting no quorum was present, the liquidator is required to make a report that the meeting was duly called but no quorum was present at the meeting. On receipt of the accounts and the report, the Registrar will register them. On receipt of the accounts and report, the official liquidator will make a scrutiny of the books and papers of the company and make a report to the Court stating the result of the scrutiny. If the report shows that the affairs of the company have been conducted bonafide i. e. not in a manner prejudicial to the interests of its members or to the public interest, then from the date of the submission of the report to the Court, the company shall be deemed to have been dissolved. If the official liquidator in the report has stated that the affairs of the company have been conducted in a manner prejudicial to the interest of its members or to the public interest, the Court shall direct the official liquidator to make a further investigation of the affairs of the company and on the report of the official liquidator on such further investigation, the Court may either make an order that the company shall stand dissolved with effect from the date to be specified in the order of the Court or to make such other order as the circumstances of the case brought out in the report permit [Sec. 497].

7.7.2 Creditors' Voluntary Winding up (Sections 500-509)

In creditors' voluntary winding up, it is the creditors who move the resolution for voluntary winding up of a company, and there is no solvency declaration made by the directors of the company. In other words, when a company is insolvent, that is, it is not able to pay its debts, it is the creditors' voluntary winding up.

Special provisions Relating to Creditors' Voluntary Winding up

There are certain special provisions to be completed with creditors' voluntary winding up. They are :

1. Meeting of Creditors (Sec. 500)

The company must call a meeting of the creditors of the company on the same day or on the next following day on which the general meeting of the company is held for passing a resolution for voluntary winding up. The company must send the notice of the meeting to the creditors by post simultaneously with the sending of the notices of the meeting of the company. The company must also cause the notice of the meeting of the creditors to be advertised once at least in the official Gazettee and once at least in two newspapers circulating in the district where the registered office or principal place of business of the company is situated. At the creditors' meeting, one of the directors shall preside. The board of directors is required to lay before the meeting of the creditors(a) a full statement of the position of the company's affairs and (b) a list of creditors of the company with the estimated amount of their claims.

2. Notice of Registrar [Sec. 501]

Notice of any resolution passed at a creditors' meeting shall be given by the company to the Registrar within 10 days of the passing thereof.

3. Appointment of Liquidator (Sec. 502)

The creditors and the company at their respective meetings may nominate a person to be liquidator for the purpose of winding up the affairs and distributing the assets of the company. If the creditors and the company nominate different persons, the persons nominated by the creditors shall be the liquidator. If no person is nominated by the creditors, the person, if any, nominated by the company shall be the liquidator.

4. Committee of Inspection

The creditors at their first or any subsequent meeting may, if they think fit, appoint a committee of inspection of not more than five members. If such committee is appointed, the company may, either at the meeting at which the winding up resolution is passed or at a later meeting, appoint not more than five persons to serve on the committee. If the creditors object to persons appointed by the company, then the matter will be referred to the Court for the final decision. The powers of such committee are the same as those of a committee of inspection appointed in a compulsory winding up.

5. Remuneration [Sec. 504]

The committee of inspection or if there is no such committee, the creditors may fix the remuneration to be paid to the liquidator or liquidators. Where the remuneration is not fixed, it will be determined by the Court. Any remuneration fixed by the committee of inspection or creditors or the Court shall not be increased.

6. Board's Power to Cease (Sec. 505)

On the appointment of a liquidator, all the powers of the board of directors shall cease, except in so far as the committee of inspection, or if there is no such committee, the creditors in a general meeting, may sanction the continuance thereof.

7. Vacancy in the Office of Liquidator (Sec. 506)

If a vacancy occurs by death, resignation, or otherwise in the office of the liquidator (other than a liquidator appointed by or by the direction of the Court), the creditors in a general meeting may fill the vacancy.

8. Final Meeting and Dissolution (Secs 508-509)

The liquidator must call a general meeting of the company and a meeting of the creditors every year within three months from the close of the liquidation year, if the winding up continues for more than one year. He must lay before the meeting an account of his acts and dealings and of the conduct of winding up during the preceding year and position of winding up. He must call, in the same manner, a final meeting when the affairs of the company are fully wound up and place the same statements before it, as he does in the case of a members' meeting in a members' voluntary winding up under Sections 496 and 497.

7.7.3 Liquidators in Voluntary Winding Up

Appointment of liquidator

In a members' voluntary winding up, the company in general meeting shall appoint one or more liquidators for the purpose of collecting the company's assets and distributing the proceeds among creditors and contributories. If a vacancy occurs by death or resignation or otherwise in the office of the liquidator the company in general meeting may fill the vacancy. [Section 490 and 492].

In the case of a creditors' voluntary winding up, the creditors and the members at their respective meetings, may nominate a person to be the liquidator of the company. However, the creditors are given a preferential right in the matter of the appointment of the liquidator with a power to the Court to vary the appointment on application made within seven days by a director, member or creditor. (Section 502).

Power of the Court to appoint liquidator

In a members' or creditors' voluntary winding up, if for any cause whatever there is no liquidator acting, the Court may appoint the official liquidator or any other person as a liquidator of the company. The Court may also appoint a liquidator on the application of the Registrar. (Section 515).

Body corporate not to be appointed as liquidator

A body corporate shall not be qualified for appointment as a liquidator of a company in a voluntary winding up. Any appointment of a body corporate as liquidator shall be void. (Section 513).

Corrupt inducement affecting appointment as liquidator

Any person who gives or agrees or offers to give, any member or creditor of the company any gratification with a view to securing his own appointment or nomination or to securing or preventing the appointment of someone else, as the liquidator is liable to a fine which may extend upto Rs. 1,000. (Section 514).

Notice by liquidator of his appointment

When a person is appointed as the liquidator and accepts the appointment, he shall publish in the official gazette a notice of his appointment, in the prescribed form. He shall also deliver a copy of such notice to the Registrar. The liquidator shall do this within 30 days of his appointment. When the liquidator fails to comply with the above provision, he is liable to a fine which may extend to Rs. 50 for each day of default. (Section 516).

Effect of the appointment of liquidator

On the appointment of a liquidator, in a members' voluntary winding up, all the powers of the directors, including managing director, whole time directors as also the manager shall cease except so far as the company in general meeting or the liquidator may sanction their continuance. (Section 491).

On the appointment of a liquidator in creditors' voluntary winding up, all the powers of the board of directors shall cease. The committee of inspection or if there is no such committee, the creditors' meeting by resolution may sanction continuance of the powers of the board. (Section 505).

Remuneration of liquidator

In a members' voluntary winding up, the general meeting shall fix the remuneration to be paid to the liquidators. Unless the question of remuneration is resolved the liquidators shall not take charge of the company. Once remuneration is fixed it cannot be increased. (Section 490).

In a creditors' voluntary winding up, the remuneration of the liquidator is fixed by the committee of inspection and if there is no committee of inspection then by the creditors. In the absence of any such fixation, the Court shall determine his remuneration. Any remuneration so fixed shall not be increased (Section 504).

All costs, charges and expenses properly incurred in the winding up, including the remuneration of the liquidator, shall subject to the rights of secured creditors, be payable out of the assets of the company in priority to all other claims (Section 520).

Removal of Liquidator

In either kind of voluntary winding up, the Court may, on cause shown, remove a liquidator and appoint the official liquidator or any other person as a liquidator in place of removed liquidator. The Court may also remove a liquidator on the application of the Registrar.

7.7.4 Powers and Duties of Liquidator in Voluntary Winding Up

Powers

The powers of the liquidator in voluntary winding up are just the same as those of the official liquidator in case of winding up by the Court. In the case of members' voluntary winding up with the sanction of a special resolution of the company and in the case of creditors' voluntary winding up with the sanction of the Court or committee of inspection or the meeting of the creditors if there is no committee of inspection, the liquidator may (a) institute or defend any suit, prosecution or other legal proceedings in the name and on behalf of the company ; (b) carry on the business of the company so far as may be necessary for the beneficial winding up of the company ; (c) to sell the immovable and movable property and actionable claims of the company by public auction or private contract; and (d) raise any money required on the security of the assets of the company (Section 512). Besides, a liquidator in voluntary winding up may, without any sanction whatever, exercise any of the other powers given by this Act to the liquidator in a winding up by the Court. In addition to these powers, a liquidator in voluntary winding up exercise (i) the power of the Court of settling a list of contributories ; (ii) the power of the Court of making calls; (iii) the power of calling general meetings of the company.

Duties

As Section 512 provides a liquidator in voluntary winding up is required to pay the debts of the company and to adjust the rights of the contributories among themselves.

7.8 WINDING UP SUBJECT TO SUPERVISION OF THE COURT

Voluntary winding up may be under the supervision of the Court. At any time after a company has passed a resolution for voluntary winding up, the Court may make an order that the voluntary winding up shall continue, but subject to such supervision of the Court. The Court may give such liberty to creditors, contributories or others to apply to the Court and generally on such terms and conditions as the Court thinks just (Sec. 522).

A petition for the continuance of a voluntary winding up subject to the supervision of the Court shall be deemed to be a petition for winding up by the Court (Sec. 523).

The Court will not in general make a supervision order on the petition of a contributory, unless it is satisfied that the resolution for winding up was so obtained that the minority of members were overborne by fraud or improper or corrupt influence. Where the company is insolvent, the wishes of the creditors only are regarded or the investigation is required.

If a company is being wound up voluntarily or subject to supervision of the Court, a petition for its winding up by the Court may be presented by :

(a) any person authorised to do so under Sec. 439 (which deals with provisions as to applications for winding up), or

(b) the official liquidator [Sec. 440(1)].

Where a supervision is made, the Court may appoint an additional liquidator or liquidators, or remove any liquidator at any time and fill any vacancy. The Court may also appoint the official liquidator as an additional liquidator or to fill any vacancy. The Registrar is also given power to apply to the Court for the removal of a liquidator and the Court may do so (Sec. 524). The liquidator appointed by the Court will act as a voluntary liquidator (Sec. 525). In a voluntary liquidation brought under the Court's supervision, the liquidator's remuneration cannot be increased.

A liquidator appointed by the Court has the same powers, is subject to the same obligations, and in all respects stand in the same position, as if he had been duly appointed in accordance with the provisions of the Companies Act with respect to the appointment of liquidators in voluntary winding up (Sec. 525).

Consequences of Winding up

The consequences of winding up may be discussed under the following heads :

1. Consequences as to Shareholders

A shareholder is liable to pay the full amount upto the face value of the shares held by him. Not only the present, but also the past members are liable on the winding up of the company. The liability of a present member is the amount remaining unpaid on the shares held by him, while a past member can be called upon to pay if the present contributory is unable to pay.

2. Consequences as to Creditors

A company, whether solvent or insolvent, can be wound up under the Act. In case of a solvent company, all claims of its creditors when proved are fully met. But in case of an insolvent company, the rules under the law of insolvency apply.

A secured creditor need not prove his claim against the company. He may realise his security and satisfy the debts. For deficiency, if any, he may put his claim before the liquidator. The secured creditor has also the option to relinquish his security and to prove the amount as if he were an unsecured creditor.

Where an insolvent company is being wound up, the insolvency rules will apply and only such claims shall be provable against the company as are provable against an insolvent person. (Section 529).

When the list of claims is settled the liquidator has to commence making payments. The assets available to the liquidator are applied in the following order :

a. Secured creditors .

b. Cost of the liquidation.

c. Preferential payments.

d. Debentureholders secured by a floating charge.

e. Unsecured creditors

f. Balance returned to the contributories.

Preferential payment

Section 530 enumerates certain debts which are to be paid in priority to all other debts. Such payments are called preferential payments. It may however by noted that such payments are made after paying the secured creditors, and costs, charges and expenses of the winding up.

These preferential payments are : (a) All revenues, taxes, cesses and rates due from the company to the Central or State Government or to a local authority. The amount should have become due and payable within 12 months before the winding up. (b) All wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding 4 months within 12 months, before the winding up and any compensation payable to any workman under any of the provision of Chapter V-A of the Industrial Disputes Act, 1947. The amount must not exceed Rs. 20,000 in the case of any one claimant. (c) All accrued holiday remuneration becoming payable to any employee or in the case of his death to any other person in his right, on the termination of his employment before or by the effect of the winding up. (d) All amounts due in respect of contributions payable by the company as employer but this is not payable if the company is being wound up voluntarily for the purpose of reconstruction and amalgamation (e) All amounts due in respect of any compensation or liability for compensation in respect of death or disablement of any employee under the Workmen's Compensation Act, 1923 but this is not payable if the company is being wound up voluntarily for reconstruction or amalgamation. (f) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employee maintained by the company. (g) The expenses of any investigation held in pursuance of Sections 235 and 237, in so far as they are payable by the company.

3. Consequences as to servants and officers

A winding up order by a Court operates as a notice of discharge to the employees and officers of the company except when the business of the company is continued. The same principle will apply as regards discharge of employees in a voluntary winding up. Where there is a contract of service for a particular period, an order for winding up will amount to wrongful discharge and damages will be allowed as for breach of contract of service.

4. Consequences of proceedings against the company

When a winding up order is made, or an official liquidator has been appointed as provisional liquidator no suit or legal proceedings can be commenced and no pending suit or legal proceeding continued against the company except with the leave of the Court and on such terms as it may impose. In the case of a voluntary winding up, the Court may restrain proceedings against the company if it thinks fit.

It may be noted that law does not prohibit proceedings being taken by the company against others including directors, or officers or other servants of the company.

5. Consequences as to costs

Where the assets of the company are insufficient to satisfy the liabilities, the Court may make an order for payment out of the assets of the costs, charges and expenses incurred in the winding up. The Court may determine the order of priority in which such payments are to be made (Section 476).

6. Consequences as to documents

When a company is being wound up whether by or under the supervision of the Court or voluntarily, the fact must be made known to all those having any dealing with the company; every document in the nature of an invoice, order for goods or business letter issued in the name of the company, after the commencement of winding up must contain a statement that the company is being wound up (Sec. 547).

Where a company is being wound up, all documents of the company and of the liquidators shall, as between the contributories of the company, be prima facie evidence of the truth of all matters recorded therein (Sec. 548).

Where an order for winding up of the company by or subject to the supervision of the Court is made, any creditor or contributory of the company may inspect the books and the papers of the company, subject to the provisions made in the rules by the Central Government in this behalf.

7.9 WINDING UP OF INSOLVENT COMPANIES

Section 529 of the Companies Act applies to winding up of the company which cannot pay all its debts i.e. to an insolvent company only in respect of the following :

(a) debts provable.

(b) the valuation of annuities and future and contingent liabilities; and

(c) the respective rights of secured and unsecured creditors.

All persons who would be entitled to prove for and receive dividends out of the assets of the company may come in under the winding up and made such claims against the company as they respectively are entitled to. But it is not necessary for a secured creditor to prove his debt in the winding up and he can stand wholly outside the winding up proceedings. However, if a secured creditor instead of giving up his security and providing for his debt proceeds to realise his security, he shall be liable to pay the expenses incurred by the liquidator for the presentation of the security before its realisation by the secured creditor.

The rules of insolvency in India are to be found in the Presidency Towns Insolvency Act, 1909 and Provincial Insolvency Act, 1920. Only such of the rules contained in these Acts as relate to the respective rights of the secured and unsecured creditors, and to debts provable and to the valuation of certain liabilities shall apply under Section 529. Apart from these provisions, in respect of other matters such as those relating to priority of debts, all questions have to be determined with reference to the Companies Act only.

Section 529 ceases to be applicable as soon as it is found the company in the course of winding up is not insolvent. The provisions of the laws of insolvency applicable to insolvent companies will not apply to such company and it will be treated as having been solvent throughout the winding up proceedings.

7.10 WINDING UP OF UNREGISTERED COMPANIES (SECTIONS 582-583)

The term "Unregistered Company" includes any partnership, association of company consisting of 8 or more members at the time when the petition for winding up is presented, but it does not include a railway company incorporated under any Act of Parliament or other Indian Law or any Act of Parliament of U.K., a company registered under the present Indian Companies Act or any of the previous Indian Companies Acts. An unregistered company may be wound up under the provisions of this Act and with some exception all the provisions relating to the winding up are applicable to it. However such a company can only be wound up by the Court and cannot be wound up voluntarily or subject to the supervision of the Court. Such a company may be wound up if (a) the company is dissolved or has ceased to carry on business or is carrying on business only to wind up its affairs; (b) the company is unable to pay its debts; and (c) the Court is of opinion that it is just and equitable that the company should be wound up.

7.11 WINDING UP OF FOREIGN COMPANIES

Where a foreign company which has been carrying on business in India, cease to carry on business in India, it may be wound up as an unregistered company, not withstanding that the foreign company, has been dissolved or otherwise ceased to exist as such under or by virtue of the laws of the country under which it was incorporated (Section 584).

7.12 EFFECTS OF WINDING UP ON ANTECEDENT AND OTHER TRANSACTIONS

The effects of winding up on antecedent and other transactions are as follows:

1. Fraudulent Preference (Sec. 531)

Any transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property, within six months before the commencement of its winding up, shall be deemed a fraudulent preference of its creditors and be invalid accordingly.

Fraudulent preference here relates similarly to fraudulent preference under insolvency law, where any individual transfers any property or makes any payment within three months before the presentation of an insolvency petition, such transfers shall be deemed a fraudulent preference in his insolvency. Under the Companies Act, 1956, the period is six months instead of three months.

2. Avoidance of the Voluntary Transfer

Section 531 A introduced by the Amendment Act, 1960, lays down that any transfer of property, movable or immovable, or any delivery of goods made by a company within a period of one year before the commencement of its winding up shall be void against the liquidator unless such transfer or delivery is made in the ordinary course of business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration.

Further, any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors in void (Sec. 532).

3. Avoidance of floating charge

Section 534, prevents an insolvent company from creating a floating charge on its undertaking to secure past debts or for moneys which do not come in the hands of the company. It provide that where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, shall unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, expect to the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration, for the charge, together with interest on that amount at the rate of five per cent, per annum or such other rate as may for the time being be notified by the Central Government in this behalf in the official gazettee :

Section 534 makes the charge invalid but the debt is not affected. The debt secured by such charge becomes an unsecured debt.

4. Disclaimer of Onerous Property (Sec. 535)

Disclaimer means abandoning. Where any part of the property of a company which is being wound up consists of :

(a) land of any tenure, burdened with onerous covenants ;

(b) shares or stock in companies;

(c) any other property which is unsaleable by reason of its binding the possessor thereof either to the performance of any onerous act or to the payment of any sum of money ; or

(d) unprofitable contracts.

The liquidator of the company may, with the leave of the Court, by a writing signed by him, at any time within 12 months after the commencement of the winding up, disclaim the property.

The disclaimer shall release the company and the property from the rights, interests and liabilities. The disclaimer shall not affect the rights or liabilities of any other person.

The Court before or on granting leave to disclaim may require such notices to be given to persons interested.

7.13 SUMMARY

Winding up of a company may be defined in the proceeding by which a company is dissolved. These are three modes of winding up of a company namely compulsory winding up by the court, voluntary winding up and voluntary winding up with the intervention of the court section 433 of the Companies Act contains the cases in which the company may be wound up by the court. The petition for winding up of a company may be presented to the court by any of the person enumerated in Section 439. The winding up proceedings are conducted by an official to be known as the official liquidator. The voluntary winding up means the winding up by the members or creditors themselves without any intervention of the court. The members and creditor are left free to settle their affairs without going to the court. The winding up with the intervention of the court is ordered when the voluntary winding up has already commenced. As a matter of fact, it is the voluntary winding up but under the supervision of the court.

7.14 KEYWORDS

Winding-up: Winding-up is a proceeding for the realisation of the assets, the payment of creditors, and the distribution of the surplus, if any, among the shareholders so that the company may be finally dissolved.

Contributory: A contributory means any person liable to contribute to the assets of a company in the event of its being wound up.

Liquidator: A liquidator is a person who is appointed by the court to conduct the proceedings in winding up the company and perform such duties in reference thereto as the court may impose.

Voluntary Winding-up: Winding-up the creditors or members without any intervention of the court is called voluntary winding-up.

Unregistered Company: It includes any partnership association, or company consisting of more than seven members at the time when petition for winding up is presented before the Tribunal.

Official Liquidator: An official liquidator is an officer who helps the court in conducting and completing the winding up proceedings.

7.15 SELF ASSESSMENT QUESTIONS

1. What are the different modes of winding up ? Discuss in detail.
2. What is compulsory winding up ? What are the grounds for compulsory winding up ?
3. Who can petition for the winding up of a company ? On what grounds can the Registrar of Companies petition for winding up of the company ?

4. Who is a liquidator ? What are the duties of a liquidator ?

5. Explain the provisions of the Companies Act in respect of the creditors' voluntary winding up. How does it differ from a members' voluntary winding up ?

6. What is winding up subject to the supervision of the Court ? What are the advantages of a supervision order ? What are the consequences of such a winding up ?

7.16 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

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

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

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

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

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

LESSON : 8

INDIAN CONTRACT ACT 1872 – ESSENTIALS OF VALID CONTRACT

STRUCTURE

8.0 Objective

8.1 Introduction

8.2 The Indian Contract Act, 1872

8.3 Definition of Contract

8.4 Essentials of a Valid Contract

8.5 Kinds of Contracts

8.6 Summary

8.7 Keywords

8.8 Self Assessment Questions

8.9 Suggested Readings

8.0 OBJECTIVE

After going through this lesson, you must be able to

(i) to discuss about the origin and importance of Indian Contract Act 1872;

(ii) to understand definition and essentials of a valid contract; and

(iii) to bring out the various kinds of contracts.

8.1 INTRODUCTION

Law of contract is the most important branch of Business Law. It would have been very difficult, to carry on trade or commerce in the absence of this law. It is not only the business community which is concerned with the law of contracts, but it affects every person. Contract is considered as the foundation of the civilised world. Since every one of us enters into a number of contracts from sunrise to sunset. When a person drinks a cup of tea, or rides a bus, or goes to the cinema to see a movie or purchases the goods, or gives a loan to friend, etc. he enters into a contract though he may be unaware of it. Such contracts create legal rights and obligations. The law of contract is mainly concerned with the enforcement of these rights and obligations.

The law of contract determines the circumstances in which a promise or an agreement shall be legally binding on the person making it. It is concerned with rights in personam as distinguished from rights in rem. For example, if X is entitled to receive a sum of money from Y, this right can only be exercised by X and not by others. This is a right in personam. On the other hand, if X owns a plot of land and Y is the immediate neighbour, the right of X to have complete possession and enjoyment of land is available not only against Y but against the whole world. This right of X is known as the right in rem.

8.2 THE INDIAN CONTRACT ACT, 1872

The laws of contract in India is contained in the Indian Contract Act, 1872. This Act is based mainly on English Common Law which is to a large extent made up of judicial precedents. It extends to the whole of India except the State of Jammu and Kashmir and came into force on the first day of September 1872. The Act is not exhaustive. It does not deal with all the branches of the law of contract. There are separate Acts which deal with contracts relating to negotiable instruments, transfer of property, sale of goods, partnership, insurance, etc. Further the Act does not affect any usage or custom of trade (Sec. 1). A minor amendment in Section 28 of the Act was made by the Indian Contract (Amendment) Act, 1996.

1. General principles of the law of contract are expressed by sections 1 to 75

(a) The contracts of Indemnity and Guarantee are given under Secs. 124-147.

(b) Sections 124-147 and 182-238 contains the principles regarding contracts of Bailment and Pledge and Contracts of Agency respectively.

The provisions of Indian Contract Act are subjection to some assumptions. The various provisions of the Indian Contract Act, it will be proper to see some of the basic assumptions underlying the Act include : (i) Subject to certain limiting principles, there shall be freedom of contract to the contracting parties and the law shall enforce only what the parties have agreed to be bound. The law shall not lay down absolute rights and liabilities of the contracting parties. Instead it shall lay down only the essentials of a valid contract and the rights and obligations it would create between the parties in the absence of anything to the contrary agreed to by the parties ; and (ii) Expectations created by promises of the parties shall be fulfilled and their non-fulfilment shall give rise to legal consequences. If the plaintiff asserts that the defendant undertook to do a certain act and failed to fulfil his promise an action at law shall apply.

8.3 DEFINITION OF CONTRACT

A legally binding agreement is called a contract. In other words a contract is an agreement which will be enforced by the courts. Salmond defines contract as, "an agreement creating and defining obligation between the parties". Halsbury defines a contract to be, "an agreement between two or more persons which is intended to be enforceable at law and is constituted by the acceptance by one party of an offer made to him by the other party to do or abstain from doing some act."

Section 2(h) of the Indian Contract Act defines a contract as, "An agreement which is enforceable at law." This definition has two important components which constitute the basis for a contract. They are : (1) An agreement, and (2) Legal obligation. We shall now examine these elements in detail.

1. **Agreement :** Every promise and every set of promises, forming the consideration for each other, is an agreement [Sec. 2 (e)]. Thus it is clear from this definition that a promise is an agreement. What is a promise? The answer to this question is contained in Section 2(b) which defines the term :" 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". An agreement, therefore, comes into existence only when one party makes a proposal or offer to the other party and that other party signifies his assent (i.e., gives his acceptance) thereto. In short, an agreement is the sum total of 'offer' and 'acceptance'.

On analysing the above definition the following characteristics of an agreement become evident :

(a) *Plurality of persons :* There must be two or more persons to make an agreement because one person cannot enter into an agreement with himself.

(b) *Consensus-ad-idem* : Both the parties to an agreement must agree about the subject-matter of the agreement in the same sense and at the same time.

2. Legal Obligation : As stated above, an agreement to become a contract must give rise to a legal obligation. Obligation is an undertaking to do or to abstain from doing some definite act. The obligation must be such as is enforceable by law. In other words, it must be a legal obligation and not merely moral, social or religious. To take an example, "Please, come to my house", says Ram to Mohan, "and we shall go out for a walk together". Mohan came to the house of Ram but Ram could not leave the house because of some important engagement. Mohan cannot sue Ram in damages for his not fulfilling the promise, the reason being that there had been no intention between Mohan and Ram to create any legal obligation by the agreement as made between them. In the circumstances, there was, in eye of law no contract between Ram and Mohan.

Similarly, an another kind of obligation which does not constitute a contract is the arrangement made between husband and wife. Such agreements are purely domestic and are not intended to create legal relationship.

The Leading case on this point is **Balfour v. Balfour (1919)**

Facts of the case are : Mr. Balfour was employed in Ceylon. Mrs. Balfour owing to ill health, had to stay in England and could not accompany him to Ceylon. On the accusation of leaving her in England for medical treatment Mr. Balfour promised to send her ƒ 30 per month while he was in abroad. But Mr. Baulfour failed to pay that amount. So Mrs. Balfour filed a suit against her husband for recovering the said amount. The court held that it was a mere domestic agreement and that the promise made by the husband in this case was not intended to be a legal obligation. Hence the suit filed by Mrs. Barfour was dismissed since there was no contract enforceable in a court of law.

Decision of the Case

(a) Agreements which do not create legal relations are not contracts.

(b) Agreements between husband and wife in domestic affairs is not a contract.

It may be noted that the law of contract deals only with such obligations which spring from agreements. Obligations which are not contractual in nature are outside the scope of the law of contract. For example, obligation to maintain wife and children, obligation to comply with the orders of a court and obligation arising from a trust do not fall within the scope of The Contract Act. Sir John

Salmond has rightly observed. "The law of contract is not the whole law of agreements, nor is it the whole law of obligations. It is the law of those agreements which create obligations and those obligations which arise from an agreement".

8.4 ESSENTIAL ELEMENTS OF A VALID CONTRACT

Students must remember that all agreements are not contracts. Only that agreement which is enforceable at law is a contract. In other words, the parties to the agreement must have intended that it shall have legal consequences and be Legally enforceable. An agreement which is not enforceable at law cannot be a contract. Thus, the term agreement is more wider in scope than contract. All contracts are agreements but all agreements are not contact.

An agreement, to be enforceable by law, must possess the essential elements of a valid contract as contained in section 10 of the Indian Contract Act. According to Section 10, "All agreements are contract if they are made by the free consent of the parties, competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void." As the details of these essentials form the subject-matter of our subsequent chapters, it is proposed to discuss them in brief here.

The essential elements of a valid contract are as follows :

1. **Offer and acceptance :** There must be a 'lawful offer' and a 'lawful acceptance' of the offer, thus resulting in an agreement. The adjective 'lawful' implies that the offer and acceptance must satisfy the requirements of the Contract Act in relation thereto.

2. **Intention to create legal relations :** There must be an intention among the parties that the agreement should be attached by legal consequences and create legal obligations. Agreements of a social or domestic nature do not

contemplate legal relations, and as such they do not give rise to a contract. An agreement to take dinner at a friend's house is not an agreement intended to create legal relations and therefore is not a contract. Agreements between husband and wife also lack the intention to create legal relationship and thus do not result in contracts.

Illustrations : (a) H promises his wife W to get her a saree if she will sing a song. W sang the song but H did not bring the saree for her. W cannot bring an action in a court to enforce the agreement as it lacked the intention to create legal relations.

(b) The defendant was a civil servant stationed in Ceylon. He and his wife were enjoying leave in England. When the defendant was due to return to Ceylon, his wife could not accompany him because of her health. The defendant agreed to send her ƒ 30 a month as maintenance expenses during the time they were thus forced to live apart. She sued for breach of this agreement. Her action was dismissed on the ground that no legal relations had been contemplated and therefore there was no contract.

In commercial agreements an intention to create legal relations is presumed. Thus, an agreement to buy and sell goods intends to create legal relationship, hence is a contract, provided other requisites of a valid contract are present. But if the parties have expressly declared their resolve that the agreement is not to create legal obligation, even a business agreement does not amount to a contract. The case of Rose & Frank Co. vs Crompton and Brothers Ltd., provides a good illustration on the point.

Illustration : In the above case R company entered into an agreement with company, by means of which the former was appointed as the agent of the latter. One clause of the agreement was a follows : "This arrangement is not entered into as a formal or legal agreement and shall not be subject to legal jurisdiction in the law courts. It was held that there was no intention to create legal relations on the part of parties to the agreement and hence there was no contract.

3. **Consensus ad idem :** The minds of both the parties must be ad idem. In other words, the two parties must have agreed about the subject matter of the contract at the same time and in the same sense. For instance, if A who owns two cars, one Ambassador and the other Fiat, offers to sell B one car, A intending it to be the Ambassador, B accepts the offer thinking that it is the Fiat, there is no consensus and hence no contract.

4. **Competency of Parties :** The parties to the agreement must be competent to contract. If either of the parties to the contract is not competent to contract, the contract is not valid. According to section 11 following are the persons who are competent to contract –

(a) who have attained the age of majority according to the law to which they are subject;

(b) who are of sound mind;

(c) who are not disqualified from contracting by any law to which they are subject.

5. **Lawful consideration :** The third essential element of a valid contract is the presence of 'consideration'. Consideration has been defined as the price paid by one party for the promise of the other. An agreement is legally enforceable only when each of the parties to it gives something and gets something. The something given or obtained is the price for the promise and is called 'consideration'. Subject to certain exception, gratuitous promises are not enforceable at law.

The consideration may be an act (doing something) or forbearance (not doing something) or a promise to do or not to do something. It may be past, present or future. But only those considerations are valid which are lawful. The consideration is lawful, unless - it is forbidden by law; or is of such a nature that, if permitted it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another; or is immoral; or is opposed to public policy (Sec. 23).

6. **Free Consent :** An agreement must have been made by free consent of the parties. A consent may not be free either on account of mistake in the minds of the parties or on account of the consent being obtained by some unfair means like coercion, fraud, misrepresentation or undue influence. In case of mutual mistakes, the contract would be void, while in case the consent is obtained by unfair means, the contract would be voidable.

7. **Lawful object :** For the formation of a valid contract it is also necessary that the parties to an agreement must agree for a lawful object. The object for which the agreement has been entered into must not be fraudulent or illegal or immoral or opposed to public policy or must not imply injury to the person or property of another (Sec. 23). If the object is unlawful for one or the other reasons mentioned above the agreement is void. Thus, when a landlord knowingly lets a house to a prostitute to carry on protection, he cannot recover the rent through a court of law.

8. **Written and Registered :** According to the Indian Contract Act, a contract may be oral or in writing. But in certain special cases it lays down that the agreement, to be valid, must be in writing or/and registered. For example, it requires that an agreement to pay a time barred debt must be in writing and an agreement to make a gift for natural love and affection must be

in writing and registered (Sec. 25). Similarly, certain other Acts also require writing or/and registration to make the agreement enforceable by law which must be observed. Thus, (i) an arbitration agreement must be in writing as per the Arbitration and Conciliation Act, 1996; (ii) an agreement for a sale of immovable property must be in writing and registered under the Transfer of Property Act, 1882 before they can be legally enforced.

9. **Not declared to be void :** The agreement must not have been declared to be expressly void. Agreements mentioned in sections 24 to 30 have been expressly declared to be void.

10. **Certainty :** Section 29 of the Contract Act provides that "Agreements, the meaning of which is not certain for capable of being made certain, are void". In order to give rise to a valid contract the terms of the agreement must not be vague or uncertain. It must be possible to ascertain the meaning of the agreement, for otherwise, it cannot be enforced.

Illustration :A agrees to sell B a hundred tons of oil. There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

11. **Possibility of Performance :** Yet another essential feature of a valid contract is that it must be capable of performance. Section 56 lays down that "An agreement to do an act impossible in itself is void". If the act is impossible in itself, physically or legally, the agreement cannot be enforced at law.

Illustration : A agrees with B to discover treasure by magic. The agreement is not enforceable.

All the elements mentioned above must be present in order to make a valid contract. If any one of them is absent the agreement does not become a contract.

8.5 KINDS OF CONTRACTS

From the point of view of Enforceability

From the point of view of enforceability a contract may be valid or voidable or void or unenforceable or illegal.

1. **Valid contract :** An agreement enforceable at law is a valid contract. An agreement becomes a contract when all the essentials of a valid contract as laid down in section 10 are fulfilled. A offers to sell his house for Rs. 10,000 to B. B agrees to buy it for this price. It is a valid contract. A contract to enter into a contract is, however, not a valid contract.

2. **Void contract :** A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable. It is a contract without any legal effects. A contract may be valid at the time when it is made but it may become void subsequent to its formation Thus, a contract with one who had been an alien friend but later on becomes an alien enemy would be a case of a void contract.

However, a void contract is not necessarily unlawful, it is destitute of legal effects. The law will not enforce such a contract, nor can it be made valid by the parties.

A void contract should be distinguished from void agreement. An agreement not enforceable at law is a void agreement. In the case of a void agreement no contract comes into existence. An agreement with a minor is void. But in the case of void contract, a contract does come into existence but subsequently ceases to be enforceable by law. An agreement which is void never matures into a contract. An agreement which becomes illegal in the course of performance is a case of avoid contract, while an agreement which is null and void *ab initio* is a case of a void agreement. Void contracts may better be called void agreements to avoid contradiction in terms.

3. **Voidable contract :** According to Section 2(i), "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". Thus, a voidable contract is one which is enforceable by law at the option of one of the parties. Until it is avoided or rescinded by the party entitled to do so by exercising his option in that behalf, it is a valid contract.

Usually a contract becomes voidable when the consent of one of the parties to the contract is obtained by coercion, undue influence, misrepresentation or fraud. Such a contract is voidable at the option of the aggrieved party i.e., the party whose consent was so caused (Secs. 19 and 19A). But the aggrieved party must exercise his option of rejecting the contract (i) within a reasonable time, and (ii) before the rights of third parties intervene, otherwise the contract cannot be repudiated.

Illustrations : (a) A. threatens to shoot B if he does not sell his new Bajaj Scooter to A for Rs. 2,000. B agrees. The contract has been brought about by coercion and is voidable at the option of B.

4. **Unenforceable contract :** It is a contract which is otherwise valid, but cannot be enforced because of some technical defect like absence of a written form or absence of a proper stamp. Such contracts must be sued upon by one or both of the parties. Such contracts cannot be proved in the court. Such contracts will not be enforced by the courts until and unless the defect is rectified.

(b) Amar intending to deceive Akabar falsely represents that five hundred quintals of indigo are made annually at Amar's factory and thereby induces

Akabar to buy the factory. The contract has been caused by fraud and is voidable at the option of Akabar.

Other circumstances under which a contract becomes voidable : The Indian Contract Act has laid down certain other situations also under which a contract becomes voidable. For example,

(i) When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, then the contract becomes voidable at the option of the party so prevented (Sec. 53).

Illustration : A. contracts with B that A shall whitewash B's house for Rs. 100. A is ready and willing to execute the work accordingly, but B prevents him from doing so. The contract becomes voidable at the option of A.

(ii) When a party to the contract promises to do a certain thing within a specified time, but fails to do it, then the contract becomes voidable at the option of the promise, if the intention of the parties was that time should be of the essence of the contract (Sec. 55).

Illustration : X agrees to sell and deliver 10 bags of wheat to Y for Rs. 2,500 within one week. But X does not supply the wheat within the specified time. The contract becomes voidable at the option of Y.

Consequences of rescission of voidable contract : Section 64 lays down the rights and obligations of the parties to a voidable contract after it is rescinded. The Section states that when a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is a promisor. If the party rescinding a voidable contract has received any benefit from another party to such contract, he must restore such benefit, so far as may be, to the person from whom it was received.

For example, when a contract for the sale of a house is avoided on the ground of undue influence, any money received on account of the price must be refunded. Notice that the Section aims at placing both the parties to a voidable contract, after its rescission, on the same footing as for there had been no contract at all. But it must be remembered that the benefit which is to be restored must have been received under the contract.

Void agreement : "An agreement not enforceable by law is said to be void" (Sec.2 (g)). Thus a void agreement does not give rise to any legal consequences and is void ab-initio. In the eye of law such an agreement is no agreement at all from its very inception. There is absence of one or more essential elements of a valid contract, except that to 'free consent', in the case of a void agreement. Thus, an agreement with a minor is void ab-initio as against him, because a minor lacks the capacity to contract. Similarly, an agreement without consideration is void ab-initio, of course with certain exceptions as laid down in Section 25. Certain agreements have been expressly declared void in the Contract Act e.g., agreements which are in restraint of trade or of marriage or of legal proceedings or which are by way of wager.

Obligation of person who has received advantage under void agreement or contract that becomes void : In this connection Section 65 lays down that when an agreement is discovered to be void or when a contract becomes void any person who has received any advantage under such agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it. Thus, this Section provides for restitution of the benefit received; so that both parties may stand unaffected by the transaction; in the following two cases :

(a) *When an agreement is discovered to be void :* In other words, when an agreement is void ab-initio but the fact of its being void being discovered at a later stage. For example, A pays B Rs. 1,000 for B's agreeing to sell his horse to him. It turns out that the horse was dead at the time of the bargain, though neither party was aware of the fact. In this case the agreement is discovered to be void and B must repay to A Rs. 1,000. It should, however, be noted that agreements which are known to be void or illegal, when they are entered into, are excluded from the purview of this Section.

(b) *When a contract becomes void :* Restitution is also allowed in the case of a void contract. For example, A agrees to sell B after one month 10 quintals of wheat at Rs. 700 per quantal and receives Rs. 600 as advance. Soon after the contract, private sales of wheat are prohibited by an Act of the legislature. The contract becomes void but A must return the sum of Rs. 600 to B. Similarly, where after accepting Rs. 1,000 as advance for singing at a concert for B, A is too ill to sing. A is not bound to make compensation to B for the loss of the profits which B would have made if A would have been able to sing, but A must refund to B the 1,000 rupees paid in advance.

5. *Illegal Contract :* A contract which is either prohibited by law or otherwise against the policy of law is an illegal contract. It is void ab-initio. Thus, a contract to commit dacoity is an illegal contract and cannot be enforced at law. An illegal contract should be distinguished from a void contract. Both are unenforceable at law but there is something more in an illegal contract. Every illegal contract is a void contract but every void contract may not be illegal contract e.g. a wagering agreement is void but not illegal or an agreement with a minor is void but not illegal. Every void contract is not illegal unless its object or consideration is (a) immoral or (b) opposed to public policy etc. A

void contract does not affect a collateral contract. But when a contract is illegal collateral contracts depending thereon are also void. An illegal contract is like an infectious disease and is fatal not only to the main contract but to collateral contract as well.

Example : X borrows Rs. 10,000 from Y for the purpose of smuggling goods.

Y knows the purpose of the loan. The agreement between X and Y is collateral to the main agreement which is illegal. The collateral agreement is also illegal.

Difference between voidable contract and void agreement

1. A void agreement has from the very beginning no legal effects. It is unenforceable at law. A voidable contract is one which one of the parties may affirm or reject at his option. It is valid and enforceable till it is repudiated or rescinded.

2. The defect in the case of voidable contract is curable and may be condoned. But a void agreement is void ab initio and its defects are incurable.

3. In the case of a void agreement even a third party cannot acquire any right from person claiming under such contract while in the case of voidable contract, a third party can acquire a valid title from a person claiming under such a contract.

4. Since a void agreement is unenforceable at law there does not arise any question of compensation on account of the non-performance of the agreement. But in case of a voidable contract, a person is entitled to compensation for loss or damages suffered by him on account of the non-performance of the contract.

5. A voidable contract does not affect the collateral transaction. But where the agreement is void on account of illegality of the object, the collateral transaction will also become void.

8.5.2 Contracts Classified on the basis of performance

1. *Unilateral contract :* A unilateral contract is one in which a promise on one side is exchanged for an act on the other wide. In such contracts one party to the contract has performed his part and an obligation is outstanding against the other party. Thus, where a doctor in a private clinic, examines a patient and gives the medicine, the patient alone remains liable to pay the fees. It is a case of unilateral contract.

2. *Bilateral contract :* In such a contract a promise on one side is exchanged for a promise on the other. It is a contract in which there is an obligation on the part of both the parties to do or to refrain from doing a particular act. A promises to paint a picture in return for which B promises to pay Rs. 500. Here a promises to paint the picture and B promises to pay. Each party is thus both a promisor and a promisee.

3. *Executed contract* : A contract is said to be executed when one party to the contract has performed his share of the obligation and the other party is still to perform his share of the promise. In executed contracts, the contract does not come into existence until one party to it has done all that he can be required to do. Thus, where A advertises a reward of Rs. 500 to anyone who finds his missing dog, and when B knowing the offer brings the missing dog, A becomes liable to pay Rs. 500.

4. *Executory contract :* It is a contract where some future act is to be done. It is one which is either wholly unperformed, or there remains something to be one of both the sides. Thus, where an agreement is made to build a house in six months, it is an executory contract.

8.5.3 Kinds of Contracts from the Point of View of Mode of Creation

From the point of view of mode of creation a contract may be anyone of the following types :

1. *Express contract :* Where both the offer and acceptance constituting an agreement enforceable at law are made in words spoken or written, it is an express contract. For example A tells B on telephone that he offers to sell his car for Rs. 1,00,000 and B in reply informs A that he accepts the offer, there is an express contract.

2. *Implied contract :* Where both the offer and acceptance constituting an agreement enforceable at law are made otherwise than in words i.e., by acts and conduct of the parties, it is an implied contract. Thus, where A, coolie in uniform takes up the luggage of B to be carried out of the Railway station without being asked by B, and B allows him to do so, then the law implies that B agrees to pay for the services of A, and there is an implied contract. Similarly, where M, a professional shoe shiner starts polishing the shoes of N without being requested to do so, and N allows M to polish his shoes knowing that M expects to be paid for the service, there comes into existence an implied contract and N is under obligation to pay to M.

3. *Constructive or quasi-contract :* It is a contract in which there is no intention on either side to make a contract, but the law imposes a contract. In such a contract rights and obligations arise not by any agreement between the parties but by operations of law. Thus, a finder of lost goods is under an obligation to find out the true owner and return the goods. Similarly, where certain books are delivered to a wrong addressee, the addressee is under an obligation either to pay for them or return them.

8.6 SUMMARY

A contract is a legally binding agreement. Section 2(h) of the Indian Contract Act defines a contract as, "An agreement which is enforceable at law". The concept of contract as outlined above, consists of two elements namely 'obligation and 'agreement'.

According to Section 10 of the Indian Contract Act "All agreements are contracts if they are made by the free consent of the parties, competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void". The following are the essential elements of a valid contract : (1) Offer and acceptance. (2) Legal relationship. (3) Consensus ad idem. (4) Competency of parties. (5) Free consent. (6) Lawful consideration. (7) Lawful object. (8) Not declared to be void. (9) Certainty (10) possibility of performance. (11) Written and Registered.

The contracts are of the following kinds

1. *Valid contract :* An agreement enforceable at law is a valid contract. An agreement becomes a contract when all the essentials of a valid contract as laid down in section 10 are fulfilled.

2. *Void contract :* A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable. It is a contract without any legal effects and is a nullity.

3. *Voidable 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 other or others is a voidable contract.

4. *Unenforceable contract* : It is a contract which is otherwise valid, but cannot be enforced because of some technical defect like absence of a written

form or absence of a proper stamp.

5. *Illegal contract :* A contract which is either prohibited by law or otherwise against the policy of law is an illegal contract. It is void *ab inito*.

6. *Express contract :* An express contract is one entered into by words which may be either spoken or written.

7. *Implied contract* : Where the proposal or acceptance is made otherwise than in words, it is an implied contract.

8. *Constructive or quasi-contract :* It is contract in which there is no intention on either side to make a contract, but the law imposes a contract. In such a contract rights and obligations arise not by any agreement between the parties but by operation of law.

9. *Executed contract :* A contract is said to be executed when one party to the contract has performed his share of the obligation and the other party is still to perform his share of the promise.

10. *Executory contract :* It is a contract where some future act is to be done. It is one which is either wholly unperformed, or there remains something to be done on both the sides.

8.7 KEYWORDS

Contract: A contract is an agreement creating and defining obligations between the parties.

Agreement: An agreement is the sum total of offer and acceptance.

Valid Contract: A valid contract is one, which satisfied all the requirements prescribed by the law for the validity of a contract.

Void Contract: It is one which was legal and enforceable which it was entered into but has subsequently become void because of certain reasons.

Voidable Contract: A voidable contract is a contract which can be avoided or set aside at the option of one of the parties to the contract.

Implied Contract: Where the proposal or acceptance is made otherwise than in words, it is an implied contract.

8.8 SELF ASSESSMENT QUESTIONS

1. "An agreement enforceable by law is a contract". Discuss the definition and bring out clearly the essentials of a valid contract.

2. "All contracts are agreements, but all agreements are not contracts". Discuss the statement explaining the essential elements of a valid contract.

3. What do you understand by the terms 'void' and 'voidable' contracts? Discuss the rights and obligations of the parties to a void contract and to a voidable contract after its rescission.

4. Write short notes on valid contract, void contract, void agreement, illegal contract, unilateral contract and bilateral contract.

5. Distinguish between :

   (a) Void and Voidable contracts

   (b) Void agreements and Void contracts

   (c) Void and Illegal agreements

6. "In business agreements, the presumption is that the parties intend to create legal relations". Discuss.

7. X invited Y and his family to dinner on a certain night. Y accepted X's invitation. On the date fixed Y drove with his family from sector 13 to Industrial Area and found his house locked. They waited upto 9.30p.m. but the hosts did not turn up. They left the place and had their meals in Piccadilly in Sector 17. The cost of meal came to Rs. 100. Can Y recover the amount?

8. M agrees to pay N Rs. 100 and in consideration N agrees to write for him 100 pages within five minutes. Is it a valid a contract?

   [Hints No, it is not a valid contract. It is a avoid agreement because as per Section 56 "an agreement to do an act impossible in itself is void"]

8.9 SUGGESTED READINGS

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

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LESSON : 9

CONSIDERATION

STRUCTURE

9.0 OBJECTIVE

After reading this lesson the students must be able to

(i) Define consideration in the eye of law;

(ii) Describe essentials of a valid consideration; and

(iii) Understand exceptions to the rule, 'No consideration, No contract'.

9.1 INTRODUCTION

According to section 10 of Indian Contract Act, 'Consideration' is one of the essential elements of a valid contract. The fact of its existence serves to distinguish those promises by which the promisor intends to be legally bound from those which are not seriously meant. In the words of Blackstone : "A consideration of some sort or other is so necessary to the forming of a contract, that a *nudum pactum*, or agreement to do or pay something on one side, without any compensation on the other, will not at law support an action; and a man cannot be compelled to perform it... The law supplies no means nor affords any remedy to compel the performance of an agreement made without consideration. If I promise a man £100 for nothing, he neither doing nor promising anything in return or to compensate me for my money, my promise has no force in law". The breach of a gratuitous promise cannot be redressed by legal remedies. It is only when a promise is made in return of 'something' from the promisee, that such promise can be enforced by law against the promisor. This something in return is the consideration for the promise.

Definition of Consideration : It may be defined as the price for which the promise of the other is bought. It is something which is of some value in the eyes of law. It may be some benefit to the plaintiff or some detriment to the defendant. It is also used in the sense of *quid pro quo* i.e. something in return.

Section 2(d) of the Indian Contract Act defines consideration as :

(a) when at the desire of the promisor,

(b) the promisee or any other person,

(c) has done or abstained from doing, or does or abstains from doing, or promises to do or abstain from doing,

(d) something, such act or abstinence or promise is called a consideration for the promise.

The definition of consideration as given in section 2(d) is a simple and practical definition. It is something of value which the promisee has given, gives or promises to give in return for the promise. It does not mean payment of money only. Forbearance to sue is good consideration. A promise can be a consideration for another promise. A single consideration may support more than one promise. It can also consist in performance. Settlement of dispute can be a good consideration for the promise. Similarly, if the promisee gives up any legal right, he gives sufficient consideration to support the other party's promise. Thus, refraining from smoking, gambling or drinking would supply the consideration needed to support another person's promise to pay a certain sum of money to the one who refrained. But the mere doing of a thing which a person is already legally bound to do is no consideration for a new promise in his favour.

Illustrations : (a) X agrees to sell his horse to Y for Rs. 10,000. Here X's promise to sell his horse is for Y's consideration to pay Rs. 10,000. Similarly, Y's promise to pay Rs. 10,000 is for X's consideration to sell his horse to Y.

(b) A agrees to give Rs. 1,000 to B as a voluntary donation for a temple building. This promise is not binding on A because there is no reciprocal consideration for his promise. However, if B has undertaken any liability on the faith of A's promise, the contract is binding on A.

(c) A promises his debtor B not to file a suit against him for one year on B's agreeing to pay him Rs. 100 more. The abstinence of A is the consideration for B's promise to pay.

9.2 ESSENTIALS OF VALID CONSIDERATION

The essentials of a valid consideration are discussed as follows :

1. **It must move at the desire of the promisor** : In order to constitute legal consideration, the act or abstinence forming the consideration for the promise must be done at the desire or request of the promisor. Thus acts done or services rendered voluntarily, or at the desire of third party, will not amount to valid consideration so as to support a contract. The logic for this may be

found in the worry and expense to which every one might be subjected, if he were obliged to pay for services, which he does not need or require.

The leading case on this point is Durga Parsad v. Baldeo (1880)

Decision : Consideration should be at the desire of the promisor.

Facts of the case are : D promised to pay P a commission on articles sold by him in a bazar in which he occupied a shop in consideration of P having expended money in the construction of such bazar. The money had not been spent by P at the request of D but was spent by him at the desire of the Collector of the District. In a suit by P it was held that there was no consideration for the promise made by D and hence no contract.

Illustration : Mr. A advanced money to B on an undertaking given by his father and obtain promissory notes for the amount advanced. On a suit to recover the amount, it was held that these pronotes were without consideration in as much as the advances were not made at the request of B. (Raja of Venkatagiri v. Krishnaya AIR 1948 P.C. 150).

A promise to subscriber to a public or a charitable object is unenforceable because there is not benefit to the promisor. But where the other party has undertaken a liability on the faith of the promise made by the promisor, it is enforceable.

The leading case on this point is *Kedar Nath v. Gori Mahomed (1886)*

Decision : An Act done at the request of the promisor is a good consideration to supply the promise.

Facts on the case are : X had agreed to subscribe Rs. 100 towards the construction of a Town Hall at Hawrah. Y the secretary of the committee, on the faith of the promise called for plans and entrusted the work to contractors and undertook liability to pay them. X refused to pay the promised amount and Y brought a suit against him. It was held that though the promise was to subscribe to a charitable institutions and there was no benefit to X, yet it was supported by consideration in that Y, the promisor suffered a detriment in having undertaken a liability to the contractors on the faith of the promise made by X.

But where nothing has been done in furtherance of the object of the fund raised a promised subscription is not legally recoverable.

2. Consideration may move from the promisee or any other person : The important feature of the definition of consideration in Section 2 (d) is that the act which is to constitute a consideration may be done by the promise or any other person. It means that as long as there is a consideration for a promise, it is immaterial who has given it. It may move from the promisee, or if the promisor has no objection, from any other person. This is wider than the concept of England, where consideration can move only from the promisee. Consideration moving from a third party who is minor is no consideration.

The leading case on this point is *Chinnaya v. Ramaya (1882)*

Decision : Consideration may move from the promisee or any other person.

Facts of the case are : An old lady made a gift of her property to her daughter with a direction to pay a certain sum of money to the maternal uncle by way of annuity. On the same day, the daughter executed a writing in favour of the maternal uncle agreeing to pay the annuity. The daughter did not, however, pay the annuity and the uncle sued to recover it. It was held that there was sufficient consideration for the uncle to recover the money from the daughter.

Illustration : X, Y and Z enter into an agreement under which X pays Rs. 1,000 to Y and Y agreed to build a house for Z. Here Z is a party to the contract but stranger to consideration and can enforce the contract.

It will be observed in the above case that there was no contract between the daughter and the maternal uncle, but as a result of the agreement between the old lady and her daughter, the uncle was the beneficiary and was entitled to the consideration though he was a stranger to the contract. Therefore, consideration need not move from the promisee, but can move from any other person.

9.3 A STRANGER TO A CONTRACT CANNOT SUE :

A person may be a stranger to the consideration but he should not be a stranger to the contract because privity of contract is essential for enforcing any of the rights arising out of the contract. It being a fundamental principle of the law of contracts that a stranger to a contract cannot use, only a person who is a party to a contract can sue on it. Thus where A mortgages his property to B in consideration of B's promise to A to pay A's debt to C, C cannot file a suit against B to enforce his promise, C being no party to the contract between A and B (Iswaram Pillai vs Sonnivaveru, 1915, 38 Mad. 753).

Exceptions : The above rule that a stranger to a contract cannot sue is subject to the following exceptions :

(i) *Where an express or implied trust is created :* In case of a trust, the beneficiary can sue in his own right to enforce his rights under the trust, though he was not a party to the contract between the settler and the trustees.

Illustration : (a) A transfers certain properties to B to be held by B in trust for the benefit of M.M. can enforce the agreement i.e., trust (M.K. Rapai vs John, (1965), A.I.R. Ker 203)

(ii) *Family settlement :* Where a provision is made in a partition or family arrangement for maintenance or marriage expenses of female members; such members, though not parties to the agreement, can sue on the footing of the arrangement.

Illustration : A daughter a long with her husband entered into a contract with her father whereby it was agreed that she will maintain her mother and the property of the father will be conveyed to them. The daughter subsequently refused to maintain the mother. On a suit it was held that the mother was entitled to require her daughter to maintain her, through she was a stranger to the contract (Veeramma vs Appayya, 1957, A.I.R. AP 965).

(iii) *When the defendant constitutes himself, as the agent of the third party.* Thus if A receives some money from B to be paid over to C and he admits of this receipt to C, then C can recover this amount from A who shall be regarded as the agent of C (Surajan vs Nanat, 1940, A.I.R. Lah 471).

(iv) *In case of agency :* Where a contract is entered into by an agent, the principal can sue on it.

(v) *In case of assignment of rights under a contract* in favour of a third party either voluntarily or by operation of law, the assignee can enforce the benefits of the contract, e.g., the assignee of an insurance policy or the official assignee on the insolvency of a person can sue on the contract even though originally they were not parties to it.

3. **Consideration may be past, present or future :** The words, "has done or abstained from doing; or does or abstains from doing; or promises clearly indicate that the consideration may consist of either something done or not done in the past, or done or not done in the present, or promised to be done or not done in the future. To put it briefly, consideration may consist of a past, present or a future act or abstinence.

Consideration may consist of an act or abstinence. For example, an agreement between B and A, under which B; on failing to pay the debt amount on the due date to A; promises to raise the rate of interest from 9 per cent to 12 per cent in consideration of A promising not to file a suit against him for another one year is a valid contract; A's abstinence being the consideration for B's promise.

Past Consideration : When something is done or suffered before the date of the agreement, at the desire of the promisor, it is called 'past consideration'. It must be noted that past consideration is good consideration only if it is given by the promisee, 'at the desire of the promisor'.

Illustrations : (i) A teaches the son of B at B's request in the month of January, and in February B promises to pay A a sum of Rs. 500 for his services. The services of A will be past consideration.

(ii) A lawyer, gave up his practice and served as manger of a landlord at the latter's request in lieu of which the landlord subsequently promised a pension. It was held that there was good past consideration. (Shiv Saran vs Kesho Prasad).

Present Consideration : When the consideration for a promise is given simultaneously with the promise it is called present consideration. A present consideration consists in doing or abstaining from doing something. A promise to give time to a debtor is good consideration. Present consideration arises where there is a promise to pay for goods sold and delivered.

Future consideration : A future or executory consideration is a promise to do or give something in return in future for the promise then made. It is also called a promise for the promise. Mutual promises to marry, a promise to do working return of promise of payment are examples of future consideration.

Illustration : A promises to deliver goods to B when the ship arrives and B promises to pay A Rs. 1000 against the receipt of goods. This is a case of future consideration, which is to be performed by both the parties when the ship arrives.

4. **It need not to be adequate :** The law of contract nowhere laid down that consideration should be adequate to the promise. What is required is that there must be some consideration for the promise. Adequacy is for the parties to decide at the time of making the agreement. Inadequacy of consideration is no ground for refusing the performance of the promise, unless it is evidence of fraud. It should be of some value in the eyes of law. Even a smallest consideration is sufficient provided it has some value. If a man gets what he contracted for, the court will not inquire whether it was an equivalent to the promise which he gave in return. Where in an agreement the consent of the promisor has been freely given, an inadequacy of the consideration will not render it unenforceable. For example **:** A agrees to sell his house worth Rs. 90,000 to B for Rs. 9,000. A's consent to the agreement was freely given, the agreement is a contract not withstanding the inadequacy of the consideration.

Consideration must be real : Though consideration need not be adequate, it must be of some value in the eyes of law, i.e., it must be real and competent. Where consideration is physically impossible, illegal, uncertain or illusory, it is not real and therefore shall not be a valid consideration.

(i) *Physically impossible :* A promise to do something which is physically impossible, e.g., to make a dead man alive or to run at a speed of 100 kilometres per hour, does not form valid consideration.

(ii) *Legally impossible :* A promise to do something which is illegal, e.g., a promise for illegal cohabitation, does not amount to good consideration.

(iii) *Uncertain consideration :* A promise to do something which is too vague and uncertain, e.g., a promise to pay such remuneration "as shall be deemed right", is no consideration in the eye of law.

(iv) *Illusory consideration :* Again, an illusory or deceptive consideration does not amount to a valid consideration. Consideration is illusory if it consists in a promise to perform a public duty, or to perform a contract already made with the promisor.

Illustration : A (the plaintiff) received a subpoena (a kind of summon) to appear at a trail as a witness on behalf of B (the defendant). B promised him a sum of money for his trouble. On default by B, A filed the suit for the recovery of the promised sum. It was held that A being under a public duty to attend and give evidence, there was no consideration for the promise and hence the promise is unenforceable (Callins vs Godefroy).

9.4 EXCEPTIONS OF THE RULE, "NO CONSIDERATION, NO CONTRACT "

Consideration being one of the essential elements of a valid contract, the general rule is that "an agreement made without consideration is void". But there are a few exceptions to the rule where an agreement without consideration will be perfectly valid and binding. These exceptions are as follows :

1. **Agreement made on account of natural love and affection :** An agreement made without consideration is enforceable if, it is (i) expressed in writing, and (ii) registered under the law for the time being in force for the registration of documents, and is (iii) made on account of natural love and affection, (iv) between parties standing in a near relation to each other. Thus there are four essential requirements which must be complied with to enforce an agreement made without consideration, as per Section 25(1).

Illustration : (a) A for natural love and affection, promises to give his son B, Rs. 1,000. A puts his promise to B into writing and registers it. This is a valid contract. (b) A, by registered agreement on account of love and affection for his brother B undertook to discharge a debt due by B to C. Actually A did not fulfil the promise. So B paid the debt. It was held that B could recover the amount of debt from A. [Venkataswamy v. Rangaswamy (1903) 13 M.L.J. 428].

It should, however, be noted that mere existence of a near relation between the parties does not necessarily import natural love and affection. Thus where a Hindu husband, after referring to quarrels and disagreement between him and his wife, executed a registered document in favour of his wife, agreeing to pay for separate residence and maintenance, it was held that the agreement was void for want of consideration because it was not made out of natural love and affection. [RajlaKhi Devi vs Bhootnath) (1990), 4,C.W. N. 488].

2. **Compensation for services rendered**

According to Section 25(2), agreement made without consideration may be valid if it is a promise to compensate wholly or in part a person who has already voluntarily done something of the promisor or something which the promisor was legally compliable to do. To apply this rule, the following essentials must exist :

(a) the act must have been done voluntarily;

(b) for the promisor or it must be something which was the legal obligation of the promisor;

(c) the promisor must be in existence at the time when the act was done';

(d) the promisor must agree now to compensate the promisee.

A promise to pay for past services voluntarily rendered would be enforceable under this rule. If, however, something has not been done voluntarily, this clause will not apply. Thus, where the services were rendered by the advocate on request and were not voluntarily it was held that this clause had no application. The promisor should be in existence at the time when the service is rendered. Work done by the promoters of a company before its formation cannot be said to have been done for the company. Such a clause in the articles of association is not binding unless it is subsequently confirmed by the company.

3. **Agreement to pay a time-barred debt** Sec. 25 (3) expressed that where there is an agreement, made in writing and signed by the debtor or by his authorised agent, to pay wholly or impart a debt barred by the law of limitation, the agreement is valid even though it is not supported by any consideration. A time barred debt cannot be recovered and therefore a promise to repay such a debt is without consideration, hence the importance of the present exception.

But before the exception can apply, it is necessary that :

(i) the debt must be such of which the creditor might have enforced payment but for the law for the limitation of suits [Sec. 25(3)];

(ii) the promisor himself must be liable for the debt;

(iii) there must be an 'express promise to pay' a time barred debt as distinguished from a mere 'acknowledgement of a liability' in respect of a debt; and

(iv) the promise must be in writing and signed by the debtor or his agent.

Illustration : A owes B Rs. 1,000, but the debt is barred by the Limitation Act. A signs a written promise to pay B Rs. 500 on account of the debt. This is a contract (Appended to Sec.25).

4. **Completed gifts :** Explanation 1 to section 25 provides that the rule 'No consideration, of contract' shall not affect validity of any gifts actually made between the donor and the donee. Thus if a person gives certain properties to another according to the provisions of the Transfer of Property Act, he cannot subsequently demand the property back on the ground that there was no consideration.

5. **Agency :** There is one more exception to the general rule. It is given in section 185 which says that no consideration is needed to create on agency. Consideration is defined to be the price for which the promise of the other is bought.

9.5 SUMMARY

Section 2(d) of the 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 promise is called a consideration for the promise. The Essentials of valid consideration are (1) It must at the desire of promisor. (2) It may move from the promisee or any other person. (3) It may be past, present or future. (4) It need not be adequate. (5) It must be real. (6) It must be lawful. No one but the parties to a contract can sue or be sued under it. A third person cannot demand performance of a duty or obligation under it even though he has a direct interest in such performance except in certain recognised cases. An agreement made without consideration is void. Section 25 specifies the cases where an agreement though made without consideration will be valid. These are :

1. An agreement though made without consideration will be valid if it is in writing and registered and is made on account of natural love and affection between parties standing in a near relation to each other.

2. An agreement made without consideration may be valid if it is a promise to compensate wholly or in part of person who has already voluntarily done something for the promisor or something which the promisor was legally compliable to do .

3. A promise to pay a time barred debt is enforceable.

4. No consideration is needed to create an agency.

5. Completed gifts.

9.6 KEYWORDS

Consideration: Consideration is the price for which the promise of other is bought, and promise thus given for value is enforceable.

Privity to Contract: Privity to contract means stranger to a contract.

Privity of Consideration: Privity of consideration means stranger to the consideration, or consideration given by any other person other than the promisee.

9.7 SELF ASSESSMENT QUESTIONS

1. Define consideration. How far is it necessary for the validity of a contract ? Critically discuss the essential elements of consideration.

2. Explain the term consideration and state the exceptions to the rule – 'No consideration, no contract'.

3. "A stranger to a contract cannot sue" Discuss are there any exceptions to this rule ?

4. "Consideration need not to be adequate but it must have some value in the eye of law". Explain.

5. A and B are friends, B treats A during A's illness. B does not accept payment form A for the treatment and A promises B's son, X, to pay him Rs. 1,000. A being in poor circumstances, is unable to pay, X sues A for the money. Can X recover?

9.8 SUGGESTED READINGS

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

Nirmal Singh, Business Law, Deep and Deep Publication Pvt. Ltd., New Delhi.

M.C. Kuchhal, Mercentile Law, Vikas Publishing House Pvt. Ltd., New Delhi.

Avtar Singh, The Priciples of Mercantile Law, Eastern Book Co., Lucknow.

M.C. Shukla, A Manual of Mercantile Law, S. Chand & Co., New Delhi.

R.S.N. Pillai and Bagavathi, Business Law, S. Chand & Co., New Delhi.

LESSON : 10
CAPACITY OF PARTIES

STRUCTURE

10.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Discuss the capacity of parties to a contract.

(b) Explain the provisions of law relating to contracts by minors.

(c) Discuss the law relating to contracts by persons of unsound mind.

10.1 INTRODUCTION

An essential element of a valid contract according to Section 10, is that the contracting parties must be 'competent to contract'. Section 11 lays down that "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". Thus a person is competent to contract under :

(a) if he is not a minor, according to the law to which he is subject,

(b) if he is not of unsound mind, and

(c) if he is not disqualified from contracting by any law to which he is subject.

We shall now discuss them one by one in detail.

10.2 MINOR

A minor is a person who is not a major. According to The Indian Majority Act, 1875, a minor is one who has not completed his or her 18th year of age. A person attains majority on completing his 18th year in India. In the following two cases, a person continues to be a minor until he completes the age of 21 years.

(a) Where a guardian of a minor person or property has been appointed under the Guardians and Wards Act, 1890; or

(b) Where the superintendence of a minor's property is assumed by a Court of Words.

10.2.1 Why should minors be protected ?

A minor has an immature mind and cannot think what is good or bad for him. Minors are often exploited and their properties stolen. As such he must be protected by law from any exploitation or ill design.

But at the same time, law should not cause unnecessary hardship to persons who deal with minors.

10.2.2 Effects of minor's agreements

A minor's agreement being void is wholly devoid of all effects. When there is no contract there should be no contractual obligation on either side. The various rules regarding minor's agreement are discussed below.

1. **An agreement with or by a minor is void**

Section 10 of the Contract Act requires that the parties to a contract must be competent and Section 11 says that a minor is not competent. But neither section makes it clear whether the contract entered into by a minor is void or voidable. Till 1903, courts in India were not unanimous on this point. The Privy Council made it perfectly clear that a minor is not competent to contract and that a contract by a minor is void *ab initio*.

The leading case on this point is *Mohori Bibi v. dharmo Das Ghose (1914; 37 Mad 38)*

Decision : An agreement with or by a minor is absolutely void.

Facts of the case are : A, a minor borrowed Rs. 20,000 from B and as a security for the same executed a mortgage in his favour. He became a major a few months later and filed a suit for the declaration that the mortgage executed by him during his minority was void and should be cancelled. It was held that a mortgage by a minor was void and B was not entitled to repayment of money.

2. **No ratification**

An agreement with minor is completely void. A minor cannot ratify the agreement even on attaining majority, because a void agreement cannot be ratified. A person who is not competent to authorise an act cannot give it validity by ratifying it. Thus, where a minor borrowed a sum of money by executing a simple pronote for it and after attaining majority executed a second pronote in respect of the original loan plus interest thereon, a suit upon the second pronote was not maintainable.

If on coming of age, a minor makes a new promise and not merely an affirmation of the old promise, for a fresh consideration, the new promise will be binding.

3. **Beneficial agreements are valid contracts :** Any agreement which is of some benefit to the minor and under which he is required to bear no obligation, is valid. In other words, a minor can be a beneficiary e.g., a payee, an endorsee of a promise under a contract (*Goekda Latcharao vs Vishwanadham Bhomayya).* Thus money advanced by a minor can be recovered by him by a suit because he can take benefit under a contract. The Hindu Minority and Guardianship Act, 1956, also provides to the same effect, namely a natural guardian is empowered to enter into a contract on behalf of the minor and the contract would be binding and enforceable if the contract is for the benefit of the minor.

Example : (i) A duly executed transfer by way of sale or mortgage in favour of a minor, who has paid the whole of the consideration money, is enforceable by him or by any other person on his behalf [(*Raghava Chariar vs Srinivasa*, (1917), 40 Mad. 308 (F.B.)].

Example : (ii) X, a minor, insured his goods with an insurance company. The goods were damaged. X filed a suit for claim. The insurance company took the plea that the person on whose behalf the goods were insured was a minor. The court rejected the plea and allowed the minor to recover the insurance money. [The General American Insurance Company Ltd. v. Madan Lal Sonu Lal (1935) 59 Bom 656].

Contracts of apprenticeship and service by a minor : A contract of apprenticeship stands on a different footing than an agreement of service by a minor. A contract of apprenticeship is valid and binding upon a minor because such a contract is protected by the Apprentices Act, 1961, provided the case falls within the terms of that Act. The Act, inter alia, provides that the minor must not be less than fourteen years of age and the contract must be entered into on behalf of the minor by his guardian. The Act was passed with a view to enabling children to learn trades, crafts and employment, by which, when they come to full age, they may gain a livelihood. So far as an agreement of service by a minor is concerned, it is void because a minor's promise to serve would supply no consideration for the promise of the defendant to pay him/her a salary.

4. **Liability for necessaries**

The case of necessaries supplied to a minor or to any person whom such minor is legally bound to support is governed by section 68 of the Indian contract Act. A claim for necessaries supplied to a minor is enforceable at law. But a minor is not liable for any price that he may promise and never for more than the value of the necessaries. There is no personal liability of the minor, but only his property is liable. A minor is also liable for the value of necessaries supplied to his wife.

"What is a necessary article", is to be determined with reference to the status and circumstances of the particular minor. Objects of mere luxury are not necessaries, nor are objects, which though of real use are excessively costly. Food and clothing may be taken as simple examples of necessaries. The necessaries would also include the infant's lodging expense, medical attendance, cost of defending a minor in civil and criminal proceedings. Loans taken by a minor to obtain necessaries also bind him. But where a minor is engaged in trade, contracts entered into by him for trading purposes are not for necessaries and are not binding on him.

Not only must the goods supplied be such as are suitable to the minor's status, they must also be actually necessary. Ten suits of clothes are necessaries for a minor whereas even three suits may not be deemed necessary for another.

The whole question turns upon the minor's status in life. Utility rather than ornament is the criterion.

Example : Inman an infant undergraduate in Cambridge bought eleven fancy waistcoats from Nash. He was at the time adequately provided with clothing. Held the waistcoats were not necessary and the price could not be recovered. [Nash v. Inman. (1908) 2. K.B.I.].

Certain services rendered to a minor have been held to be necessaries. These include education, medical advice, a house given to a minor on rent for the purpose of living and continuing his studies, etc.

Goods necessary when ordered might have ceased to be necessary by the time they are delivered e.g., where a minor orders a suit from a tailor but buys other suits before that order is actually delivered. Here the minor could not be made to pay the tailor.

The following have been held to be necessaries :

(i) Livery for an officer's servant.

(ii) Horse, when doctor ordered riding exercise.

(iii) Goods supplied to a minor's wife for her support.

(iv) Rings purchased as gifts to the minor's fiancee.

(v) A racing bicycle.

On the other hand, following have been held not to be necessaries :

(i) Goods supplied for the purpose of trading.

(ii) A silver-gift goblet.

(iii) Cigars and tobacoo.

(iv) Refreshment to an undergraduate for entertaining.

5. **The rule of estoppel does not apply to a minor**

Where a minor by misrepresenting his age has induced the other party to enter into a contract with him, he cannot be made liable on the contract. There can be no estoppel against a minor. In other words, a minor is not estoppled from pleading his infancy in order to avoid a contract. It has been held by a Full Bench of the Bombay High Court in the case of Gadigeppa v. Balangowda (A.I.R. 193, BOM 561) that where an infant represents fraudulently that he is of majority age and thereby induces another to enter into a contract with him, then in an action founded on the contract, the infant is not estopped from setting up infancy. The court may, however, require the minor to compensate the other party on the ground of equity. This is based on the rule that a minor can have no privilege to cheat men.

Fraudulent misrepresentation as to age by an infant will operate against him in certain cases. If a minor obtains property or goods by misrepresenting his age, he can be compelled to restore it but only so long as the same is traceable in his possession.

If by misrepresenting himself to be of full age, has obtained money from a trustee and given release, the release is good and he cannot compel the trustee to make payment a second time.

6. **No Specific performance**

A minor's contract being absolutely void, there can be no question of the specific performance of such a contract. A guardian of minor cannot bind the minor by an agreement for the purchase of immovable property; so the minor cannot ask for the specific performance of the contract which the guardian had no power to enter into.

7. **Liability for torts**

A minor is liable in tort. Thus, where a minor borrowed a horse for riding only he was held liable when he let the horse to one of his friends who jumped and killed the horse. Similarly, a minor was held liable for his failure to return certain instruments which he had hired and passed on to a friend. But a minor cannot be made liable for a breach of contract by framing the action on tort. You cannot convert a contract into a tort to enable you to sue an infant.

8. **Partnership**

A minor being incompetent to contract cannot be a partner in a partnership firm, but under section 30 of the Indian Partnership Act, he can be admitted to the benefits of partnership.

9. **Minor agent.** A minor can be an agent (Sec. 184). He shall bind the principal by his acts done in the course of such an agency, but he cannot be held personally liable for negligence or breach of duty. Thus in appointing a minor as an agent, the principal runs a great risk.

10. **Minor and insolvency.** A minor cannot be adjudicated as an insolvent, for, he is incapable of contracting debts. Even for necessaries supplied to him, he is not personally liable, only his property is liable (Sec. 68).

11. **Contract by minor and adult jointly.** Where a minor and an adult jointly enter into an agreement with another person, the minor has no liability but the contract as a whole can be enforced against the adult (Jamna Bai vs Vasanta Rao). In Sain Das vs Ram Chand, [(1923). 4 Lah. 334] where there was a joint

purchase by two vendees, one of whom was a minor, it was held that the vendor could enforce the contract against the major vendee.

12. **Minor shareholder.** A minor, being incompetent to contract, cannot be a shareholder of the company. A company can also refuse to register transfer or transmission of shares in favour of a minor unless the shares are fully paid. It follows from it that a minor, acting through his lawful guardian, may become a shareholder of the company, in case of transfer or transmission of fully paid shares to him. Logically also, if a minor could legally hold property in his name, it would be wrong to debar him from holding fully paid up shares in his own name.

10.3 PERSONS OF UNSOUND MIND

As stated earlier, the section 11 disqualifies a person who is not of sound mind from entering into a contract. Contracts made by persons of unsound mind like a minor's contract are void. The reason is that a contract requires assent of two minds but a person of unsound mind has nothing which the law recognises as a mind.

Section 12 deals with the question as to what is sound mind for the purpose of entering into a contract. It lays down that, "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".

The Section further states that :

(i) "A person who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind." Thus a patient in a lunatic asylum, who is at intervals of sound mind, may contract during those intervals.

(ii) "A person who is usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind". Thus, 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 interest, cannot contract while such delirium or drunkenness lasts.

In Halsbury's Laws of england , it is stated "The general theory of the law in regard to acts done, contracts made by parties affecting their rights and interests, is that in all cases there must be a free and full consent to bind the parties. Consent is an act of reason accompanied by deliberation, and it is upon the ground that there is a want of rational and deliberate consent that the conveyance and contracts of unsound mind are generally deemed to be invalid; or in other words, (subject to exceptions), there cannot be a contract by a person of unsound mind."

Unsoundness of mind may arise from : (a) Idiocy – It is God given and permanent, with no intervals of saneness. The mental powers of an idiot are completely absent because of lack of development of the brain; (b) Lunacy or Insanity – It is a disease of the brain. A lunatic loses the use of his reason due to some mental strain or disease. Of course he may have lucid intervals of sanity: (d) Drunkenness – It produces temporary incapacity, till the drunkard is under the effect of intoxication, provided it is so excessive as to suspend the reason for a time and create impotence of mind; (d) Hypnotism – It also produces temporary incapacity, till the person is under the impact of artificially induced sleep; (e) Mental decay on account of old age, etc.

Effects of agreements made by persons of unsound mind : An agreement entered into by a person of unsound mind is treated on the same footing as that of minor's and therefore an agreement by a person of unsound mind is absolutely void and inoperative as against him but he can derive benefit under it (Jugal Kishore vs Cheddu, 1903, ALL L.J.43). The property of a person of unsound mind is, however, always liable for necessaries supplied to him or to any one whom he is legally bound to support, under Section 68 of the Act.

10.4 DISQUALIFIED PERSONS

The third type of incompetent persons, as per Section 11, are those who are "disqualified from contracting by any law to which they are subject". These are:

1. Alien enemies : An alien living in India is competent to contract with citizens of India. He can maintain an action on a contract entered into by him during peace time. But if a war is declared, an alien enemy cannot enter into any contract with an Indian citizen. Contracts entered into before the declaration of war are either stayed or terminated but contracts entered into during the war are unenforceable.

2. **Foreign sovereigns and ambassadors :** These persons are immune from the jurisdiction of local courts, unless they voluntarily submit to its jurisdiction. These persons have right to contract but can claim the privilege of not being sued. The rules regarding suits by or against foreign sovereigns are laid down in sections 84 to 87 of Civil-Procedure Code.

Example : E, who was a diplomat and was on the staff of a foreign embassy rented a house belonging to M.M. sued him for arrears of rent. It was held that no action could be brought against him as he was protected by diplomatic privileges. [Engelke v. Musman (1928) A.C. 433].

3. Convict : A convict is one who is found guilty and is imprisioned. During the period of imprisonment, a convict is incompetent (a) to enter into contracts, and (b) to sue on contracts made before conviction. On the expiry of the sentence, he is at liberty to institute a suit and the Law of Limitation is held in abeyance during the period of his sentence.

4. **Married women :** Married women are competent to enter into contracts with respect to their separate properties (*Stridhan*) provided they are Major and are of sound mind. They cannot enter into contracts with respect to their husbands' properties. A married woman can, however, act as an agent of her husband and bind her husband's property for necessaries supplied to her, if he fails to provide her with these.

5. **Insolvents :** An insolvent cannot enter into a contract as his property vests in the official receiver or official assignee. This disqualification of an insolvent is removed after he is discharged.

6. **Joint-stock company and corporation incorporated under a special Act** (like L.I.C., U.T.I.). A company/Corporation is an artificial person created by law. It cannot enter into contracts outside the powers conferred upon it by its Memorandum of Association or by the provisions of its special Act as the case may be. Again, being an artificial person (and not a natural person) it cannot enter into contracts of a strictly personal nature e.g. marriage.

10.5 SUMMARY

An agreement will be a contract if it is entered into by parties who are competent to contract. 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. An infant or a minor is a person who is not a major. A person attains majority on completing his 21st year in England and 18th year in India. If the property of a minor is under the management of the court of wards, or a guardian is appointed by the court, he attains majority only on his completing the 21st year.

Rules relating to a minor's contract are as follows :

1. A minor is not competent to contract and that a contract by a minor is void *ab initio*.

2. Minor cannot ratify the agreement even on attaining majorioty, because a void agreement cannot be ratified.

3. Where a minor by misrepresenting his age has induced the other party to enter into a contract with him, he cannot be made liable on the contract. There can be no estoppel against a minor.

4. A minor's contract being absolutely void, there can be no question of the specific performance of such a contract.

5. If a contract is beneficial to a minor it can be enforced by him.

6. A minor cannot be declared insolvent even though there are dues payable from the properties of the minor.

7. A minor being incompetent to contract cannot be a partner in a partnership firm, but under section 30 of the Indian Partnership Act, he can be admitted to the benefits of partnership.

8. A minor can act as an agent. But he will not be liable to his principal for his acts. A minor can draw, deliver and endorse negotiable instruments without himself being liable.

Section 11 disqualifies a person who is not of sound mind from entering into a contract. A person is said to be of sound mind for the purpose of aiming 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.

Unsoundness of mind does not mean weakness of mind or loss of memory. It means not only lack of capacity to understand the terms of the contract but also lack of understanding to realise the effect of the terms of the contract. There is always a presumption in favour of sanity.

The third type of incompetent persons, as per Section 11, are those who are "disqualified from contracting by any law to which they are subject". These include Alient enemies, foreign sovereigns and ambassadors, convict, married women, insolvents and joint-stock company and corporation incorporated under a special act.

10.6 KEYWORDS

Minor: A minor is a person who has not attained the age of majority.

Estoppel: It means prevention of a claim or ascertain by law.

Ramification: Ramification is the act of conforming or approving.

Persons of Unsound Mind: A person of unsound mind is one who is not of sound mind.

Alien: An alien is a person who is foreigner to the land.

Convict: A convict is oen who is found guilty and is imprisoned.

10.7 SELF ASSESSMENT QUESTIONS

1. "Parties to a contract must be competent to contract". Explain.
2. Discuss the provisions of law relating to contracts by minors.
3. Discuss the law relating to contracts by persons of unsound mind.

4. Is the minor's contract void or voidable? Can the guardian of a minor make a contract for the minor ?

5. Is a minor bound on his agreement for necessaries? Is he liable upon a bill of exchange which he has accepted in payment for necessaries?

6. Can a promise by a person on attaining majority to repay money lent and advanced to him during his minority be enforced?

7. An infant made the following contracts : (i) an engagement to marry a girl, (ii) a credit purchase of an engagement ring for his finance (iii) a hire-purchase contract for a set of gold clubs. He now wishes to call of his engagement. Is he liable upon any of the above contracts ?

8. A, an infant, borrows Rs. 2,000 from B and executes a promissory note for the amount in favour of B. On his attaining majority, the minor executes another promissory note in lieu of the first which is then cancelled. Is the second promissory note valid ?

   [Hints : The second promissory note is invalid, for a minor's agreement, being void ab-initio, cannot be made valid by subsequent ratification (Mohindra vs Kailash)].

10.8 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

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

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

LESSON : 11
FREE CONTENT

STRUCTURE

11.0 OBJECTIVE

After reading this lesson, you should be able to-

a) Explain the elements which affect the consent of the parties.

b) State the circumstances under which a contract can be affected on the ground of mistake.

c) Discuss the consequences of misrepresentation.

d) Explain the essentials and legal rules for a fraud.

e) State the circumstances under which a contract is said to be induced by undue influence.

11.1 INTRODUCTION

According to Section 13, 'Two or more persons are said to have consented when they agree upon the same upon the same thing in the same sense'. A contract which is regular in all other respects may still fail because there is no real consent to it by one or both of the parties. There is no consensus ad idem or meeting of the minds. Consent may be rendered unreal by mistake, misrepresentation, fraud, coercion or undue influence. When there is no consent at all, as in mutual mistake, there is no contract.

This is defined by Salmond as error in consensus, so that there was not at the relevant tune any real agreement or common intention between the parties, or their minds had not met. Error in consensus-a misunderstanding-prevents the existence of any consensus ad idem and therefore of any contract.

When there is consent, but no free consent, there is generally a contract voidable at the option of the party whose consent was not free, as in the case of misrepresentation, fraud, undue influence or coercion. This is known as error in causa. In this case a true contract is constituted by consent of the parties, but the consent of one of the parties was induced or caused by the supposed existence of a fact which actually did not exist.

11.2 DEFINITION OF FREE CONSENT

The term 'free consent' may be defined as the consent which is obtained by the free will of the parties, and neither party was forced or induced to give his consent. If the consent is there but it is not free or real, then the contract will be voidable at the option of the party whose consent is not free. The term 'free consent' is defined in Section 14 of the Indian Contract Act, which reads as under:

Consent is said to be free when it is not caused by-

1. coercion, as defined in Section 15, or

2. undue influence, as defined in Section 16, or

3. fraud, as defined in Section 17, or

4. misrepresentation, as defined in Section 18, or

5. mistake, subject to the provisions of Sections 20, 21 and 22.

Consent is said to be so caused when it would not have been given but for the existence of such coercion, undue influence, fraud, misrepresentation or mistake."

The analysis of this section shows that when consent of either party is obtained by one of the above-mentioned elements, it will not be free. When the consent is there but it is not free. Salmond describes it as error in causa.

11.3 ELEMENTS WHICH AFFECT THE CONSENT OF THE PARTIES

According to Section 14, the following elements affect the consent of the parties:

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

The consent obtained by any of the above elements is not free consent. It may be noted that in the first four elements mention above (i.e., coercion, undue influence, fraud and misrepresentation), the consent is there but it is not free. But in the last element (i.e., mistake), there is no consent at all because there is no identity of minds. The effect of 'no free consent' and 'no consent at all' on the contract may be stated as under:

a) When the consent is not free, then the contract is voidable at the option of the party whose consent is not free. A voidable contract is enforceable at the option of the party whose consent was not free.

b) When there is no consent, then the contract is void ab initio (i.e., from the very beginning). In fact, no contract will come into existence in such a case. A void contract being void ab initio, is not enforceable at the option of either party.

Thus, there is lot of difference between 'no free consent' and 'no consent at all.' In the following cases, there is complete absence of consent (a) when there is error as to the nature of the contract itself, (b) when there is error as to the identity of the parties, (c) when there is error as to the subject-matter of contract.

11.4 MISTAKE

The law believes that contracts are made to be kept; the whole structure of business depends on this, as the businessmen depend on the validity of contracts. Accordingly, the law says most clearly that it will not aid anyone to evade consequences on the plea that the was mistaken. On the other hand, the law also realises that mistakes do occur, and that these mistakes are so fundamental that there is no contract at all. So, if the law recognises mistake in contract, that mistake will render the contract void. This is the basic law of mistake in contract.

The general common law rule is that mistake made by one or both parties in making a contract has no effect on the validity of contract. For example, an error of judgement is not an operative mistake and does not affect the validity of the contract. If A buys an article thinking it is worth Rs. 10, when in fact it is worth only Rs. 5, the contract is good and A must bear the loss if there has been no misrepresentation by the seller.

Mistake of fact

Section 20 of the Contract Act provides: "When both the parties to an agreement are under a mistake as to a matter of fact essential to agreement, the agreement is void." Thus, to be operative (so as to render the contract void) the mistake must be (i) on the part of both the parties, (ii) of fact and not of law or opinion, and (iii) so fundamental as to negate mistake of fact, the contract would be void. Such a mistake prevents the formation of any contract at all, and the court will declare it void. But as Section 22 provides unilateral mistake of fact will not render the contract voidable.

Mistake of law

If there is mistake of law of land, the contract is binding because everyone is deemed to have knowledge of his own law, and ignorance of law is no excuse. But mistake of foreign law and mistake of private rights are treated as mistakes of fact, and are excusable. The laws of a foreign country require to be proved in Indian courts as ordinary fact, and so a mistake of foreign law makes the contract void. Similarly, if a contract is made in ignorance of private rights, it would be void, e.g. where A buys property which already belongs to him.

Operative Mistake of Fact

Operative mistakes may be classified into the following categories:

a) Mistake as to the nature of the contract itself.

b) Unilateral mistake, i.e. mistake made by one party only.

c) Bilateral mistake, where both parties make a mistake, which may be either (i) Common Mistake, or (ii) Mutual Mistake.

Common Mistake occurs where both parties have made the same mistake and may also be designed as identical bilateral mistake. Mutual Mistake occurs where both parties make a different mistake and may also be called non-identical bilateral mistake. These are clearly differentiated in following paragraphs between themselves and contrasted with unilateral mistake.

a) Mistake as to a nature of contract

The general rule is that a person who signs as instrument is bound by its terms even if he has not read it.

But if a person signs a contract in the mistaken belief that he is signing a document of a different nature, there will be a mistake which avoids the contract.

The mistake must be as to the nature of the contract and not merely as to the contents of the document, and also the mistake must be due to either (a) the blindness, illiteracy, or senility of the person signing, or (b) a trick or fraudulent misrepresentation by the other party as to the nature of the document.

b) Unilateral Mistake

Unilateral mistake occurs when one of the parties to a contract is mistaken as to some fundamental fact concerning the contract and the other party knows this. This latter requirement is important because if B does not know that A is mistaken, the contract is good. Unilateral mistakes may be of two types: (i) regarding identity of party and (ii) unilateral mistake of offeror.

(i) Identity of party: The cases of unilateral mistake are mainly concerned with mistake by one party as to the identity of the other party. It is rule of law that if a person intends to contract with A, B cannot give himself if any rights under if. Here, when a contract is made in which personalities of the contracting parties are or may be of importance, no other person can interpose and adopt the contract.

For example, where M intends to contract only with A but enters into contract with B, believing him to be A, the contract is vitiated by mistake, as there is no Consensus ad idem.

Remember that mistake as to identity of the person with whom the contract is made will operate to nullify the contract only if:

(a) the identity is of material importance to the contract, and

(b) the mistake is known to the other party, i.e. he knows that it is not intended that he should become a party to the contract but some other person is intended.

In Cundy V. Lindsay (1878 3 A.C.459), one Blenkarn by imitating the signature of a reputable firm called Blenkarn and Son, induced Lindsay to supply him with goods on credit, which he afterwards sold to Cundy, an innocent purchaser. Lindsay claimed the recovery of the goods, or their value from Cundy. It was held that the contract between Blenkarn and Lindsay was void for mistake, and that no property passed to Cundy. Cundy was liable to Lindsay from the value of the goods.

In Philips V. Brooks (1919 2 K.B.243), the plaintiff was a jeweller. One North entered his shop and asked to see some jewellery. He chose one ring worth £450 and a pearl necklace, priced £2,250 and offered to buy them. The jeweller accepted the offer. North then offered to pay by cheque. The jeweller accepted the cheque, but said delivery would be delayed until the cheque was cleared. North then said that he was Sir George Bullough, a well-known person, and gave a London address, which the jeweller checked in the directory. Since North had signed the cheque as George Bullough, the jeweller was deceived as to his identity and allowed him to take away the ring. North promptly pledged the ring with Brooks, a pawnbroker, for £350. The cheque was dishonoured and the jeweller claimed to recover the ring from Brooks. It was held that the contract was made before the identity became important, therefore it was not void on the ground of mistake. The jeweller intended to contract, and did contract with the person present whoever he was. The misrepresentation took place at the time of signing the cheque after the man who had bought it, namely, North. The contract could be avoided on the ground of fraudulent misrepresentation before the ring was pawned, but since at the time the ring was pledged it had not been avoided, the pawn broker got good title.

In Lake v. Simmons (1927 A.C.487), A woman, by falsely representing to a firm of jewellers that she was the wife of a certain Baron, obtained two pearl neckless on the pretext of showing them to her husband with a view to buying at the agreed price. The woman then sold the neckless to an innocent buyer. It was held that there was no contract between the jewellers and the woman and therefore the buyer from her must return the necklaces to the jewellers. Though the woman got the physical possession of the necklace, there was no mental assent, as the jewellers intended to deal not with her but quite a different person, namely, the wife of the Baron.

In Said v.Butt (1920 3 K.B.497), B, the manager director of a Theatre, gave instructions that a ticket was not to be sold to S.S. knew this, and asked a friend to buy a ticket from him. With this ticket, S went to the theatre, but B refused to allow him to enter. It was held that there was no contract with S, as the theatre company never intended to contract with S. By mere device of an agent he could not constitute himself as the contractor with the theatre owners who had already refused him ticket.

In the words of Sir William Anson: "If a man accepts an offer which is plainly meant for another, or if he becomes party to a contract by falsely representing himself to be another, the contract in either case is void, or to put it more accurately, no contract ever comes into existence. In the first case one party takes advantage of the mistake, if the other creates it."

(ii) Unilateral mistake of offeror where the offeror makes a material mistake in expressing his intention, and the Offeree knows, or is deemed to know of the error, the mistake is operative and the contract is void.

In Hartog v. Colin Shields (1939 3 E.R.566). H claimed damages for breach of contract, alleging that C had agreed to sell him 30,000 Argentinian hare skins and had failed to deliver them. C contended that there was a material mistake in the offer and that H was well aware of this mistake when he accepted the offer. The mistake alleged by C was the skins were offered at certain prices per pound instead of per piece. In the negotiations preceding the agreement, reference had always been made to prices per piece, and it was also the custom of the trade. Held, the contract was void expressed C's real intention; H must have known that is was made under a mistake.

But if there is a mistake on the part of one party alone, and the other does not, and cannot be deemed to know of the mistake, the contract is binding.

In Van Praagh v. Everidge (1902 2 Ch. 266), at a sale of landed properties by auction, E purchased one lot in mistake for another. The price was not extravagant and the mistake was solely due to his own carelessness. Held, the contract was binding on E.

c) Bilateral Mistake

A bilateral mistake, as observed earlier, arises when both parties to a contract are mistaken as regards a fact essential to the contract. They may have made a common or identical mistake; or a mutual or non-identical mistake.

Following may be cases of bilateral mistakes-

(i) Common mistake as to the existence of the subject.

(ii) Common mistake as to the fact fundamental to the agreement.

(iii) Mutual or non-identical mistake as to the identity of the subject matter.

(iv) Mistake as to quality of subject-matter or promise.

(v) Mistake as to non-disclosure in contracts of utmost good faith.

(i) Common mistake as to the existence of the subject-matter. Where both parties believe the subject-matter of the contract to be in existence at the time of the contract but in fact it is not in existence, there is operative mistake and the contract is void.

If A agrees to sell his car to B, and unknown to them both the car had at the time of the sale been destroyed by fire, then the contract will be voids because A has innocently undertaken an obligation which he cannot fulfil.

In Scott v. Coulson (1903 2 Ch. 249), G agreed to assign to H a policy of assurance upon the life of L.L. had died before the agreement was made. Held, no contract on account of common mistake.

Again in Couturier v. Hastie (1857 8 Exch. 40), there was a contract to buy cargo described as shipped from port A to port B and believed to be at sea which in fact had got lost earlier unknown to the parties and hence not in existence at the time of the contract. It was held that the contract was void due to the common mistake of parties.

But where the circumstances are such that the seller is deemed to have warranted the existence of the goods, the seller is probably liable to the buyer for breach of contract if the goods are non-existent.

(ii) **Common mistake as to a fact fundamental to the agreement.** Where the parties have made a contract based on a common misapprehension relating to the fundamental subject-matter of the contract there is 'operative mistake'. This means that the contract actually made is essentially different from the contract the parties intend to make.

(iii) **Mutual or non-identical mistake as to the identity of the subject-matter.** Where the parties are both mistaken as to a fundamental fact concerning the contract but each party has made a different mistake, there is a mutual or non-identical mistake.

Thus, if A offers to sell his Ambassador Car, and B agrees to buy thinking A means his Fiat Car, there is a bilateral mistake which is mutual or non-identical. The contract does not come into existence under such a mistake, because there is no consensus ad idem. The parties have negotiated completely at cross-purposes and they were never in agreement.

There would be no contract even if the mistake was caused by the negligence of a third party.

In Henkel v. page (1870 6 Ex.7), P wrote to H inquiring the price of rifles and suggested that he might buy as many as fifty. On receipt of a reply he wired "send three rifles". Due to the mistake of the telegraph clerk the message transmitted to H was "send the rifles." H despatched 50 rifles. Held, there was no contract between the parties.

(iv) Mistake as to quality of subject-matter or promise. Mistake as to the quality raises difficult question. If the mistake is bilateral and because of the mistake the thing does not possess the quality bargained for the contract is obviously void. But if the mistake is only unilateral difficulty arises. Mere mistake as to quality of the subject-matter of a contract does not invalidate it, but mistake of one party to the promise of the other party as to quality of subject-matter, known to that other party, does invalidate the contract. Such a question generally arises in cases of sale of goods. The principle commonly applicable is caveat emptor-Let the buyer beware. There is generally no obligation on a contracting party to enlighten the other party even where he knows or suspects there is a misapprehension.

For example, A offers to sell a watch to B, and B thinking it is a gold watch, offers Rs. 5000 for it. A knowing the watch is not gold, accepts B's offer without enlightening him. The contract is binding, provided A made no representation in the matter.

But where a party knowing that the other was labouring under a mistake "snatches a bargain" by hurriedly closing the transaction, this unilateral mistake will enable the party to avoid the contract.

(v) **Mistake through non-disclosure in contracts of utmost good faith or uberrimae fidei.** A contract uberrimae fidei is a contract of utmost good faith. In such a contract the law imposes a special duty to act with the utmost good faith, i.e. to disclose all material information. Failure so to disclose all facts truthfully renders the contract voidable at the option of the party. Here silencer can amount to misrepresentation.

Contracts *uberrimae fidei* (utmost good faith)

Contracts *unberrimae fidei* are-

(a) Contracts of insurance of all kinds. The assured must disclose to the insurer all material facts; and non-disclosure or misstatement will render the contract of insurance void (Ratan Lal v. Metropolitan Co., 1959 Pat. 413).

(b) Contracts to take shares in a company under a prospectus. When a company invites the public to subscribe for its shares by means of a prospectus, it is under statutory obligation to disclose truthfully the various matters set out in the Companies Act, 1956. Any person responsible for the non-disclosure of any of these matters is liable to damages. Also, the contract to take shares is voidable where there is a material non-disclosure in the prospectus.

(c) Contracts for the sale of land. The vender is under a duty to purchaser to show good title to the land he has contracted to sell. He must, therefore, disclose all defects in title. This duty does not extend to physical defects in the property itself.

(d) Contracts of family arrangements. When members of a family make agreements or arrangements for the settlement of the family property, each member of the family must make full disclosure of every material fact within his knowledge.

(e) Suretyship and partnership contracts. Contracts of suretyship and contracts of partnership, though often described as contracts unberrimae fidei, are not properly so described: they do not require utmost good faith at their formation. In both cases, after the contract has been made there is a duty of utmost good faith on the parties to disclose to each other all material facts coming to light after the making of the contract.

11.5 MISREPRESENTATION

A representation is a statement of fact made by one party to the contract to the other which induces the other to enter into the contract. According to Section 18, misrepresentation is a representation that is untrue. But representation always means a statement of fact not a statement of intention or of opinion or of law.

An untrue statement or misrepresentation may be either (i) Innocent, or (ii) Wilful or Deliberate with intention to deceive and is called Fraud.

Innocent Misrepresentation

Innocent misrepresentation is a misstatement made innocently and with an honest belief as to its truth. It is sometimes called "Invalidating Misrepresentation". The effect of innocent misrepresentation of fact is that the party misled by it may repudiated the contract and (i) raise the misrepresentation as defence to any action the other party may bring against him, or (ii) sue for rescission of the contract and restitution of anything he has transferred to the misrepresenter.

Damages of misrepresentation

Generally, the injured party cannot get damages for innocent misrepresentation. But in the following exceptional cases he can get damages:

(a) From promoters or directors who made such misrepresentation in a prospectus under Company Law;

(b) Against an agent who commits a breach of warranty of authority;

(c) From a person who (at the Court's discretion) is stopped from denying a statement he has made where (i) he made a positive statement intending that it should be relied on, and (ii) the innocent party did rely on it, and thereby suffered damage.

What to be proved?

It should be remembered that in order to avoid a contract on the ground of misrepresentation, it is necessary to prove that (i) there was a representation or assertion, (ii) such representation induced the party aggrieved to enter into contract, (iii) the assertion was of fact (and not of law, as ignorance of law is no excuse); (iv) the statement was not a mere opinion, or hearsay, or commendation (i.e. reasonable praise) or tradesman's "puff", (v) the statement, which has become or turned out to be untrue, was made with an honest belief in its truth.

Effect

In an innocent misrepresentation, the party aggrieved may avoid the agreement, even though the statement was true at the time it was made but became untrue later by reason of change of circumstances.

11.6 FRAUD OR WILFUL MISREPRESENTATION

Section 17 of the Contract Act defines Fraud as follows : Fraud means and includes any of the following acts committed by a party to a contract, or with his connivance or by a party to a contract, or with his connivance or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract :

1. the suggestion as to a fact, of that which is not true, by one who does not believe it to be true;
2. the active concealment of a fact by one having knowledge or belief of the fact;
3. a promise made without any intention of performing it;
4. any other act fitted to deceive; and
5. any such act or omission as the law specially declares to be fraudulent.

But mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak or unless his silence is, in itself, equivalent to speech.

In the worlds of Lord Herschel Fraud is "an untrue statement made knowingly, or without belief in its truth, or recklessly, careless whether it be true or false" with intent to deceive.

In simple terms, fraud is false statement or wilful concealment of a material fact with intent to deceive another party. The party deceived or defrauded can avoid the contract and also claim damages.

Characteristics of Fraud. The essential characteristic of fraud are following -

(a) There must be representation or assertion and it must be false, or there must be active or wilful concealment of a material fact. If there is an actual false statement, the case is simple, A, intending to deceive B, falsely represent that the Television set he is offering for sale is German made, when it is in fact a locally made set. If concealment is alleged mere non-disclosure of material facts, however morally censurable, does not render a contract voidable. Mere silence is not misrepresentation, unless silence is in itself equivalent to speech, or where it is the duty of person keeping silence to speak; as where a fiduciary relation exists between the contracting parties or the contract requires utmost good faith. Disclosure is also essential where part-truth amounts to falsehood. If part only of facts is disclosed, and the undisclosed part so modifies the part disclosed as to render it, by itself, substantially untrue, there is a duty to disclose the full facts. Non-disclosure will amount to fraud.

In R.V. Kylsant (1932 1 K.B. 442). A prospectus contained statements which were true; that the company had paid dividends every year between 1921 and 1927. In fact, in each of these years the company had incurred substantial losses, and was only able to pay the specified dividends out of secret reserves. No disclosure was made of these losses. Held, the prospectus was false, because it put before intending investors figures which apparently disclosed the existing position of the company, but in fact it hid it, and Lord Kylsant, a director, who knew that it was false was guilty of fraud.

(b) The representation must be of fact. The assertion must be of fact and not a mere expression of opinion, or hearsay, or puffery of flourishing description.

Thus, if A, who is about to sell a horse to B, says that the horse is a beauty and is worth Rs. 10,000 that is A's opinion and B is at liberty to reject it. But if in fact he paid only Rs. 5000 for it, then A has misstated a fact, and if B has been induced by that statement to buy the horse, he may rescind the contract on the ground of fraud.

(c) There must be knowledge of the falsehood of the representation or a reckless disregard as to its being true or false. In a reckless misstatement the person is not sure as to the fact in his own mind; he feels a doubt, yet he represents to the other party, as if he is certain about the truth of the fact represented by him. Such misrepresentation is fraud. Also a promise made without an intention of performing it is fraud. To buy goods with the preconceived idea of getting goods without paying for them is fraud.

(d) The representation must be made with the object of inducing the party deceived to act upon it. The assertion must be made with the intention of inducing one to act on the assertion who does so act. This means that there is an inducement in fact and the assertion is one which necessarily influenced and induced the party to act. The party misled must not have exercised his own skill of judgement.

(e) The representation must in fact deceive. The representation must be acted upon as it was intended to be acted upon so that the party misled is actually deceived. A deceit which does not deceive is not fraud.

(f) The plaintiff must be thereby damnified. It is a common saying that "there is no fraud without damage", for an action being one of deceit, and unless the plaintiff and sustained damage or injury, no action will lie. The damage may consist of actual and temporal injury, that is, some losses of money or money's worth, or some tangible detriment capable of assessment.

Difference between Misrepresentation and Fraud

The main difference between fraud and misrepresentation is that in fraud the person making misrepresentation does believe it to be true and in misrepresentation he does not believe it to be true. In both the cases it is a misstatement of facts which mislead the promisor. Misrepresentation (often called innocent misrepresentation) differs form fraud (often called fraud or wilful misrepresentation) in following respects.

(i) Intention of the Party. Fraud generally implies that there is an intention to deceive whereas misrepresentation may be innocent. Thus both in fraud and misrepresentation, there is statement which is false, but the distinction between them mainly turns round the intention of the party. A false statement without any intention to deceive would be misrepresentation but a false statement deliberately or recklessly made to deceive another is a case of fraud.

(ii) Additional action for damages. Fraud gives right to an action for deceit, in addition to its effects of avoidance of the contract, and the party aggrieved can recover damages if he has sustained any in consequence of fraud practised upon him by the other party. Misrepresentation merely goes to avoid the contract.

(iii) Discovery of truth by ordinary diligence. If consent to an agreement is caused by passive fraud (fraudulent silence) or innocent misrepresentation, the contract is not voidable if the representee had the means of discovering truth with ordinary diligence. But where consent to an agreement is caused by active fraud, the contract is truly voidable even though the party defrauded had the means of discovering with ordinary diligence.

11.7 COERCION

Coercion is defined by Section 15 of the Contract Act as "the committing or threatening to commit, any act forbidden by the Indian Penal Code, or the unlawful detaining, or threatening to detain, any property to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement." The doing of any act forbidden by the Indian Penal Code will still be coercion, even though such an act is done in a place where the Penal Code is not in force.

What is coercion in India is 'duress' under English law, but coercion covers much wider field. Duress is limited to actual violence or threats of violence to the person, or imprisonment or the threat of criminal proceeding to the person coerced or those near or dear to him, such as his wife, children or parents. Threats to property are not duress. Coercion, on the other hand, maybe against person or property, and the person coerced may be any person, not necessarily the party to the contract or his wife, parent or child.

In Multhiah Chettiar v. Karuppan Chetti (1927 50 Mad. 786), an agent refused to hand over the account books, bonds etc., of the business to his successor agent unless the principal gave him a release of all liabilities during the term of his agency. The principal did so but later succeeded in the suit to declare the release deed as vitiated by coercion.

In Keshavji v. Harjivan (1887 B om. 556), a son forged his father's endorsement to promissory notes on the strength of which the bankers advanced money. When the fraud was known the bankers wanted to launch a prosecution against the son. The father was induced to come to a settlement with the Bank to save the son. The settlement was set aside on the ground of coercion, as the father was not a free agent.

In Cumming v. Ince (L.R. 1 H.L. 200), an old lady was induced to settle property on one of her relatives by the threat of unlawful confinement in a mental home. Held, the settlement could be set aside on the ground of duress i.e., the threat of false imprisonment.

In Kaufman v. Gerson (1904 1 K. B. 591), K sued G on a contract, made in France, which K had coerced G into making by threats of prosecuting G's husband for a criminal offence which he had committed. Held, G was not liable under the contract, as per consent was obtained through coercion.

In Ranganayakamnna v. Alwar Setti (1890) 13 Mad, 214, an adoption by a girl, aged 13, was held not binding, when it had been obtained from her by her husband's relatives by pressure on her by obstructing the removal of her husband's dead body.

It should, however, be noted that mere threat by one person to another to prosecute him does not amount to coercion. There must be a contract made under the threat, and that contract should be one sought to be avoided because of coercion (Ramchandra v. Bank of Kohlapur, 1952 Bom. 715). It may be repeated that coercion may proceed from any person, and may be directed against any person, even a stranger, and also against goods e.g., by unlawful detention of goods.

11.8 UNDUE INFLUENCE

Under influence occurs where a party enters into a contract under any kind of influence, mental pressure of persuasion, which prevents him from exercising a free and independent judgement. It makes the contract voidable by the party influence or whose consent was not free.

Section 16 of our Contract Act states that a contract is induced by undue influence where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.

It further states that a person is deemed to be in a position to dominate the will of another (i) where he holds a real or apparent authority over the other, or (ii) where he stands in a fiduciary relation to the other; or (iii) he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress.

It is clear from this definition that contracts which may be rescinded for undue influence fall into two categories. Firstly, those where is no special relationship between the parties. Secondly, those where a special relationship exists.

In the first case under influence must be proves as a fact, by the party alleging it, in the second it is presumed to exist. In litigation, however, the two classes are not mutually exclusive and a plaintiff may allege both that undue influence be presumed and that it existed in fact.

It was stated in Smith v. Kay (1859 7. L.C. 750): "The principle of undue influence applies to every case where the influence is acquired or abused, where confidence is reposed and betrayed".

Undue influence is a kind of "mental coercion", it destroys the free agency of one and constrains him to do which is against his will, and which he would not have done if left to his own judgement and volition, so that his act becomes the act of the one exercising the influence, rather than his own act.

Where no relationship between parties exists. Where no special relationship exists between the contracting parties, the plaintiff (i.e. the party influenced) must prove two things: (i) that the other party was in a position to dominate his will, (ii) that the contract was substantially unfair giving the dominant party unfair advantage.

It was observed in Bhola Ram v. Piari Devi, (1962 Pat. 168), undue influence has its origin in coercion or fraud. Domination of the will of a person is a kind of mental coercion and the use of his position by a person who dominates the will of the other to obtain an unfair advantage to himself or to his near relations is a variety of fraud.

In Karnal Distillery Co. Ltd. V. Ladli Prasad, (1958 Punj 190), confirmed by the Supreme Court (in 1963 S.C. 1279), the elder brother was shown to have exercise undue influence over his younger brother in respect of a compromise arrangement, the transaction was held to be voidable at the instance of the younger brother. It was observed that when one member of the family exercises weightly influence in the domestic counsels either from age, from character or from superior position acquired from other circumstances an inference of undue influences has to be drawn.

The influence subjugates the other's will to his injury. It was further stated in this case that once the position of dominance is proved to exist, it is deemed to continue till its termination is established. So all transactions during such dominance are vitiated. However, a plea of undue influence can only be raised by a party to the contract and not by a third party, unless there was any connivance between the person using undue influence and the third party benefiting by the contract.

Where special relationship exists - In the second class of cases, undue influence is presumed either because of an exceptional authority one has over the other or he stands in a fiduciary position to the other and owes a duty to give that other a disinterested advice. The possibility that he may put his own interest uppermost is so obvious that he comes under a duty to prove that he has not abused the position.

Whether fiduciary or confidential relationship exists or not, the question is always the same - was undue influence used to procure the contract or gift? But the burden of proof is different. If B seeks to avoid a contract with A, then in the absence of any confidential relationship, the entire onus is on B to prove undue influence, but if he shows the existence of such relationship, the onus is on A to prove that undue influence was not used. A must rebut the presumption of undue influence.

To discharge the onus that he did not employ undue influence, the party must show that the other party to whom he owed the duty in fact acted voluntarily, in the sense that he was free to make an independent and informed estimate of the expediency of the contract or other transaction. The other party received independent advice before he completed the contract.

A few examples will illustrate undue influence.

(i) A, having advanced money to his son B during his minority, upon B's becoming major obtained, by misuse of parental influence, a bond from B for a greater amount than the sum due in respect of the advance. A employed undue influence.

(ii) A, a man enfeedabled by disease or age, is induced by B's influence over him as his medical attendant, to agree to pay B an unreasonable sum for his professional service. B employs undue influence.

(iii) A Hindu, well advanced in years, with the object of securing benefits to his soul in the next world, gave his whole property to his Guru or spiritual adviser. There was undue influence. Similarly, where a cestui que trust (beneficiary) had no independent advice it was held a gift by him to the trustee of certain shares forming part of the trust fund was void.

(iv) In Debi Prasad v. Chhotey Lal, All. 438, D was the grandson of C's own brother, and attended to the comforts of C in his illness, as he was also old, infirm and weak. C executed a deed of gift at the behest of D. The deed was vitiated by undue influence as it was clearly as unconscionable transaction. D was held to have had dominant influence over C, a sick, inform and old man. Undue influence was presumed because of fiduciary relation.

But, as was held by the Supreme Court in Chandra v. Ganga Prasad, 1967 S.C. 878, there can be no presumption as to undue influence simply because the donor was related to the party and that he was of a weak disposition. What is essential of proof is the dominating will of the donee and if he used that position to obtain an unfair advantage over the donor.

In Afsar Shaikh v. Soleman Bibi, 1976 S.C. 163, the Supreme Court again emphasised that a general allegation in the plaint that the plaintiff was a simple old man of ninety who had reposed confidence in the defendant is much too insufficient to amount to an averment of undue influence. Merely relying on the other for advice does not amount to being unduly influenced. But if the transaction appears to be unconscionable, then the burden of proving that it was not induced by undue influence is to be upon the person who was in a position to dominate the will of the other.

A third party contracting with notice of the exercise of undue influence by another is in no better position than if he had exercised undue influence himself.

In Lancashire Loand Ltd. V. Black (1934 1 K.B. 380), B, a married woman, under the undue influence of her mother, who was an extravagant woman, borrowed money on the security of her own property. The daughter did not understand the nature of the transaction, and the only advice she did not understand the nature of the transaction, and the only advice she received was from a solicitor acting for the mother and the moneylender. The moneylender, therefore, knew all the circumstances between B and her mother. Held, the moneylenders were in no better position that the mother, and the contract was voidable by the daugher.

Unconscionable Transactions

When a person, without being fraudulent forces another to enter into an agreement by making an unconscious use of his superior power he is said to make an: unconscionable bargain. Such a bargain is voidable. The test is that between two parties on unequal footing one has sought to make an exorbitant profit of the other's distress. Where a person is heavily indebted to another and for a fresh loan is made to agree to pay exorbitant rate of interest, it will be an unconscionable transaction.

Similarly, where an heir to an estate borrowed Rs. 3,700 to enable him to prosecute his claim when he was without even the means of subsistence and gave the lender a decree only for Rs. 3,700 with interest at 50% per annum.

Also, where a spendthrift and a drunkard 18 years of age executed a bond in favour of his creditor agreeing to pay compound interest at 2 percent per annum with monthly rests, it was held the bargain was unconscionable.

In the following two cases the bargain was held unconscionable :

Where a poor Hindu widow borrowed Rs. 1,500 from a moneylender at 100% per annum for the purpose of enabling her to establish her claim for maintenance; and where an illiterate agriculturist heavily indebted to a moneylender sold his land worth thrice the amount of the debt under pressure of payment.

It must be remembered that in such cases the moneylender must be "in a position to dominate the will" of the borrower, and the bargain must be unconscionable within the meaning of clause 3 of Section 16. The mere fact that the rate of interest is exorbitant is no ground for relief under this section unless it be shown that the creditor was in a position to dominate the will of the borrower. Nowadays, however, drastic legislation in most of the States has provided greater protection to debtors.

Purda Nishin Woman

The law throws around a Purda Nishin woman a special cloak of protection, and demands that person who deals with her must show affirmatively and conclusively that the deed was not only executed by, but was explained to, and was really understood by the lady. It must also be proved that no coercion or undue influence was exercised on her, either by the party to the transaction or by a third party, and that she had executed the document of her free will. The reason is that the ordinary presumption that a person understands the document to which he has affixed his name does not apply in the case of Purda Nishin Woman. But a lady, whether Hindu or Muslim, who is claiming to be Purda Nishin must prove complete seclusion; and some degree of seclusion is not sufficient to entitle her to get special protection.

Difference between coercion and undue influence

(i) Moral and Physical Force. In undue influence the influence is due to moral pressure whereas in coercion it is due to physical force. Undue influence is sometimes marked as 'moral coercion' which is distinct from 'physical coercion' or coercion in true sense.

(ii) Relationship between Parties. In the case of undue influence there must be certain relationship between the parties which places-one party in a position to dominate the will of the other i.e. undue influence is between the parties to the transaction, the promise procures the promisor's constant by undue influence. Coercion need not proceed from the promisee nor need it be directly against the promisor, that is, existence of certain relationship is not necessary in case of coercion.

(iii) Way of obtaining consent. In undue influence the consent is obtained by dominating the will of the giver and the consent is freely given under the belief that he is not to be put to any loss by giving such consent. In case of coercion, the consent is obtained by committing or threatening to commit an offence, and the person is forced to give his consent.

(iv) Legal consequences. Where the consent of the promisor is procured by coercion, the contract is voidable at his option but where the promisor's consent is procured by undue influence, the contract is either voidable or court may enforce it in a modified form.

(v) Character of the consent. Briefly, undue in influence is of a moral character and is more subtle and intangible; coercion is chiefly of a physical character and is of an avowedly violent character.

11.9 SUMMARY

Mistake, misrepresentation, fraud, coercion and undue influence are the elements which affect the consent of the parties. Mistake generally takes place where the concerned parties are not fully aware of the terms of the agreement and they take the terms in a different sense. In an innocent misrepresentation, the party aggrieved may avoid the agreement, even though the statement was true at the time it was made but became untrue latter by reason of change of circumstances. The basic difference between fraud and misrepresentation is that in fraud the person making misrepresentation does believe it to be true and in misrepresentation he does not believe it to be true. An agreement, in which the consent is caused by coercion, is voidable at the option of the party whose consent was so obtained. When a party enters into a contract under any kind of mental pressure, unfair influence or persuasion by the superior party, the undue influence is said to be employed.

11.10 KEYWORDS

Mistake: Mistake may be defined as incorrect belief about something.

Bilateral Mistake: It is a mistake in which both the parties to an agreement are confused about the facts which are essential to the agreement.

Misrepresentation: Misrepresentation is a false representation which is made innocently.

Fraud: Fraud may be defined as an intentional, deliberate or wilful misstatement of facts, which are material for the formation of a contract.

Free Consent: Free consent is the consent which is obtained by the free will of the parties, and neither party was forced or induced to give his consent.

Coercion: It means forcibly compelling a person to enter into a contract.

Undue Influence: It means the unfair use of one's superior power in order to obtain the consent of a person who is in a weaker position.

11.11 SELF ASSESSMENT QUESTIONS

1. State when a consent is not said to be free. What is effect of such consent on the formation of a contract?
2. A contract caused by mistake is void. Explain with illustrations.
3. Explain and illustrate the effect of mistake of fact on contracts.
4. Explain with illustration, the effect of mistake of facts on an agreement with reference to (i) mistake relating to subject-matter. (ii) mistake relating to the identity of the parties and (iii) mistake relating to the nature of the transaction.
5. What is fraud? Distinguish it with misrepresentation.
6. What remedies are available to a person induced to enter into a contract by (a) misrepresentation which is not fraudulent, (b) fraud.

7. "Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud". Explain.

8. (a) 'An attempt at deceit which does not deceive is not fraud'. Explain.
   (b) Does a threat to commit suicide amount to coercion?

9. (a) Ignorance of law is no excuse'. Explain.
   (b) What is the effect on a contract of bilateral mistake relating to a matter of fact ?
   (c) When does the aggrieved party lose the right to rescind the contract of fraud?

10. (a) When is a party said to be in position to dominate the will of another?
    (b) What is difference between coercion and undue influence ?
    (c) Undue influence is subtle form of coercion. Explain.

11. (a) What are unconscionable transactions ?
    (b) What are rules regarding agreements with purda nishin women ?
    (c) What are contracts Uberrimae Fidei (utmost good faith)

11.12 SUGGESTED READINGS

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S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

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LESSON-12

DISCHARGE AND BREACH OF CONTRACT

STRUCTURE

12.0 OBJECTIVES

After reading this lesson, you should be able to

a) Explain the circumstances under which a contract is said to be discharged.

b) Discuss the impossibility of performance as a mode of discharge of contract.

c) Enumerate the doctrine of frustration.

d) Explain the breach of contract as a mode of discharge of contract.

e) Discuss the remedies available to an aggrieved party on the breach of contract.

12.1 INTRODUCTION

A valid contract creates certain obligations on all the contracting parties, and the parties become liable to fulfil their respective obligations. When the parties fulfil their respective obligations, their liability under the contract, comes to an end and the contract is said to be discharged. Thus, the discharge of a contract means that the parties are no more liable under the contract. In other words, when the rights and obligations created by the contract come to an end, the contract is said to be discharged. The discharge of a contract may, therefore, be defined as the termination of contractual relationship between the parties.

12.2 MODES OF DISCHARGE OF A CONTRACT

Contracts may be discharged by any one of the following modes (for details see chart)

A. By Performance
B. By Consent or Agreement
C. By Impossibility of Performance
D. By Lapse of Time
E. By Operation of Law
F. By Breach of Contract

12.3 DISCHARGE BY PERFORMANCE

The obvious mode of discharge of a contract is by performance, for that is what the contract parties had contemplated at the time of entering into it. Every person who is bound by an obligation must be ready to perform it at the time when he had promised to perform it. According to Section (Sec.) 37 of the Contract Act, the parties to a contract must perform their respective promises, unless such performance is dispensed with or excused under the provision of this Act or of any other law. A person who is bound to perform a contract must be ready to perform it at the time when he has under taken to do so. When a

DISCHARGE OF CONTRACT

- A) By Performance
  - a) Actual Performance
  - b) Tender of Attempted Performance
- B) By concent or Agreement
  - By Express Consent
  - By Implied Consent
    - (a) Novation
    - (b) Alteration
    - (c) Recession
    - (d) Remission
    - (e) Waiver
    - (f) Acceptance of any other satisfaction
- C) By Impossibility of Performance
  - Impossibility at the time of Contract
  - Superving or Subsequent Impossibility
    - Covered' by Doctrine of Impossibility
      - a) Destruction of Subject matter
      - b) Non-existence of a state of affairs
      - c) Death or Personal Incapability
      - d) Supervening Illegality of change of law
      - e) Declaration of war
    - Not covered by Doctorine of impossibility (not an excuse)
      - (a) Difficulty of Performance
      - (b) Commercial impossibility
      - (c) Failure of third party
      - (d) Partial impossibility
      - (e) Strikes, Lockouts and civil disturbances
- D) By Lapse of Time
- E) By Operation of Law
  - (a) By death
  - (b) By merger
  - (c) By unauthorised alteration of terms of contract
  - (d) By Insolvency
  - (e) By Rights and Liabilities vesting on the same person
- F) By Beach of Contract
  - Actual breach
    - (a) At the time of performance
    - (b) During Performance
  - Anticipatory Breach
    - (a) Implied Repudiation
    - (b) Express Repudiation

contract is performed the parties are discharged and the contract is terminated. Performance may be of two types-actual and attempted.

a) *Actual Performance* - When the parties of the contract perform their promises, it is called actual performance. After such a performance the contract is discharged. It is the most common way of discharged of a contract.

b) *Attempted Performance* - Attempted performance or tender takes place when a person who is bound to perform a promise has been ready and willing to perform and has offered to perform his promise at proper time and place but the other party does not accept performance. In such a case, the contract is discharged of the wrongful refusal to accept the performance.

12.4 DISCHARGE BY MUTUAL AGREEMENT OF CONSENT

By agreement of all parties to the contract, or waiver or release by the party entitled to performance, a contract may be discharged. The discharge by consent may be expressed or implied; and an expressed consent may be given at the time of the formation of the contract or subsequently. For example, it may be agreed at the time of making the contract that on the happening of an event one or both parties will be absolved from performance. A buyer may be given the option to return the goods sold within a specified period of time, if certain conditions are not fulfilled.

In Head v Tattersall (1871) Ex. 7, the contract was for the purchase of a horse on the undersigned that the buyer could return the same within two days if the horse had not been hunted with the Bicester hounds. The horse was returned within two days as it had not been hunted with the Bicester hounds. The Court held the return valid.

Express consent subsequently to the formation of the contract may be given by waiver; release, abandonment, novation, remission, alteration, rescission and in English law, by accord and satisfaction. Each one of these methods is dealt with here. Sec. 62 and 63 expressly provide for these methods and are reproduced here:

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

“Every promisee may dispense with or remit, wholly or in part, the performance of the promisee made to him, or may extend the time for such performance, or may accept instead of it any satisfaction which he thinks fit.” Section 63.

The analysis of these sections reveal that the original contract is discharged when the parties enter into a fresh contract in place of original contract. And the following are the important methods for the discharge of a contract by a fresh contract:

a) Novation: Novation occurs when a new contract is substituted for an existing contract, either between the same parties or between different parties, the consideration mutually being the discharged of the old contract.

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

A common example of novation arises in the case of partnership contracts. For a valid novation it is not enough that a new promiser agrees to assume original promisor’s obligation, the promises too should consent to the change.

The following pre-requisites must be established by a party to make out a case of novation - (i) the old contract, (ii) The existence of liability under that contract, (iii) The assent of all parties to the extinguishment of liability under the old contract. (iv) The assent of the all the parties to the creation of the liability under the new contract and (v) the validity of the new contract.

A novation is ought to be before the time of performance expires, otherwise, there would be breach of contract, and the parties will by the new contract be only trying to adjust the remedial rights, which arises out of the breach of the old contract.

(b) Alteration: Alteration of a contract takes place when one or more of the terms of the contract are changed. Alteration is valid when it is made with the consent of all the parties to the contract. Where, however, an alteration of written contract is made by one party to the contract without the consent of the other party and of a material fact, so that the legal effect of the instrument is changed, the contract is discharged and the other party is also discharged from his duties.

Example: A agreed to supply to B 50 bags of rice at the rate of Rs. 100 per bag. The delivery was to be made in five equal installments, the first supply was to commence from 1st June. Subsequently, A and B entered into an agreement that the delivery would be made in two equal installments and the price would be Rs. 105 per bag. In this case, the old contract is discharged and the parties become bound by the contract with changed terms.

Following are various rules regarding the discharge of contract by alteration - (i) Alteration must be by a party to the contract, or a stranger while the document is in the possession of a party of the contract, and for his benefit. But exception is made if it is caused by mistake or accident (ii) it must be in a material part- what alternation can be said to be material depends upon the character of the instrument and other circumstances of the case.

(c) Rescission: A contract may be rescinded by agreement between the parties at any time before it is discharged by performance or in some other way. For example, a contract for the sale of goods can be discharged by mutual agreement between the buyer and the seller at any time before delivery of the goods or payment of the price.

Rescission may also take place in the following manner: Where a party to contract fails to perform his obligation, the other party can rescind the contract without prejudice to his rights to receive compensation for breach of contract. In avoidable contract one of the parties has the option of rescinding the contract.

Examples

(i) A promises to deliver certain goods to B on a certain date. Before the date of performance, A and B mutually agree that the contract will not be performed. The parties have rescind the contract.

(ii) A was induced to enter into an agreement by concern. He can rescind the contract.

(d) Remission: Remission is the acceptance of a lessor sum than what was contracted for a lessor fulfillment of the promise made. Sec. 63 specifically provides for remission of performance of promise. Thus, the law in India is different from that in England. In the latter country, remission must be supported by a fresh consideration. In India, under Sec.63, a promisee may remit or give up a part of his claim and a promise to do so is binding even though there is no consideration for doing so.

Examples

(i) A owes B Rs.5,000. A pays to B and B accepts in full satisfaction Rs. 2,000. The whole debt is discharged.

(ii) A owes B Rs. 5,000. C pays to B Rs. 1,000 and B accepts them in satisfaction of his claim on A. This payment is discharge of the whole claim.

(e) Waiver: Waiver means the intentional relinquishment of a right which a person is entitled to. A party may waive its rights under the contract, whereupon the other party is released from its obligations. In the case of an executory contract, (e.g., an agreement to sell and buy), each party may excuse the other from paying for or from buying the goods. In the case of unilateral promise, the party entitled to performance may waive performance of it.

Example: A promised to paint a picture for B. Afterwards, B forbade him to do so. In this case, B has waived his right to claim the performance. And thus, A is no longer liable to perform the promise. However, the party who has waived the compliance with a particular condition, may withdraw his waiver by giving reasonable notice.

(f) Acceptance of any other satisfaction: Sometimes, the party entitled to claim performance accepts any other satisfaction instead of the performance of the contract. In such cases, the other party is discharged from the performance of his liability under the contract. Section 63 of the Indian Contract Act provides for this provision. According to this section, the party who has the right to demand performance, may accept any other satisfaction, which he thinks fit, instead of the performance of the promise made to him. And such acceptance, discharges the whole obligations under the contract.

Example: A owed B, under a contract, a sum of money, the amount of which had not been ascertained. Without ascertaining the amount, A gave Rs. 2000 to B. And B accepted this amount in satisfaction of the sum due under the contract. In this case, A is discharged of the whole debt due under the contract, whatever may be its amount.

12.5 DISCHARGE BY IMPOSSIBILITY OF PERFORMANCE

The law relating to discharge by impossibility of performance of a contract is laid down in Sec.56 of the Contract Act. Section 56 states:

"An agreement to do an act impossible in itself is void. A contract to do an act which, after the contract is made becomes impossible, or by reason of some extent which the promisor could not present, unlawful becomes void when the act becomes impossible or unlawful.

Where one person has promised to do something which he knew, or with reasonable diligence, might have known, and which the promisee did now know to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise."

Examples

a) A agrees with B to discover treasure by magic. The agreement is void.

b) A and B contract to marry each other. Before the time fixed for the marriage, A goes mad. The contract becomes void.

c) A contracts to marry B, being already married to C, and being forbidden by the law to which he is subject to practise polygamy. A must make compensation to B for the loss caused to her by the non-performance of his promise.

This section covers a wide range causes and lays down certain clears rules. It is clear from the different parts of the section that impossibility is of various kinds. The impossibility may be absolute, i.e. inherent in the nature of the matter promised; or it may exist only relatively to the ability and circumstances of the promisor. The former is objective, (viz., inherent in the nature of the thing to be done) and discharges and contract. The latter is subjective impossibility, i.e. it is due to the inability of the individual promisor to perform his promise, and does not discharge a contractual duty.

The performance may be impossible as a matter of fact; or it may be impossible by the rules of law. The impossibility may exist at the time of contracting either with or without the knowledge of the parties or it may arise subsequently to the making of the contract, and in the latter case, it may be caused by events beyond the control of the parties or it may be caused by some act of the promisor or promisee.

(i) Impossibility at the Time of Contract

A contract to perform something that is obviously impossible, e.g. a promise to ride a horse to the moon, is void because there is no consideration for the contract. Here both parties were aware of the impossibility. It may be that at the time of the agreement both parties were ignorant of impossibility. In such a case also the contract is void on the ground of mistake. In their case the contract is void ab initio. In such a case, there is no contract to terminate and the parties are excused from performance (Sec.56, Para 1). Promise, which are manifestly impossible cannot be binding.

(ii) Subsequent or Supervening Impossibility

Para 2 of Sec.56 provides that subsequent or supervening impossibility or illegality will make the contract void in certain circumstances and the contract will be discharged. Supervening impossibility may occur in many ways, some of which are explained below.

Discharge by Supervening Impossibility

A contract will discharge by subsequent or supervening impossibility in any of the following ways:

(a) Destruction of Subject-Matter

When there is a contract in respect to a particular subject matter which is later destroyed without the fault of the parties, the contract is discharged.

In Taylor v. Caldwell (1863) 122 E.R. 299, the leading case on this point, a music hall was agreed to be let out for a series of contracts on certain days. The hall was burn down before the date of the first contract. The contract was held to have become void and the owner of the hall was absolved from liability to let the hall as promised. Blackburn J. observed in this case as follows: “In contracts in which the performance depends on the continued existence of given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance."

(b) Non-existence of a state of things necessary for performance

When a contract is entered into on the basis of the continued existence of a certain state of things, the contract is discharged if the state of things changes or cases to exist. In this case there is no destruction of any property affected by the contract, but the use of that property contemplated by the contract has became impossible

In Krell v. Henry (1903) 2 K.B. 740, H hired a room from K for two days. The room was taken for the purpose, as both parties well known, of using the room to view the coronation procession of Kind Edward VII, although the contract contained no reference to the coronation. Owing to the King's illness the procession was abandoned. Held, that H was excused from paying rent for the room, as the existence of the procession was the basis of the contract, and its cancellation discharged the contract.

(c) Death or Personal Incapacity

Where the personal qualification of a party is the basis of the contract, the contract is discharged by death or physical disablement of that party. In other words the death or illness of a particular person whose action is necessary for the promised performance discharges the duty to render that performance.

In Robinson v. Davidson (1871) L.R. 6 Ex. 269 contracted with D that D should play the piano at a concert given on a specific day. D was ill on the day in question and unable to perform. The contract was discharged and D's illness excused him from performance.

(d) Discharge by supervening illegality

A contract which is contrary to law at the time of its formation is void. But if, after the making of the contract, owing to an alteration of the law or the act of some person armed with statutory authority the performance of the contract becomes impossible, the contract becomes impossible, the contract is discharged. This is so because the performance of the promise is prevented or prohibited by a subsequent change in the law.

In Baily v. De Crespignay (1869) L.R. 4 Q.B. 180, D leased some land to B and convenanted that he would not erect any but ornamental buildings upon the adjoining land. A railway company, under statutory powers, took this adjoining land and built a railway station on it. Held, D was excused from performance of his convenient, because the railway company's statutory power had rendered it impossible.

On the other hand, if at the time of the making of the contract, compulsory powers are in existence, the exercise of which may affect the contract, a party knowing of those powers cannot rely on the fact that they are subsequently exercised as a defence to his breach of contract. The exercise of the compulsory powers was event which might have been anticipated and guarded against in the contract. Also, a continuing contract is not discharged by a prohibitive regulation which may be determined or varied and leaves a substantial part of the contract capable of execution. So, where a notification regulating retail prices was issued which did not make performance of the contact impossible or unlawful, the parties were not discharged. But if a contract to be performed in a foreign country becomes illegal owing to a change in the law of that country, the contract is discharged.

(e) Declaration of War

A contract entered into during war with an alien enemy is void ab initio. A contract entered into, before the war commence, between citizens of countries subsequently at war remains suspended during the pendency of the war, provided it does not involve intercourse with the alien enemy or is not helpful to him or his country. Such a contract will be revived and may be enforced at he end of the war. If a contract entered into before the outbreak of the war amounts to aiding the enemy in the pursuit of war, it would be abrogated or discharged and not merely suspended. It will also be discharged if it cannot remain suspended, e.g., the contract involves the continuous performance of mutual duties.

Case which are not covered by the Doctrine of Supervening Impossibility (Impossibility not an Excuse)

Apart from the cases mentioned above, impossibility does not discharge contracts. Therefore, impossibility of performance is as a rule not an excuse from performance. He who agrees to do an act should do it unless absolutely impossible which may happen in any one of the ways discussed above. It may be stated, as a general rule, that impossibility to perform arising subsequently to the agreement will not, as a rule discharge the promisor, because when there is positive contract to do a thing which is not unlawful, the promisor must perform it or pay damages for not doing it, although the performance becomes unexpectedly burdensome or even impossible on account of unforeseen events. The supervening event should destroy the contract itself. Merely making the contract difficult cannot attract Section 56. Some of the circumstances in which a contract is not discharged on the ground of supervening impossibility are stated here:

(a) Difficulty of Performance

The mere fact that performance is more difficult or expensive or less profitable that the parties anticipated, does not discharge the duty of performance. Increased or unexpected difficulty and expense do not, as a rule excuse from performance.

Examples

(i) A sold to B certain quality of Finland timber to be delivered between July and September, 1999 No deliveries were made before August when war broke out and transport was disorganised so that A could not bring any timber from Finland. Held, B was not concerned with the way in which A was going to get timber from Finland and therefore the impossibility of getting timber from Finland did not excuse performance.

(ii) A promised to send certain goods from Bombay to Antwerp in September. In August war broke out, and the shipping space was not available except at very rates. Held, the increased freight rates did not excuse performance.

(b) Commencial Impossibility

Commencial impossibility to perform a contract will not discharge the contract. A contract cannot be said to be impossible of performance because expectation of higher profits is not realised. A promisor's contractual duty to lay gas mains is not discharged because the outbreak of war makes it expensive to procure the necessary materials.

(c) Failure of third party

The principle of supervening impossibility does not extend to the case of a third person on whose work the promisor relied.

In Gana Saran v. Firm Ram Charan, 1952 S.C.9, a contract between the parties provided that 61 bales as noted below are to be given to you by us; we shall go on supplying goods to you of the Victoria Mills as soon as they are supplied to us by the said mill." In a suit for damages for non delivery of goods the defendants pleaded impossibility and frustration on the ground that the goods were not supplied to them by the mill. Held, that the law is contained Sec. 56 of the Act, and the worlds" as soon as they did not convey the meaning that delivery was contingent on their being supplied by the mills. The case did not fall within the provisions of Sec. 56, as the default was due to the fault of the defendant.

(d) Partial Impossibility

Partial impossibility rarely discharges a promisor beyond the extent of the impossibility. This, if the state of things in question is not the sole basis of the contract, so that there will still remain a substantial portion, through not all, of what was contract for, the contract will not discharged. In other word, where there are several purposes for which a contact is made is made, failure of one of the objects does not terminate the contract.

In H.B. Steamboat Co. V.Hutton (1903) 2 K.B. 683, the company agreed to let a boat to H to view naval review at the coronation and to cruise round the fleet. Owing to the King's illness the navel review was cancelled, but the fleet was assembled and boat might have been used for the intended cruise. Held, the Co. were not discharged from performance as the naval was not naval was not the sole basis of the contract.

(e) Strikes, lockouts and civil disturbances

Strikes, lockouts and disturbances like riots do not terminate contracts unless there is a clause in the contract providing that in such cases the contract is not to be performed or that the time of performance is to be extended.

The lessee of certain salt pans failed to repair them according to the terms of his contract, on the ground of a strike of the workmen, Held, a strike of workmen is not sufficient reason to excuse performances of a term of the contract.

The Doctrine of Frustration

The Common law of England started with the harsh doctrine that unless the parties expressly stipulated to the contrary, impossibility was no defence to an action for breach of a contract. In course of time, however, exceptions were introduced to modify the severity of the Doctrine. In English cases, it has been now held that when the common object of a contract can not longer be carried out, the court may declare the contract to be at an end. This is known as the

Doctrine of Frustration. The doctrine developed in England under the guise of reading implied to stick to a contract the purpose of which has disappeared.

Thus, when the performance depends on the continued existence of a given person or thing, a condition is implied that impossibility of performance arising from the perishing of the person or thing shall excuse performance. If the act became impossible subsequently be reason of some event which the promisor could prevent, the contract is discharged. This is based on the maixm les non cogit ad imposibilia - the law does not compel the impossible. This discharge of a contract rendered impossible of performance by external causes beyond the contemplation of the parties is known as frustration.

Frustration, as said above, is device by which the rules as to absolute contracts are reconciled with a special exception which justice demands. It has become a gloss on the older theory impossibility which it has greatly developed under the guise of reading “implied terms” into contracts. Therefore, as observed by Lord Radcliffe, Frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because circumstances in which performance is called for would render it a thing radically different from hat which was undertaken by the contract. Non haec in foedera veni- “It was not this that I promised to do.”

Furthermore, under the doctrine of frustration the fundamental assumption underlying the contract becomes impossible, The performance of the contract may do not be actually impossible, but if the contract can not be performed as originally contemplated by the parties, there is frustration. In such a case, there is a frustration of the object of the contract. Where, for instance, goods were seized as prize and then released and transshipped so that they arrived two years late, the arrival was not such as was contemplated by the parties. The discharge of a contract by reason of frustration follows automatically when the relevant event happens and does not depend on the volition or election of either party. The doctrine applies if the disturbing cause goes to the extent of substantially preventing the performance of the whole contract. Thus, a contract may become frustrated or impossible of performance by an Act of Legislature, or by operation of law; it may be discharged by a subsequent declaration of war, or by emergency regulations. The frustration of venture may arise through an Act of God vis majeure. An Act of God or vis majeur is “an accident due to natural causes, directly and exclusively, without human intervention and which could not have been avoided by any amount of foresight or care.”

The doctrine of frustration has no application to demise of land to a lease of furnished house, or to a building lease for 99 days. It does not extent to the case of a third person on whose work the promisor relied. Commercial impossibility also does not frustrate a contract. The doctrine does not apply where the event which is said to have frustrated the object of the contract arises from an international act or election of a party.

Indian Law Regrading Frustration

In India, the law is codified and Sec. 56 which deals with the subject provides for discharges of contract by impossibility of performance or frustration. Para 1 And 2 Sec. 56 read as follows.

“An agreement to do an act impossible in itself is void.”

“A contract to do and act which after the contract is made, becomes impossible, or by reason of some event which the promisor could not prevent, unlawful, becomes void when the act becomes impossible or unlawful...”

It is clear from the language of the section that it departs from the English law to a large extent and lays down positive rules of law which according to English decisions are only matter of construction depending on the intention of parties. There is no question of reading implied terms if contract is equivalent to supervening impossibility or illegality. The point of frustration raises some difficulties but a recent pronouncement of the Supreme Court has clarified the position.

In Satyabrat Ghose V. Mugneeram Bangur & Co., who were the owners of a large tract of land started a scheme for its development for residential purposes and accordingly divided in into a large number of plots for the sale of which they invited offers from intending buyers. The company's plan was to accept a small portion of the price by way of earnest money from the buyers at the time of agreement, construct the roads and drains itself and within one month after their completion call upon the buyers to complete the construction by paying one-third of the price at the time of the registration and the balance within 6 years bearing interest 6 percent per annum, time being deemed the essence of the contract.

B entered into a contact on those terms with M & Co., in 5-8-1919 and later on assigned the contract to S. Shortly prior to that assignment a portion of the land covered by the scheme was requisitioned for military purposes by the Government under the Defence of India Rules, and later the rest of the land was also requisitioned. M & Co., thereupon informed B that the land pertaining to the schemed was taken possession of by the Government and there was no knowing how long the Government would retain possession and that the company could not, therefore, take up the construction of roads and drains during the continuance of the war and possible for many years after its termination. The company also wrote to B to treat the contract as cancelled and take back the earnest money. This letter was handed over by B to his assignee S, who asserted that the company was bound by the contract and could not resile. S filed a suit for declaration that the contract date 5-8-19 was subsisting and that S, as assignee of B, was entitled to get the conveyance executed and registered by the company on payment of consideration mentioned in the agreement and in the manner and under the conditions specified therein. The company contended that the contract of sale became discharged by frustration as it became impossible of performance by reason of supervening events. On appeal the Supreme Court held that it could not be said the requisition order vitally affected the contract or made its performance impossible and accordingly the appeal was allowed and the suit was decreed.

The law relating to frustration in India as laid down by the Supreme Court in Satyabrat Ghose’s case may be summed up as follows:

“ The Court in India should look primarily to the law as embodied in Secs. 32 and 56 of the Indian Contract Act. Indeed, the above sections of the Contract Act embrace the whole of the Indian law on the subject. Sec. 32 applies in cases of contingent contract and Sec. 56 covers the rest. Under either, however, impossibility is the central or dominating idea and the determinating factor. “*The essential idea upon which the doctrine of frustration is based is that of immpossibility of performance of the contract.*” In fact, impossibility and frustration are after used as interchangeable expressions. The changed circumstances made performance of it as they did not promise to an impossibility. The doctrine of frustration is in reality an aspect or part of the law of discharge of contract by reason of supervening impossibility or illegality of the act agreed to be done and hence comes within the purview of sec. 55.

In deciding cases in India the only doctrine that we have to go by is that of supervening impossibility as laid down in Section 56, taking work impossible in its practical and not literal sense.

Section 56 days down a rule of positive law and does not leave the matter to be determined according to the intention of the parties. Therefore, in India, the doctrine of frustration is applied not on the ground that parties themselves agreed to an implied term which operated to release them from performance; of the contract. The relief is given by the Court on the Ground of subsequent impossibility when it finds that the whole purpose or the basis of a contract was frustration by the intrusion of occurrence of an unexpected event or change or circumstances which was beyond what was contemplated by the parties at time when they entered into the agreement. When such an event or change of circumstances occurs which is so fundamental as to be regarded by law as striking at the root of the contract as a whole, is the Court which can pronounce the contract to be frustration and at an end.

In applying this rule the Court has to examine the nature and terms of the contract before it and the circumstances under which it was made and to determine whether or not the disturbing element which is alleged to have happened in the particular case has substantially prevented the performance of the contract as a whole. If the answer be in the affirmative, the contract will stand dissolved or discharged by virtue of Sec.

Effects of Subervening Impossibility or Frustration

Sections 56 and 65 of the Indian Contract Act expressly provide for the consequences of the impossibility of performance as follows.

1. When the performance of a contract becomes subsequently impossible or illegal, the contract becomes void. Section 56, para 2.

2. When a contract becomes void, any person who has received and advantage under it must restore it, or make compensation for it to the person from whom he received it.

3. Where one person has premised to do something which he knew or with reasonable diligence, might have known, and which the promisee did not know to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise-Section 566, para 3.

A contracts to marry B being already married to C and being forbidden by the law to which he is subject to practice polygamy. A must take compensation to B for any loss caused to her by the non-performance of his promise.

12.6 DISCHARGE BY LAPSE OF TIME

The Limitation Act., in some circumstances, affords a good defence to suits for breach of contract, and in fact terminates the contracts by depriving the party of his remedy at law. For example, where a debtor has failed to repay the loan on the stipulated date the creditor must file the suit against him within three years of the default. If the three years expire and he takes no action, he will be barred from his remedy, and the other party is discharged of his liability to perform. The period of limitation for simple contracts is three years in India and six years in England, and in the case of Special Contracts it is twelve years.

Example: A borrowed Rs. 5000 from B, a moneylender, and agreed to repay the loan on 31st March 1983. On 31st March, 1983, A failed to repay the loan. But B did not take any legal action against A till 31st March, 1986. In this case, B cannot recover the amount of loan from A as the limitation period for the recover of loan is three years from the date of default, which has expired. And thus, A is discharged from his liability to pay the loan.

The different period of limitation for the enforcement of some of the important contracts/rights is as under:

	Description of Suit	Period of Limitation	Time from which the Period begins
a)	Sit for the recovery of money	3 years	When the loan is made
b)	Suit by surety against principal debtor.	3 years	When the surety pays the creditor.
c)	Sit for declaration	3 years	When the right to sue first accrues.
d)	Suit by mortgagor to redeem or recover possession of immoveable property.	30 years	When the right to redeem or recover possession.
e)	Suit to enforce payment of money secured by a mortgage	12 years	When the money sued for becomes due
f)	By a landlord to recover possession from a tenant	12 years	When the tenancy is determined.

12.7 DISCHARGE BY OPERATION OF LAW

Discharge under this head may take place as follows:

(a) By Death

Where contract requires personal skill or ability, the contract is terminated on the death of the promisor. In case of other contracts the right and liabilities of a deceased person are transferred to his legal representatives.

Example: A, an expert, agreed with B to translate some part of book from French to English. A died before the translation work started. In this case, the contract is of personal nature as it involves the personal qualification of the promisor (A). And thus, the contract is discharged on the death of A.

(b) By Merger

Where the parties embody the inferior contract in a superior contract, when between the same parties, new contract is entered into, and security of a higher degree, or a higher king is taken, the previous contract merges in the higher security. Where securities of the same kind of degree are taken there is no merger.

Example: A gave his land on lease to B. Subsequently, B bought the land which he was holding under the lease. In this cease, B becomes the owner of the property and his rights as a lessee merge into his rights as the owner. And thus, his rights as a lessee vanish, and are not to be enforced.

(c) By the unauthorised alteration of terms of the contract

Where a party to a contract in writings makes any material alternation without the knowledge and consent of the other, the contract can be avoided by the other party. An alternation every by a stranger will entitle the other party to avoid the contract, but where the alteration is due to mere accident or is not material, contract cannot be avoided.

Example: A contracted to sell his plot of 500 sq. yards to B for s. 100,000. The sale deed was executed which was in possession of A. Before the registration of the sale deed, A altered the deed and made it a deed for the sale of 300 sq. yards plot for Rs. 100,000. In this case, the contract is discharged and B is not bound to purchase the plot.

(d) By insolvency

The Insolvency Act provides for discharge of a contract contracts under particular circumstances. So where the Insolvency Court passes an order discharging the insolvent, this order exonerates or discharges him from liabilities on all debts incurred previous to his adjudication.

(e) Right and liability vesting in the same person

Where rights and liabilities under a contract vest in same person the contract is terminated and other parties to contract are discharged For example, when a bill of exchange passes in the hands of the acceptor, the parties are discharged.

12.8 DISCHARGE BY BREACH OF CONTRACT

We have seen contract must strictly perform according to its terms, But where the promisor has neither performed his contract nor tendered performance and where the performance is not excused by consent express or implied, or where the performance is defective, there is a breach of the contract by him. Which entitles the other party to file a suit. If the contract is unilateral the only remedy for the other party is to claim relief for beach can claim relief for breach and also in certain circumstances is exonerated from liability to perform his part of the contract.

The breach of contract may be (I) actual (ii) constructive or anticipatory. The actual breach may take place (a) at the time when performance is due, or (b) when actually performing the contract. The constructive or anticipatory breach of contract, i.e. a breach before the time for performance has arrived, may also take place in two ways, namely, (a) by the promisor doing an act which makes the performance of his promise impossible to perform his promise.

(i) Actual breach of Contract

(a) Actual Breach of Contract at the time when Performance is due- where a person fails to perform a contract, when performance is due the other party can hold him liable for breach. But, if a party who has failed to perform the contract at the appointed time, subsequently expresses willingness to perform the question whether he can do so or not would depend upon whether time was of the essence of the contract or not. In all mercantile contracts time is the essence of the contract and breach of contracts results on failure to perform within the limited time. This specially so in shipping contracts. In a sale of goods subject to rapid fluctuations of market price, the time of delivery is of the essence. There are other transactions, e.g. contract relating to sale of land in which time is not deemed to be of the essence unless parties specially stipulate to the effect, But the terms of the contract, or the nature of the property sold, will determine whether time was of the essence. In the case of sale of a house to be immediately occupied or sale of a business as a going concern, time is not of the essence and the party express willingness to perform it after the appointed time, the law permits him to do so subject to payment of compensations for failure or due performance. The party accepting that he intends to claim compensation otherwise he is deemed to have waived the right to compensation (Sec. 55)

(b) Actual Breach during the Performance of the contract- where a party apparently performs the promise but the other party says that it is not a proper performance according to the contract, the question arises whether there is a breach of the contract exonerating the other party from performance of his part of the bargain. If breach is of a condition vital to the contract, the contract is discharged and the other party need not perform his part of the bargain. In the case of sale of goods by description, unless the goods answering to the description are offered, the buyer is not bound to take delivery or to pay for them. But if the breach is only of a collateral term (non-essential condition) this will not exonerate the party from performance of his part of the bargain, but only entitle him to claim damages. Where the buyer has obtained possession of goods and his right of enjoyment is disturbed in any way he can claim damages caused by the breach of the implied warranty of quiet possession. Where the promisor had made more than one promise, or a divisible promise his repudiation must either be of the whole contract, or of a part of it which is a condition precedent to the promisee's liability, else the promisee will not be entitled to treat such repudiation as equivalent to the breach of the whole contract.

(ii) Constructive or Anticipatory Breach of Contract

It may sometimes happens that even before the time of performance arrives the promisor may do some act which makes the performance impossible or may definitely renounce the contract or show his intention not to perform it. Thus where A promised to assign to B within 7 years from the date of promise all his interests in 4 houses for Rs. 10,000 and before the end of the years assigned all his interests to another person, it was held that without waiting for the 7 years to elapse B could sue for breach of the promise.

In another case a carrier was engaged in April to accompany his employer on a tour of three months to commence on June, 1. On May 11 the employer wrote to the courier that he had changed his mind and declined his services but refused to make him an compensation. On May 22 the courier brought his action for breach of contract, and the defence was that there could be no breach before June 1. It was held that the courier was entitled to treat the letter of May 11, equivalent to breach of contract.

It is to be note that a constructive or anticipating breach of contract does not give rise to a right of action, unless the promisee elects to treat it as equivalent to actual breach, Thus, instead of bringing an immediate action as in the examples given above, the promisee may treat the conduct, act or notice of the promisor as inoperative, and wait for the time when the contract is to be performed, and then hold the promisor responsible for all the consequence of non-performance. But in that case the promisee keeps the contract alive for the benefit of the promisor not only to complete the contract in spite of previous repudiation, but also to avail himself any excuse for non-performance which may have come into existence before the time fixed for performance.

Thus, in our second example, if the carrier had waited till June 1, the employer could withdraw his letter of May 11, and ask the carrier to accompany him on tour, or if performance had become impossible due to some cause, such as the declaration of war, the courier would have lost his remedy and the employer would have been excused from performance. A party putting and end to the contract must restore any advantage he may have received.

12.9 REMEDIES FOR BREACH OF CONTRACT

Where there is a breach of contract on the part of one party, the injured party becomes entitled to any one or more of the following reliefs:

1. Rescission of the contract with the result that the injured party is freed from all obligations under the contract;
2. Suits for damages;
3. Suit upon a quantum meruit;
4. Suit for specific performance of the contract;
5. Suit for an injunction.

1. Rescission

In one party has broken his contract, the other party may treat the breach as discharge, and refuse to perform his part of the contract. He may also successfully defend an action for non-performance, or an action brought for specific performance. Sec.75 further entitles him to compensation for any damage he may have sustained through the non-fulfillment of the contract.

For instance, A singer, contracts with B manager of a theatre, to sing at his theatre for two nights in every week during the next two months, and B engages to pay her Rs. 100 for each nights's performance. On the sixth night, A willfully absents herself from the theatre, and B in consequence, rescinds the contract. B is entitled to claim compensation for the damage which he has sustained through the non-fulfillment of the contract.

2. Damages

Where a contract has been broken, the party who suffers by such breach is entitled, under Sec.73 to receive from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when make the contract, to be likely to result from the breach of it.

But compensation is not to be given for any remote or indirect loss or damage sustained by reason of the breach. Compensation is also available against a party for breach of a quasi-contract. Sec73 is based on the leading case of Hadley V. Baxendale (1854) 9 Ex. 34 the facts the which are as follows:

The plaintiff, an owner of a mill, delivered a broken shaft to the defendant common carrier to take to a manufacturer to copy it and make a new one. The carrier delayed delivery of the shaft beyond a reasonable time, as a result of which the mill was idle for a longer period than should have been necessary. The plaintiff did not make known to the defendant carrier that delay would result in a loss of profits. Held, the carrier was not liable for loss of profits during the period of delay.

Alderson, B observed in this case, "When two parties have made a contract, which one of them has broken, the damage which the other party ought to receive in respect of such breach should be either such as may fairly be considered as arising naturally, i.e., according to the usual course of things from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both the parties a the time the contract was entered into as a probable result of the breach.” This statement of law is known as the Rule in Hadley v. Baxendale.

The Principle enunciated in Sec. 73 is that a party who suffers by the breach of contract is entitled to:

a) Such damages as naturally arose in the usual course of things, as a result of the breach;

b) and if he claims special damages for any loss sustained (which would not ordinarily flow from the breach) he must prove that the other party knew at the time of making the contract that the special loss was likely to result from the breach of the contract;

c) Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach;

d) Compensation for quasi-contract as damage is the same as for a contract.

Following examples has been given under Sec. 73 of the Act-

A contracts to sell and deliver 50 maunds of saltpetre to B at a certain paid on delivery a breaks his promise. B is entitled to receive from A, by of the price for which B might have obtained 50 maunds of saltpetre of like quality a the time when the saltpetre ought to have been delivered.

Liquidated Damages and Un-liquidated Damages

Where there is breach of contract by one party, the other party is entitled to sue for damages. Therefore, unless the court passes a decree for a specified amount, the claim for damages is merely a right to sue and not a debt or actionable claim. Consequently, this claim can be assigned or transferred, since it is not a debt under the law.

The suit may be for liquidated damages or un-liquidated damages.

Liquidated damages are damages agreed upon by the parties in the contract itself to be paid by the party breaking the contract in case of breach. The plaintiff has only to prove the breach of contract, and no proof of loss is required. But liquidated damages must appear to be a genuine pre-estimate of the loss that will be caused to one party if the contract is broken by the other. Where no damages are fixed by the contract, but the amount of compensation claim for a breach of contract is left be assessed by the court, damages claimed are called unliquidated damages.

Unliquidated damages may be classified as follows:

a) Ordinary Or Compensatory Damages

In deciding a suit for damages, the court has to answer two questions: (I) Proximity and remoteness of damage (ii) Measure of damages. The judge has to first decide whether or not the damage has resulted from proximate consequences of the breach, for remote consequences are not regarded. Once the court has decided that the damage is sufficiently proximate, it will the turn to the measure of damages, that is the amount of money that will compensate the plaintiff. The question of remoteness of damage is governed by the maxim recognised in Hadely v. Baxendale and Sec. 73 our contract Act. in jure unon remota causa, sed proxima spectatur- "In law not the remote cause, but the proximate cause is taken notice of."

Thus, if the damage of loss suffered by reason of the breach of the contract is remote or indirect no compensation would be allowed. The aggrieved party however, would in case of breach of contract, be entitled to recover compensation for damage or loss caused to him thereby, if such loss or damage arose naturally and directly in the usual course of things from such breach, of which the parties to the contract knew, at the time of making the contract, to be likely to result from breach of contract. The first part of this rule states the case for ordinary damages and the later concerns with special damages.

In Hadley v. Baxendale, the common negligence delayed delivery of the broken shaft to the manufacturer who has to copy it and make a new one. On account of the delay by the common carrier the mill remained idle for a longer period that should have been necessary. The plaintiff did not make known to the defendant, the common carrier, that for want of the shaft the mill would remain idle which would result in a loss of profit. The plaintiff was held entitled to recover damages for delay in delivery but not for loss of profits occasioned by the closure of the mill since there was no way the common carrier could have been foreseen that the mere absence of a shaft would cause the closure for the mill. The mill-owner could have recovered damages for loss of profit if he had informed the carrier of the likely result of delayed delivery.

Measure of damages

The measure of damages is the estimated loss directly and naturally resulting in the ordinary course of events, from the breach of contract. The injured party is to be put in the same financial position as he would have been if the contract had been performed according to its terms.

In the case of sale and purchase, the damages, payable would be the difference between the contract price and the market price at the date of the breach. The damages are calculated as on the date of breach and any subsequent change of circumstances tending to an increase or reduction of damage cannot be taken note of.

A cow was sold with condition that it was free from disease. The cow was suffering from foot and mouth disease at the time of sale. Not only the cow die but it also infected other cows of the buyer. Held damages could be recovered for the entire loss.

b) Special Damages

Special damages are those resulting from a breach of contract under some special circumstances. If at the time of entering into a contract a person has notice of special circumstances which make special loss the likely result of the breach in the ordinary course of things, than upon his breaking the contract and the special loss following the breach, he will be required to make good the special loss. If therefore there be any special damage which is attributable to the wrongful act, then special damages, if proved, will be awarded. Hence if an unusual damage is likely to be sustained as the result of a breach of contract, its nature should be communicated to the other party before the contract is made so that he contracts subject to the prospective liability. Thus, if in Hadley v. Baxendale, the mill-owner had told the carrier that delay would result in a loss of profits through stoppage of the mill, he would have recovered damages for such a loss.

(c) Exemplary or Punitive Damages

These damages are sum awarded beyond the pecuniary loss sustained by the injured party. Ordinarily, damages for breach of contract are intended to compensate the plaintiff, not to punish the defendant. The object of exemplary damages is to punish the defendant and to deter him and others from similar conduct in the future. Award of exemplary damages is made in only two cases: (I) Breach of promise of marriage cases, (ii) where a bank wrongfully dishonors a commercial customer’s cheque.

In a breach of promise to marry, the amount of the damages will depend upon the extent of injury to the party’s feelings. It is really and additionally sum known as a solatium awarded to the jilted women as a solace for her injured feelings.

In the case of wrongful dishonor of a cheque of a customer who is a trader the rule is the smaller the cheque dishonored the greater the damage.

(d) Nominal Damages

Nominal damages consist of a small of money, e.g., a rupee. They are a token award where there has been an infringement of contractual right, but no actual loss has been suffered. These damages are awarded to establish the right to decree for breach of contract.

(e) Contemptuous Damages

Damages are said to be contemptuous, when the court finds that a breach has been committed, but that the breach is so insignificant or petty that a reasonable man would not have filed a suit. A rupee or even less may be awarded to mark the court's disapproval of the plaintiffs conduct in bringing the action. The law does not take account of trifling things; and where it does, It awards also something of a contemptuous character. Such damages have been awarded to male plaintiffs in breach of marriage actions.

Liquidated Damages and PENALTY

Where the parties have fixed at the time of contract the damages that would be payable in case of breach, a question may arise (in English law at least) whether the provision amounts to "liquidated damages" or a "penalty" Courts in English give effect to liquidated damages, but they relieve against penalty.

The test of the two is that where the amount fixed is a genuine per-estimate of the loss in case of breach; it is liquidated damages and will be allowed, and if the amount fixed is without any regard to probable loss, but in terrarium, is a penalty and will not be allowed.

In Indian law, there is no such difference between liquidated damage and penalty, as Sec. 74 specifically provides payment of only "reasonable" compensation "sec. reads:

"When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach or if the contract contains any other stipulation by way of penalty the party complaining of the breach is entitled whether or not actual damage or loss is proved to have been caused thereby, to received from the party who has broken the contract a reasonable compensation not excluding the amount so named or as the case may be the penalty stipulated for. A stipulation for increased interest from the date of default may be stipulation by way of penalty.....”

The party suffering from breach is entitled to get the actual damages he has suffered. With regard to the amount named in the contract, the compensation payable is the reasonable amount up to the stipulated amount whether it is by way of liquidated damages or penalty.

a) A contracts with B to pay BB Rs. 1,000 if he fails to pay B Rs. 500 on a given day. A fails to pay B Rs. 500 on that day. B is entitled to recover from A such compensation not exceeding Rs. 1000 as the Court considers reasonable.

b) A contracts with B that, if A practices as a surgeon within Calcutta he will pay B Rs. 5,000 A practices as a surgeon in Calcutta. B is entitled to such compensation, not exceeding Rs. 5000 as the court considers reasonable.

c) A gives a recognizance binding him a penalty of Rs. 500 to appear in Court on a certain day. He forfeits his recognizance. He is liable to pay the whole penalty

Payment of Interest

With regard to the payment of interest the following rules have been laid down.

1. Payment of interest in case of default. Where a contract provides that the amount should be paid by a particular date and in default, it will be payable with interest, the court will give effect to the stipulation if the interest is reasonable. Where the interest is exorbitant the Court will give relief.

2. Payment of interest as higher rate Where the bound provides that in default of the payment of the principal by a stated date enhanced interest should be payable, if the enhanced interest is made payable from the

date of default and is reasonable, it is regarded compensation and is allowed. But if the enhanced interest is exorbitant, e.g. increase from 12 percent to 75 percent, it will be penalty and relief will be granted against it.

3. Payment of compound interest. The Court do not lean towards compound interest, they do not award in the absence of stipulation but where there is a stipulation for its payment it is the absence of disentitling circumstances, allowed i.e. it will be allowed only if it is the absence of disentitling circumstances allowed, i.e. it will be allowed only if it is not an enhanced rate.

3. Suit for Quantum Meruit

Quantummeruit as much as he has earned. Suing on quantum meruit is the suing for the value of so much as is done. The in jured party can use for quantum meruit, i.e. if the injured party has done can estimated at a money value of so much as he has already done.

A places an order with B for the supply of 100 chairs to be delivered by installments. B delivers 20 chairs when A informs him that he will require no more. In this case A’s erudition discharges B from the obligation to supply the remaining chairs. He can sue A for the breach of contract for the value of 20 chairs already supplied. The later will be called suit for quantum meruit.

4. Suit for Specific Performance

Instead of, or addition to awarding damages to the injured party a decree for specific performance may be granted. Specific performance means the actual carrying out by the parties carrying out their agreement. This remedy, however, is discretionary and will not granted in the following cases.

1. Where monetary compensation is an adequate remedy.
2. Where the Court can not supervise the execution of the contract, e.g. a

building contract.

3. Where the contract is for personal services.
4. Where one of the parties is a minor.

Specific performance is usually granted in contracts connected with land, e.g. purchase of particular plot of house, or to take debentures in company. In the case of sale of goods, it will only be granted in the case of specific goods and is not ordered as a rule unless the goods are unique and cannot easily be purchased in the marked or are of special value to the party suing by reason of personal or family associations.

5. Suit for Injunction

An injunction is a mode of securing the specific performance of a negative terms of the contract. It is an order of the court whereby an individual is required to refrain from the further doing of the act complained of. It may be used to prevent many wrongful acts, e.g. torts, but in the context of contract the remedy will be granted to enforce a negative stipulation in a contract in a case where damages would not be an adequate remedy. Thus , where a party to a contract is doing something which he had promised not to do, the court may in its discretion, issue and order to the defendant restraining him from doing what he promised not to do. Its application may be extended to contracts where is no actual negative stipulation but where one may be inferred. In Metropolitan Electric Supply Company v. Ginder (1901) 2 Ch. 799, G agreed to make the whole electric required by his premises from the plaintiffs. Held, this was in substance an agreement not to take energy from any other person and it could be enforced by injunction.

12.10 SUMMARY

When the rights and obligations created by the contract come to an end, the contract is said to be discharged. The various modes in which a contract may be discharged are by performance, impossibility of performance, agreement, operation of law, lapse of time and breach. The contract is said to be discharged when parties to a contract, perform their respective obligations which they have agreed to. Sometimes, the performance of a contract is impossible. In such cases, the contract is discharged because the parties cannot perform their respective obligations. A contract may be discharged by mutual agreement of the concerned parties. The important methods for discharge of a contract by a fresh contract are novation, rescission, alternation, remission, waives and acceptance of any other satisfaction. In certain circumstances, the contract is discharged by the operation of law. If the contracts is not performed and the aggrieved party does not enforce his rights within the limitation period, then he is debarred from enforcing the contract. If any party fails to perform his obligation, these occurs a breach of contract. And the other party (the aggrieved or injured party) can enforce his rights in the Court of Law. Suit for rescission, damages, quantum meruit, specific performance and injuctions are the remedies available to the aggrieved party.

12.11 KEYWORDS

Breach of Contract: A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract.

Restitution: It is return of the benefit received by one party to the contract from the other under a void contract.

Injunction: Injunction is generally granted to prevent the breach of an obligation arising out of a contract.

Discharge of Contract: It is the termination of contractual relationship between the parties.

Novation: Novation is the substitution of existing contract for a new contract.

Rescission: It is the cancellation of the contract.

Remission: Remission is the acceptance of lesser fulfillment of the terms of the promise.

12.12 SELF ASSESSMENT QUESTIONS

1. State the circumstances under which a contract is said to be discharged.
2. What is meant by supervening impossibility. Discuss its effect in the performance of a contract.
3. Explain the law of frustration of contract. Give illustrations.
4. Write a note on discharge of contract by consent.
5. Does an impossibility which arises subsequent to the formation of a contract excuse the promisor from performing the contract in all cases?
6. Explain 'breach of contract' as a mode of discharge of contract.
7. What remedies are available to an aggrieved party on the breach of a contract.
8. What are consequences of breach of a contract?
9. What are the principles usually followed to access damages for breach of a contract.
10. "If a contract is broken, the law will endeavor so for as money can do it, to place the injured party in the same position as if the contract had been performed." Comment.
11. Under what circumstances is a party entitled of specific performances?

12.13 SUGGESTED READINGS

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

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

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

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LESSON : 13

SALE OF GOODS ACT 1930: FORMATION OF CONTRACT OF SALES; CAPACITY TO BUY AND SELL; BAIL AGREEMENT

STRUCTURE

13.0 OBJECTIVE

After reading this lesson, you should be able to

a) Define a contract of sale of goods and state its essentials.

b) Make a distinction between sale and agreement to sell, and sale and hire purchase.

c) Define the goods and explain various types of goods.

d) State the rules governing the passing of tile to the goods from the seller to the purchases.

e) Define bailment and explain its features.

13.1 INTRODUCTION

Most of economic activities involve buying and selling of movable goods. The sale of goods may on cash or credit basis. The goods may be sold on the spot these may be a promise to sell the some in future. The law relating to the sale of goods or movable in India is contained in the Sale of Goods Act, 1930. Before the passing of the present Act, the law relating to the sale of goods was contained in Chapter VII of the Indian Contract act, 1872. The provisions of Chapter VII were found to be unsatisfactory and the present Act was passed with the main object of making the provisions more clear. The Act came into force on Ist July, 1930. It contains 66 Sections and extends to the whole of the India except the State of Jammu and Kashmir. The sales of Goods Act, 1930, is based on English Act.

13.2 CONTRACT OF SALES OF GOODS

A contract of sales of goods is a contract whereby the sellers transfers or agrees to transfer the property in goods to the buyer for a price (Section 4).

The term 'Contract of Sale' is a generic term and includes:

i) Sales; and

ii) Agreement to sell

Where the seller transfer the property in the goods immediately to the buyer is a sale. But where the transfer of the property in the goods is to take place in a future time a subject to some conditions thereafter to be fulfilled, the contract is called an agreement to sell. An agreement to sell becomes a sale when the time passed as the conditions are fulfilled subject to which the property in the goods is to be transferred.

13.3 ESSENTIALS OF A CONTRACT OF SALE

The general provisions of Indian Contract Act continue to be applicable to the contract of sales of goods in so far as they are not inconsistent with the express provisions of Sale of Goods Act (Section 3). Thus, for example, the provisions of Contract Act relating to capacity of the parties, free consent, agreements in restraint of trade, wagering agreements and measure of damages continue to be applicable to a contract of sale of goods. But the definition of consideration stands modified to the extent that in a contract of sale of goods consideration must be by way of ‘price’ i.e., only money consideration [Section 2(10) and 4]

The following are the essentials of the contract of sale:

1. Contract

The word contract means an agreement enforceable at law. It presumes free consent on the part of the parties who should be competent to contract. Thus, a compulsory transfer of goods under a Nationalisation Act is not a sale. The agreement must be made for a lawful consideration and with a lawful object. In other words all the essential elements of a valid contract must also be present in a contract of sale.

2. Two Parties

To constitute a contract there must be two parties, viz., a buyer and a seller, as a person cannot buy his own goods. According to Section 4(1), there may be a contract of sale between one part-owner and another, e.g. if A and B jointly own a typewriter, A may sell his ownership in the typewriter to B, thereby making B sole owner of the goods. Similarly, a partner may buy the goods from the firm in which he is a partner and vice-versa. There is, however, one exceptional case when a person may buy his own goods. Where a person’s goods are sold in execution of a decree, he may himself buy them, so as to save them from a transfer of ownership to someone else (Moore vs Singer Manufacturing Co.).

Example: A partnership firm was dissolved and the surplus assets; including the stock in trade, were divided among the partners, in spite. Held, it was not a sale as the partners themselves were the joint owners of the goods and they could not be both sellers and buyers [State of Gujarat v Raman Lal S & Co, AIR (1965) Guj Co].

There are certain other exceptions to the rule that the same person cannot be both a purchaser and a seller. These are:

a) A part owner can sell his share to the other part owner so as to make the other part owner the sole owner of the goods

b) A partner may also buy the goods from the firm in which he is a partner and vice versa.

c) Where a pawnee sells the goods pledged with him on non-payment of bill money, the pawnor may himself buy such goods.

d) In case there is a sale by auction, the seller may reserve right of making a bid at the auction and may thus purchase his own goods.

3. Transfer of Property

Property means 'ownership'. Transfer of property in the goods is another essential of a contract of sale of goods. A mere transfer of possession of the goods cannot be termed as sale. To constitute a contract of sale the seller must either transfer or agree to transfer the property in the goods to the buyer. The term 'property' as used in the Sale of Goods Act, means 'general property' in goods as distinguished from ' special property' [Section 2(11)]. If P who owns certain goods pledges from to R, he has general property in the goods, whereas R (the Pawnee) has special property or interest in the goods to the extent of the amount of balance he has made to the pawnor]. Similarly, in the case of bailment of goods for the purpose of repair, the bailee has special interest in goods bailed to the extent of his labour charges.

4. Goods

According to Section 2(7), "goods means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale". Thus every kind of movable property except actionable claim and money is regarded as 'goods' Goodwill, trade marks, patents right, copyrights, electricity, water, gas, decree of a court of law are all regarded as goods - Shares and stock are also included in goods. With regard to growing crops, grass and things attached to or forming part of the land, such things are regarded as goods as soon as they are agreed to be separated from the land. Thus where trees were sold so that they could be cut out and separated from the land and then taken away by the buyer, it was held that there was a contract for sale of movable property or goods (Kursell vs Timber Operators & Contractors Ltd) But contracts for sale of things 'forming part of the land itself' are not contracts for sale of goods. For example, a contract for the sale of coal mine or building stone quarry is not a contract of sale of goods.

Money is not regarded goods because it is the medium of exchange through which goods can be bought. Old and rare coins, however, may be treated as goods and sold as such.

5. Price

To constitute a valid contract of sale, consideration for transfer must be money paid or promised. Where there is no money consideration the transaction is not a contract of sale, as for instance goods given in exchange for goods or as remuneration for work or labour. H owner, an existing debt due from the seller the buyer is sufficient. Further, there is nothing to prevent the consideration from being partly in money and partly in goods or some other articles of value. For example, when an old car is returned to the dealer for a new one and the difference is paid in cash, that would be a sale.

The term 'contract of sale' is a generic term and includes both a 'sale' and an 'agreement to sell' Sale: where under a contract of sale the property in the goods is immediately transferred at the time of making the contract from the seller to the buyer, the contract is called a 'sale' [Sec 4(3)]. It refers to an 'absolute sale', e.g., an outright sale on a counter in a shop. There is immediate conveyance of the ownership and mostly of the subject matter of the sale as well (delivery may also be given in future). It is an executed contract.

13.4 AN AGREEMENT TO SELL

Where under a contract of sale the transfer of property in the goods is to take place at a future time or subject to same condition thereafter to be fulfilled, the contract is called 'an agreement to sell' [Section 7(3)]. It is an executory contract and refers to a conditional sale.

Examples

(i) On 1 January, X agrees with Y that he will sell Y his scooter on 15 January for a sum of Rs 4,000. It is an agreement to sell, since X agrees to transfer the ownership of the scooter to y at a future time.

(ii) X buys some furniture for Rs 5,000 and agrees to pay for that in the monthly installments, the ownership to pass to him on the payment of second installment. There is an agreement to sell for the furniture dealer.

The Sales of Goods Act does not prescribe any particular form to constitute a valid contract of sale. A contract of sale of goods can be made by mere offer and acceptance . The offer may be made either by the seller or the buyer and the same must be accepted by the other . Neither payment nor delivery is necessary at the time of making the contract of sale. Further, such a contract may be amide either orally or in writing or partly orally and partly in writing or may be even implied from the contract of the parties.

13.5 DIFFERENCE BETWEEN SALE AND AGREEMENT TO SELL

A contract for sale of goods is a contract whereby the seller transfers or agrees to transfer the property in the goods to the buyer for a price. Therefore, the effect of a contract of sale is the transfer of property in the goods from the seller to the buyer. On the sale of goods, the property in them is transferred from the seller to the buyer immediately, but where an agreement of sale is entered into, the property in the goods passes only after the seller has fulfilled certain conditions subsequently [Section 4(3)]. Thus, whether a contract of sale of goods is an absolute sale or an agreement to sell, depends on the fact whether it contemplates immediate transfer from the seller to the buyer or the transfer is to take place in future date. The following are the points of difference between them.

(i) Transfer of Property

In a sale, the property in the goods passes from the seller to the buyer immediately so that the seller is no more the owner of the goods sold. In an agreement to sell, the transfer of property in the goods is to take place at a future time or subject to certain conditions to be fulfilled. In this sense, a sale is an executed contract and an agreement to sell is an executory contract.

(ii) Risk of Loss

In a sale, the buyer immediately becomes the owner of the goods and the risk as a rule passes to the buyer; under an agreement to sell, the seller remains the owner and the risk is with him. Thus under a sale, if the goods are destroyed the loss falls on the buyer, even though the goods are in the possession of the seller. But, under an agreement to sell, the loss will fall on the seller in the case of destruction of goods even though they are in the possession of the buyer.

(iii) Consequences of Breach

In case of sale, if the buyer wrongfully neglects or refuses to pay the price of the goods, the seller can sue for the price, even though the goods are still in his possession. In case of an agreement to sell, if the buyer fails to accept and pay for the goods, the seller can only sue for damages and not for the price, even though the goods are in the possession of buyer.

(iv) Insolvency of the Buyer

In a sale, if the buyer is adjudged an insolvent, the seller in the absence of a lien over the goods is bound to deliver the goods to the official Receiver or Assignee. The seller, will, however, be entitled to a rateable dividend for the price of the goods. On the other hand, in an agreement to sell, when the buyer becomes insolvent before he pays for the goods, the seller may not part with the goods.

(v) Insolvency of the Seller

In a sale, if the seller becomes insolvent, the buyer being the owner is entitled to recover the goods from the Official Receiver or Assignee. In an agreement to sell, if the buyer, who has paid the price, finds that the seller has become insolvent, he can only claim a rateable dividend and not the goods because property in them has not yet passed to him.

(vi) Right to Resale

In a sale, the property is with the buyer and as such the seller (in possession of goods after sale) cannot resell the goods. If he does so, the subsequent buyer having knowledge of the previous sale does not acquire a title to the gods. The original buyer can sue and recover the goods from the third person on owner, and can also sue the seller for the breach of contract as well as for the tort conversion. The right to recover the goods from the third person is, however, lost if the subsequent buyer had bought them bonfire without notice of the previous sale (Section 30).

On the other hand, in an agreement to sell, the property in the goods remains with the seller and as such he can dispose of the goods as he likes and the original buyer can sue him for the breach of contract only. In this case, the subsequent buyer gets a good title to the goods, irrespective of his knowledge of previous sale. Further, goods forming the subject matter of an agreement to sell can also be attached in execution of a decree of a court of law against the seller.

13.6 DISTINCTION BETWEEN SALE AND HIRE-PURCHASE

The difference between a contract of sale and hire-purchase agreement are given below:

1. Nature of Contract

A sale is an executed contract in which the ownership is transferred from the seller to the buyer as soon as the contract entered into

In a hire-purchase agreement it becomes the property of the buyer only after a certain agreed number of installments is paid till then the hire purchaser stands in the position of the bailee an d not the owner of the goods.

2. Termination of the Contract

In a sale the buyer cannot terminate the contract and as such is bound to pay the price of the goods.

On the other hand, the hire-purchase has an option to terminate the contract at any stage, and cannot be forced to pay the further installments.

3 Insolvency of the Buyer Risk of Loss

In a sale of seller takes the risk of any loss resulting from the insolvency of the buyer. But in a hire-purchase the owner is not at any risk because if the hirer does not pay any installments the seller has a right to take back the goods.

4. Implied Conditions and Warranties

A sale is subject to the implied condition and warranties provided under the sale of Goods Act 1930

A hire-purchase agreement is not subject to such implied warranties and conditions. It is however, subject to the implied conditions provided in the hire purchase agreement.

5. Effect of Payments

In a sale even if the payment is made by the buyer in installments the amount payable by the buyer to the seller is reduced, for the payment made by the buyer to the seller is towards price of the goods.

The installments paid by the hire-purchase are regarded as payment towards the price of the goods till the option to purchase the goods is exercised.

6. Resale

The buyer in a sale can resell the goods. But the hire-purchase cannot resell unless he has paid all the installments of hire.

13.7 GOODS– SUBJECT MATTER OF CONTRACT OF SALE

Goods form the subject-matter of a contract of sale. According to Section 2(7), “goods” means every kind of movable property other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of land which are agreed to be severed before sale or under the contract of sale. Trade marks, copy rights, patent rights, goodwill, electricity, water, gas are all goods.

Actionable claim and money are not goods. An actionable claim is something which can only be enforced by action in a Court of law. A debt due from one person to another is an actionable claim and cannot be bought or sold as goods. It can only be assigned. Money here means current money and not old rare coins.

The definition of the term 'goods' also suggests that it includes stocks and shares, growing crops, grass and things attached to or forming part of land which are agreed to be severed from land before sale. Growing crops and grass are included in the definition of the term 'goods' because they are to be severed from land. Trees which are agreed to be severed before sale or under the contract of sale are goods [Badri Prasad v State of MP, AIR (1970) SC 706]

Goods may be classified into various types as shown below:

1. Existing goods; or
2. Future goods; or
3. Contingent goods

1. Existing goods

Goods earned and possessed by the seller at the time of the making of the contact of sale are called existing goods. Sometimes the seller may be in possession but may not be the owner of the goods e.g. sale of goods by a mercantile agent. Existing goods may again be either specific, or ascertained or unascertained.

a) Specific Goods

These are the goods which are identified and agreed upon at the time a contract of sale is made. To be specific the goods must be actually identified; it is not sufficient that they are capable of identification e.g. If X who owns a number of horses, promises to sell one of them, the contract is for unspecified goods.

b) Ascertained Goods

These are the goods which are identified in accordance with the agreement after the contract of sale is made. Though commonly used as similar in meaning to specific goods, these are not always the same.

c) Unascertained Goods

It means generic goods. These goods can be defined by description or even by sample. The seller in the use of a contract for the sale of unascertained goods has the option, rather the right to supply any goods of the kind or the quality contracted for. He is not bound to deliver any particular goods and he
may furnish any goods answering their description in the contract.

2. Future Goods

Goods to be manufactured, produced or acquired by the seller after the making of the contract of sale are called 'future goods' [Sec 2(6)]. These goods may be either not yet in existence or be in existence but not yet acquired by the seller. It is worth noting that there can be no present sale of future goods because property cannot pass in what is not owned by the seller at the time of the contract. So even if the parties purport to effect a present sale of future goods, in law it operates only as an 'agreement to sell [Sec 6(3)].

Examples

X agrees to sell to Y all the mangoes which will be produced in this garden next year. It is contract to sale of future goods, amounting to 'an agreement to sell'.

P contracts on 1 January 1990, to sell to B ten bales of Egyptian cotton to be delivered and paid for on 1 March, 1990. This is a valid contract of sale, amounting to 'an agreement to sell' even though P has no cotton bales with him at the time of making the contract.

3. Contingent Goods

Goods, the acquisition of which by the seller depends upon an uncertain contingency are called 'contingent goods' [Sec. 6(2)]. Obviously they are a type of future goods and therefore, a contract for the sale of contingent goods also operates as 'an agreement to sell' and not a 'sale' so far as the question of passing of property to the buyer is concerned. In other words, like the future goods, in the case of contingent goods also the property does not pass to the buyer at the time of making the contract.

It is important to not that a contract of sale of contingent goods is enforceable only if the event on the happening of which the performance of the contract is dependent happens, otherwise the contract becomes void.

13.8 ASCERTAINMENT OF PRICE (SECTIONS 9 & 10)

'Price' means the monetary consideration for sale of goods' [Section 2(10)]. By virtue of Section 9, the price may be (1) fixed by the contract, or (20 agreed to be fixed in a manner provided by the contract, e.g. by a valuer, or (3) determined by the course of dealings between the parties.

When it cannot be fixed in any of the above ways, the buyer is bound to pay to the seller a reasonable price. What is a reasonable price is a question of fact in each case.

Section 10 provides for the determination of price by a third party. Where there is an agreement to sell goods on the terms that price has to be fixed by the third party and he either does not or cannot make such valuation, the agreement will do void. In case the third party is prevented by the default of either party from fixing the price, the party at fault will be liable to the damages to the others to the other part, who is not at fault. However, a buyer who has received and appreciated the goods must pay a reasonable price for them in any eventuality.

13.9 STIPULATIONS AS TO TIME (SEC. 11)

Stipulations as to time in a contract of sale fall under the following two heads:

1. Stipulations related to time of payment
2. Stipulations not relating to time of payment, e.g. delivery of goods etc.

Stipulations relating to time of payment are not of the essence of a contract of sale, unless a different intention appears from the contract. As regards other stipulations, time may be of the essence of the contract but this essentially depends on the terms of the contract. In a contract of sale, stipulations other than those relating to the time of payment are regarded as of the essence of the contract. Thus if a time is fixed for the delivery of goods, the delivery must be made at the fixed time, otherwise the other party is entitled to put an end to the contract.

13.10 CAPACITY TO BUY AND SELL

A sale of goods means transfer of ownership of the goods by the seller to the buyer. 'Buyer' means a person who buys or agrees to buy goods [Sub Section (1)]; 'seller' means a person who sells or agrees to sell goods [Sub Section (13)]. The two terms 'buyer' and 'seller' are complementary and represent the two parties to a contract of sale of goods.

In every contract of sale there is an implied condition on the part of the seller that in the case of sale he has a right to sell the goods and in the case of an agreement to sell he will have a right to sell the goods at the time when the property in them is to pass.

Usually the owner of the goods or his agent may sell the goods. If a person has no title to the goods or otherwise does not have a right to dispose of certain goods, the buyer of such goods has a right to reject them and to claim back the price if the same has already been paid and refuse to pay if the price has not been paid till then. The leading case on this point is Rowland v Divall (1923). In this case, C purchased a motor car for D, and after using it for sometime he was compelled to return it to the true owner, it becoming clear that D had obtained the car by theft. It has held that D had not fulfilled the condition as to title and C was, therefore, entitled to recover the purchase money from D.

Similarly, if the buyer having bought the goods from a seller takes the delivery of the same but is compelled to pay the price to his seller, who sold the goods without having a right to sell the same [Dickenson v Naul, (1833) 4B & Ad 638)]

Lack of title to the goods is not the only factor because of which the seller may not have a right to sell the goods. If a vendor can be stopped by process of law from selling, he has not the right to sell the goods. Accordingly a sale which would be a breach of patent, copyright, or trade mark may be repudiated by the buyer.

In Niblett v Confectioners' Materials Co Ltd (1921) the sellers sold to the buyers tins of condensed milk c.i.f. from New York to London. Some of the tins were bearing the labels marked "Nissly Brand" which was the trade mark of a third person, Nestle Co. At the instance of the Nestle Co. the Commissioners of customs detained the goods. The buyers had to remove those labels before taking delivery of those tins of condensed milk. The buyers suffered a loss because they had to sell the tins of milk without proper labels at a lower price. The buyers sued the sellers to claim compensation. The court held that the sellers had made a breach of condition that they had a right to sell the goods and as such they were bound to pay damages for the loss suffered by the buyers. Further, Section 27 of the Act of the true owner states:

Subject to the provisions of this Act and of any other law for the time being a force, whose goods are sold by a person who is not the owner thereof and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had.

This rule is derived from the maxim "nemo dat quad habet", which means that nobody can give what he himself has not got, i.e., a seller cannot give a better title than that of his own. If the title of the seller is defective the buyer's title will also be subject to the same defect. It means that the buyer cannot acquire a superior title to that of the seller.

Transfer of Title by Non-Owners

The above stated general rule contained in Sec 27 is subject to the provisions of this Act an of any other law for the time being in force. Various exceptions to this rule have been mentioned in this Act and the Indian Contract Act and in those exceptional situations the seller of the goods may not be having a good title to the goods, yet the buyer of the goods gets a good title to them. The exceptions are:

1. Sale by a mercantile agent (Sec. 27)

A mercantile agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods [Sec 2(9)]. Thus as a rule of mercantile agent having an authority to sell goods conveys a good title to the buyer. But by virtue of this provision (provision to Sec. 27) a mercantile agent can convey a good title to the buyer even though he sells goods without having any authority from the principal To do so, provided the following conditions are satisfied.

a) he should be in possession of the goods or documents of title to the goods in his capacity as mercantile agent and with the consent of the owner.

b) he should sell the goods while acting in the ordinary course of business.

c) The buyer should act in good faith without having any notice, at the time of the contract, that the agent has no authority to sell.

Examples

F entrusted his car to a mercantile agent for sale at a stated price and not below that. The agent sold it to S, a bonafide purchaser, below the reserve price and misappropriated the proceeds. S resold the car to K, the defendant. Held, S obtained a good title to the car from the mercantile agent and he conveyed a good title to K and therefore, F was not entitled to recover the car from K (Folkes v s King).

In Pearson v Rose & Young Ltd, the plaintiff gave possession of his motor car to Hunt, a mercantile agent, to know if the same could be sold. He did not actually authorise Hunt to sell the same. Hunt took the registration book relating to the car from the plaintiff by trick and then sold the car without the plaintiff's authority or knowledge. Hunt sold the car to X, X sold it to Y and Y sold the same to the defendants. The plaintiff sued the defendants to claim damages for conversion on the ground that Hunt had no authority to sell and, therefore, no good title could be passed to any subsequent transferee.

It was observed that though Hunt got possession of the car as a mercantile agent but not the registration book. The sale of a second hand car without the registration book could not be considered to be in the ordinary course of business. It was held that for passing a good title, Hunt should have obtained the possession of the car as well as registration book with the consent of the owner, in the absence of which Hunt was not able to pass a good title to his transferee or the subsequent buyers.

It is also necessary that the mercantile agent must have obtained the possession of the goods or the documents of title in his capacity as a mercantile agent and not in any other capacity. If he is in possession in any other capacity he cannot convey a good title.

2. Transfer of title by Estoppel - Sec 27

Generally the owner of the goods can question the title of the transferee by contending that the seller did not have a right to sell the goods. Sometimes the law of estoppel may apply against the owner of the goods and he may not be allowed to deny seller's authority to sell. The closing words of the rule contained in Sec. 27 are as under:

Unless the owner of the goods is by his conduct precluded from denying the sellers authority to sell.

As noted above sometimes the law of estoppel may apply against the owner of the goods and he may be estopped from denying seller's right to sell the goods. In other words, because of application of rule of estoppel against him he may not be able to assert that the seller of the goods did not have a right to sell and thus the buyer may have a good title even though the seller of the goods did not actually have a right to sell them. When the owner of the goods by his act or omission makes the buyer to believe that the seller of those goods has a right to sell them, subsequently he cannot deny the existence of such a right in the seller.

In reference to sale of goods, estoppel may arise in any of the following ways:

i) The owner standing by, when the sale is effected, or

ii) Still more, by his assisting the sale, or

iii) by permitting goods to go into the possession of another with all the insignia of possession thereof and apparent title, or

iv) if he has otherwise acted or made representations so as to induce the buyer to alter his position to his prejudice.

Example

M, the owner of a wagon allowed one of his employees K, to have his name painted on it. M did so for the purpose of inducing the public to believe that the wagon belonged to K. C purchased the wagon from K in good faith. C acquires a good title as M is estopped from denying K's authority to sell (O'Connor v Clark).

3. Sale by One of Joint Owners - Section 28

Sale by one of the joint owners constitutes another exception to the rule of nemo dat quod non habet. According to Sec 28, if one of the several joint owners is in sole possession of the goods with the permission of the other co-owners a sale by him will convey a good title to the buyer who buys in good faith and at the time of buying has no notice of the fact that such a joint owner has no authority to sell.

4. Sale by a Person in Possession of Goods under a Voidable Contract- Sec. 29

Section 29 deal with the case of a sale by a person who has obtained possession of goods under a voidable contract. It provides that a person in possession of goods under a voidable contract which has not been canceled can transfer a good title to the buyer who buys the goods in good faith. This exception is limited to contracts of sale voidable under Sections 19 and 19A of the Contract Act; i.e.) Voidable on the ground of coercion, fraud, misrepresentation and undue influence. It does not extend to all voidable contracts. Further, if the contract under which the seller obtains goods is void, then even an innocent buyer of the gods from such a seller does not acquire title to the goods.

5. Sale by Seller in Possession after Sale [Sec. 30(1)]

Where a seller, after having sold the goods, continues to be in possession of the goods or of the documents of title to them and again sells or pledges them either himself or through a mercantile agent, he will convey a good title to the buyer or the pledgee provided the buyer or the pledgee acts in good faith and without notice of the previous sale. For the application of this exception it is essential that the possession of the seller must be as seller and not as hirer or bailee.

6. Sale by the Buyer in Possession- Sec 30(2)

Section 30(2) deals with a case where the buyer is in possession of the goods but the property in them has not passed to him. This section says that if a buyer has obtained the possession of the goods or the documents of title to them with the consent of the seller any sale, pledge or other disposition thereof to any person will convey a good title to the transferee provided the person receiving the goods was acting in good faith and without any notice as regards any lien or other right of the original seller in respect of those goods.

In Cahn v Pockett's Bristol Steam Channel Co, A sold certain copper to B and forwarded to him the bill of exchange along with the bill of lading which was endorsed in blank with a view to have the acceptance or the payment of the bill of exchange. B, who was insolvent, did not accept the bill of exchange. Instead of returning the bill of lading and the dishonored bill of exchange to A, he transferred the bill of lading to C, who took the same in good faith and for consideration. It was held that since B had obtained the bill of lading with the consent of a, the transfer by B could convey a good title to C, and the right of A to stop the goods in transit was defeated.

Buyer means a person who buys or agrees to buy. Even if a person has agreed to buy conditionally he can convey a good title.

A person who takes the goods on hire-purchase cannot be considered to be a person who has "agreed to buy" the goods and, therefore, a sale of goods by him does not convey a good title to the buyer. In Belsize Motor supply co. v Cox, Belsize Motor Supply Co, let out a taxi-cab to Allred Burgeess Ltd, under the hire-purchase agreement and the latter were to pay an amount of £ 374 in twelve monthly installments. Before all the installments were paid, Alfred Burgess Ltd pledged the vehicle with Cox. Cox was held liable for conversion of the taxi-cab because Alfred Burgess Ltd was not a person who had "agreed to buy" and therefore, he could not convey a good title to Cox..

7. Resale by an Unpaid Seller [Sec 54(3)]

Where an unpaid seller who has right of lien or stoppage in transit resells the goods, the buyer acquires a good title thereto as against the original buyer, even though the resale may not be justified in the circumstances, i.e. no notice of the resale has been given to the original buyer. Thus, a buyer at a resale acquires a good title.

8. Sale by finder of Goods - Sec 169, Indian Contract Act

According to Sec 71, Indian Contract act, the finder of goods is subject to the same responsibility as the bailee. He is to take due care of the goods while they are in his possession and also to return them when their owner has been found. According to Sec 169 of the Contract Act, however, if the owner cannot with a reasonable diligence be found or if the refuses upon demand, to pay the lawful changes of the finder, the finder may sell the goods -

1. When the thing is in danger of perishing or of losing the greater part of its value, or
2. When the lawful changes of the finder, in respect of the thing found, amount to two-third of its value.

When the finder of goods sells them under the circumstances stated above, the buyer of such good gets a good title to them.

9. Sale by Pawnee - Sec. 176, Indian Contract Act

Normally the pawnee of the goods is under a duty to return them if the debt secured by such goods is paid back to him. He may retain such goods until the debt and interest thereon and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged are paid to him. According to Sec. 176, Indian Contract Act, if the pawnor makes a default in the payment of the debt, the pawnee may either sue him for the debt or may sell the goods pledged on giving the pawnor reasonable notice of the sale. Upon such a sale being made by the pawnee the buyer of such gods acquires a good title to them.

10. Sale by Authorised Officer

In some cases, a special power of sale is given to officers of court, liquidators of companies, receivers insolvent's estate, custom officers for duties remaining unpaid, etc. All these persons are not owners, yet they sell properties of others, and convey a better title to the buyers than they themselves possess.

13.11 BAILMENT

Sections 148 to 181 contained in Chapter IX of the Contract Act deal with law relating to bailment. Section 148 of the Contract Act defines bailment as “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 who delivers the goods is called the ‘bailer’ and the person to whom those goods are delivered is called ‘bailee’.

Essential Features of Bailment

From the definition given by Section 148 it follows that a bailment has the following characteristics:

1. It is a delivery of movable goods by one person to another person.
2. The goods are delivered for some purpose. If the goods are delivered by mistake, without any purpose, there is no bailment.
3. The goods are delivered subject to the condition that when the purpose is accomplished the goods are to be returned in specie or disposed of according to the directions of the bailer.

It is to be noted that bailment is concerned with only movable goods. Money is not included in the category of movable goods.

Sale and Bailment - Distinction

The following are the main points of difference between the sale and bailment:

1. Transfer of Property and Possession

In a sale the property in the goods is transferred from the seller to the buyer and the buyer can therefore, deal with the goods in anyway he desires. On the other hand, bailment involves only transfer of possession of goods from the bailer to the bailee for any of the reasons like repair, safe custody etc. and the bailee can only deal with the goods in accordance with the directions of the bailer.

2. Return of Goods

Normally sale, goods cannot be returned unless there is a breach of some condition. However, in bailment the bailee must return the goods to the bailer on the accomplishment of the purpose for which the bailment was made.

3. Consideration

In a sale the consideration is the price in terms of money. In a bailment the consideration is an undertaking to return the goods after the accomplishment of purpose.

13.12 SUMMARY

Contract of sale is a contract by which the ownership of movable goods is transferred from the seller to the buyer. Where the property in the goods is immediately transferred to the buyer, the contract of sale is called a sale. Where the property in goods is to be transferred to the buyer at some future date or on the fulfillment of a certain condition, the contract of sale is called an agreement to sell. Only the goods can be the subject-matter of contract of sale. The goods may be classified into existing, future and contingent goods. There can be no valid sale of goods without the price. Stipulation relating to time of payment are not of the essence of a contract of sales unless a different intention appears from a contract. A seller cannot give a better title than that of his own. It the title of the seller is defective the buyer's title will also be subject to the same defect. In case of bailment, the goods are delivered by one person to another for some purpose and on the condition that the goods shall be returned back on the achievement of the purpose.

13.13 KEYWORDS

Contract of Sale: 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.

Goods: Goods means every kind of movable property other than actionable claims and money and includes stock and shares growing crops, grass and things attached to or forming part of the land which he agreed to be severed before the sale or under the contract of sale.

Sale: Where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale.

Agreement to Sell: Where the transfer of the property in the goods is to take a place at a future time or subject to some condition thereafter to be fulfilled the contract is called an agreement to sell.

Future Goods: These are the goods which are not in existence at the time of contract of sale.

Price: The money paid for the purchase of goods is called the price.

Hire Purchase Agreement: A hire purchase agreement is an agreement under which the owner delivers his goods on hire basis to a person called 'hirer' for his use.

Bailment: When the goods are delivered by one person to another for some purpose and on the condition that the goods shall be returned back on the achievement of the purpose, it is a case of bailment of goods.

13.14 SELF ASSESSMENT QUESTIONS

1. What is a contract of sale? State its essential characteristics
2. Define the term ‘goods’. Explain different types of goods.
3. Distinguish between:
   a) Sale and agreement to sell
   b) Sale and bailment
4. “A seller cannot convey a better title to the buyer than he himself has”. Discuss this rule of law and point out the exception.

13.15 SUGGESTED READINGS

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LESSON NO. : 14

RIGHTS OF UNPAID SELLER

STRUCTURE

14.0 OBJECTIVE

After reading this lesson, you should be able to

a) Explain when the seller of goods is deemed to be an unpaid seller.

b) State the rights of unpaid seller against the goods.

c) Discuss the rights of unpaid seller against the buyer personally.

14.1 INTRODUCTION

The seller of goods is deemed to be an 'unpaid seller':

(a) When the whole of the price has not been paid or tendered.

(b) When a bill of exchange or other negotiable instrument (such as cheque) has been received as conditional payment, and it has been dishonoured [Section 45(1)].

The term 'seller' includes any person who is in the position of a seller (for instance, an agent of the seller to whom the bill of lading has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for the price) [Section 45(2)].

The above definition of unpaid seller states the following :

(i) The seller shall be called an unpaid seller even when only a small portion of the price remains to be paid.

(ii) It is for the non-payment of the price and not for other expenses, that a seller is termed as an unpaid seller.

(iii) Where the goods have been sold on credit, the seller cannot be called as an unpaid seller during the credit period unless the buyer becomes insolvent. On the expiry of credit period if the price remains unpaid, then only the seller will become an unpaid seller.

(iv) Where the full price has been tendered by the buyer and the seller has refused to accept it, the seller cannot be called as unpaid seller.

Example : State whether the seller is an unpaid seller or not in each of the following alternative cases :

(a) X sold some goods to Y for Rs. 10,000. Y paid Rs. 9000 but failed to pay the balance.

(b) X sold some goods to Y for Rs. 10,000 and received a cheque for the full price as conditional payment. On presentment, the cheque was dishonoured by the Bank.

(c) X sold some goods to Y for Rs. 10,000 on a credit of one month. One month has not yet expired.

(d) X sold some goods to Y for Rs. 10,000 on a credit of one month and one month has expired and the price remains unpaid,

(e) X sold some goods to Y for Rs. 10,000 on a credit of one month. Y became insolvent during the period of credit.

Solution :

(a) : X is an unpaid seller because the full price has not been paid.

(b) : X is an unpaid seller because the cheque received as conditional payment has been dishonoured.

(c) : X is not an unpaid seller because the credit period has not yet expired and the buyer has not yet become insolvent.

(d) : X is an unpaid seller because the price remains unpaid even after the expiry of credit period.

(e) : X is an unpaid seller because the buyer has become insolvent.

14.2 RIGHTS OF UNPAID SELLER

The rights of an unpaid seller may broadly classified under the following two categories :

1. Rights against the goods

2. Rights against the buyer personally

The various rights of an unpaid seller have been shown in figure 1

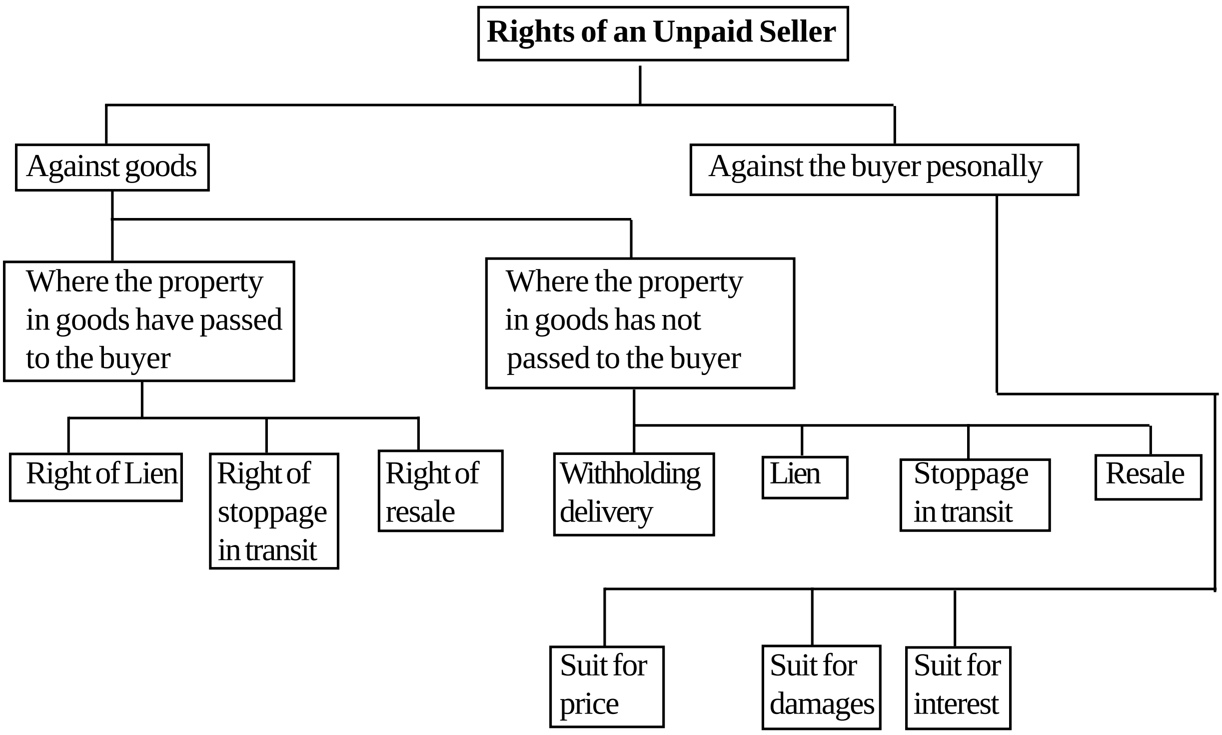

Figure 1

14.2.1 Rights of an unpaid seller against the goods

Sometimes, after the sale of the goods, the seller still has the possession of the sold goods. In such cases, an unpaid seller has certain rights against the goods. These rights may be discussed under the following two heads:

1. Where the ownership of the goods is transferred to the buyer.
2. Where the ownership of the goods is not transferred to the buyer.

1. Rights of unpaid seller against the goods where the property in the goods have passed to the buyer

An unpaid seller has the following rights against the goods not with standing the fact that the property in the goods has passed to the buyer:

(a) Right of lien ;

(b) Right of stoppage of goods in transit;

(c) Right of resale.

(a) **Right of Lien**

"Lien" is the right to retain possession of goods until certain charges due in respect of them are paid. The unpaid seller has the right to retain the goods until he receives their price . By way of exercise of this right the seller can refuse to deliver the goods to the buyer until the payment of the price even though the ownership in the goods has already passed to the buyer. By a mere exercise of this right, the contract of sale of goods is not automatically rescinded. According to Section 47 this right can be exercised in the following situation :

(i) **When the goods have been sold without any stipulation as to credit** i.e., the sale of the goods has been on cash basis. It has already been observed under Section 32 that if there is no agreement to the contrary the payment of the price and the delivery of the goods are concurrent condition. It means that if the goods have not been sold on credit the seller expects that the buyer shall pay the price against the goods. The seller can refuse to deliver them to the buyer or in other words he can exercise the right of lien over thew goods, if the buyer is not ready and willing to pay their price in exchange for the goods.

(ii) **When the goods have been sold on credit** the seller can exercise the right of lien on the expiry of the period of credit. As soon as the period of credit expires the price becomes due and the seller can exercise the right of lien thereafter. Even though originally the seller had agreed to sell them on credit but now since the price has become payable because of the expiry of the period of credit the seller can refuse to part with the goods until he is paid for them. For example, on Ist January A sells a horse to B and it is agreed that the buyer may take the delivery at any time he likes and the price is payable on Ist Mach. If the buyer has not taken the delivery of the goods by Ist March and he demands the delivery after this date, the seller can refuse to part with the horse until the buyer pays for them.

(iii) The seller can also exercise this right of lien when, before the delivery of the goods to him, the buyer becomes insolvent. Even though the seller had sold the goods on credit and the period of credit has not yet expired but the buyer has become insolvent, the seller's right of lien can be exercised. When the goods are sold on credit the presumption is that the buyer shall maintain his solvency. If that condition can no more be satisfied, the seller is entitled to the exercise of this right. For example, the goods are sold on Ist January and the period of credit extends upto Ist March, if the buyer becomes insolvent on 15th January and he has not yet taken the delivery of the goods the seller may exercise his right of lien if the buyer demands delivery at any time after 15th January although originally he had agreed to deliver the goods to the buyer on credit. By the insolvency of the buyer during the period of credit the right of lien which may have been suspended earlier for the period of credit is revived and the credit granted earlier comes to an end.

The term ‘insolvent’ here does not mean a person who has been adjudged insolvent under the Insolvency Law. In Sale of Goods Act “a person is said to be insolvent who has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he has committed an act of insolvency or not”. [Section 2 (8)]

The right of lien is linked with possession and not with title. It is essentially a right over the property of another person. The unpaid seller’s lien can be exercised only so long as the goods are in the actual possession of the seller or his agent. Once the possession is lost, the lien is also lost. The right of lien cannot be exercised during the currency of credit term. When the term expires, the unpaid seller may exercise the right of lien. The lien of the unpaid seller is for the price only; so when the price has been paid or tendered, he cannot retain possession of the goods any longer. Again the right of lien does not extend to other charges which the seller may have to incur for storing the goods during the exercise of the lien.

Example : A sold certain shares to B. The relative share certificates and transfer forms duly signed were handed over by the seller to the buyer against payment of price by cheque. The buyer became insolvent. It was held by the Privy Council that the seller had no lien on shares because his lien ceased when he parted with the possession. Bharucha *v*. Wadihah, 28 Bom. L.R. 777 (P.C.).

The right of lien is indivisible in nature, and so the buyer is not entitled to claim delivery of a portion of the goods on payment of a proportionate price. Further this right is available even after part delivery of the goods has been made, unless such part delivery is made under such circumstances as to show an agreement to waive the lien.

Example : A sells to B a certain quantity of sugar. It is agreed that three months credit shall be given. B allows the sugar to remain in A's warehouse til the expiry of the three months, and then does not pay for them. A may retain the goods for price.

Conditions for the Exercise of Right of Lien

The following are conditions precedent to the exercise of the right of lien:

(a) The ownership must have passed to the buyer.

(b) The goods must be in possession of the seller or under his control as bailee, etc.

(c) The possession of the goods by the seller must not expressly exclude the right of lien.

(d) The whole or part of the price must remain unpaid. It may be noted that the lien can be exercised only for price. Thus the seller cannot claim lien for godown charges, for storing of goods in exercise of his lien for price.

The lien of an unpaid seller is a particular one. It is the personal right which can be exercised only by him and not by his assignee or his creditors.

Part Delivery : Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien.

Thus in case of part delivery of the goods, the unpaid seller may exercise his right of lien on the reminder, but where part delivery has been made under circumstances as to show an agreement to waive the lien, the seller cannot exercise his lien. If for example, out of 100 bags of weighed which were to be supplied by the seller to the buyer, 20 have already been delivered to the buyer, the seller may exercise his right of lien over the other 80 bags. If, however, the buyers gets the whole of the goods weight but takes away only a part of them, the delivery of the part of the goods in such a case would operate as delivery of the whole and the seller's right of lien over the remaining goods would come to an end. Similarly if an essential part of the machinery has been delivered by the seller to the buyer, the seller cannot exercise his right of lien over the remaining parts.

Termination of lien : The unpaid seller's right of lien may be lost in any of the following ways :

1. **By payment of price :** The right of lien comes to an end when the seller ceases to be an unpaid seller, i.e., when the buyer pays or tenders the price to the seller. It has been noted under Section 47(1) that the unpaid seller is entitled to exercise his right of lien until payment or tender of the price in respect of certain goods, the payment or tender of the price, therefore, terminates the seller's right to retain the goods. Merely obtaining the decree does not mean the payment of the price and, therefore, Section 49(2) states that unpaid seller, having a lien on the goods, does not lose his lien by reason only that he has obtained a decree for the price of the goods.

2. **By delivery to the carrier** : Since the right of lien is a right to retain the possession so long as the seller continues in possession the right would obviously come to an end when the seller loses the possession. The seller loses such a possession when he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the gods. Though the delivery of the goods to a carrier or the bailee for the purpose of transmission to the buyer results in end of lien but that results in

the beginning of the right of stoppage in transit. Of course, the right of stoppage in transit cannot be exercised until the buyer has become insolvent.

For the termination of the lien the delivery to the carrier or some other bailee must have been made without reserving the right of disposal i.e. , a right of not delivering the goods to the buyer until he fulfils the required condition, generally that condition being the payment of the price, the seller can exercise his right of lien.

3. **By the buyer obtaining possession of the goods :** When the buyer or his agent lawfully obtains the possession of the goods the right of lien comes to an end. If the buyer, at the time of the contract of sale, is already in possession of the goods, although as a bailee for the seller, the seller cannot exercise a right of lien in respect of those goods. If the buyer once obtains the possession the right of lien comes to an end, and such a right cannot be exercised even if the seller again gets back the possession of those goods. Thus, where a refrigerator after being sold was delivered to the buyer and since It was not functioning properly, the buyer delivered two of its parts to the sellers for repairs, it was held that the seller could not exercise his lien over those parts.

4. **By waiver :** Unpaid seller's right of lien is also lost by waiver thereof. According to Section 46(1) (a) an unpaid seller gets his right of lien by implication of law. A party to a contract may waive his rights, expressly or impliedly, according to Section 62. Section 49(1)(c) expressly provides that the right of lien comes to an end by waiver thereof. Such a waiver may be presumed when the seller allows a period of credit to the buyer, or delivers a part of the goods to the buyer or his agent under the circumstances which show that he does not want to exercise his right of lien, or, when the seller assents to a sub-sale which the buyer may have made.

5. **Disposition of the goods by the buyer** : According to Section 53, the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods by the buyer. This general rule is subject to two exceptions :

(i) When the seller himself assents to a sub-sale or other disposition of the goods by the buyer.

(ii) When the buyer having lawfully obtained possession of document of title to the goods transfers the same to a transferee is good faith and for consideration and the transfer is by way of sale.

In the above-stated two exceptional cases the unpaid seller's right of lien comes to an end.

(b) **Right of stoppage of Goods in Transit (Sections 50-52)**

The second important right which is available to an unpaid seller is the right of stoppage in transit. The right to stoppage means the right to stop further transit of the goods, to resume possession thereof and to retain the same till the price is paid. The right can be exercised under the following circumstances:

(i) The seller must be unpaid.

(ii) The seller must have parted with the possession of the goods and the buyer must not have acquired it.

(iii) The buyer must be insolvent.

(iv) The property must have passed from the seller to the buyer.

The right of stoppage in transit arises only after the seller has parted with possession of the goods and the buyer has become insolvent. This right is only available when the goods are neither in the possession of the seller nor that of the buyer, but are in the possession of a middlemen for the purpose of transmission to the buyer.

Example : B, who had bought goods from M/s. Clark & Co. of Glasgow, instructed the sellers to send the goods by a certain named ship to Melbourne. Goods were first railed to London and then shipped to Melbourne, a mate's receipt being sent to buyers. On becoming insolvent, the sellers gave notice to the Rail Company to stop delivery to buyers, but it was too late. They then gave fresh notice to the shipowners claiming back the goods before the ship arrived at Melbourne. On arrival there, the receiver in bankruptcy of B demanded the bills of lading from the master. Held, the goods having been effectively stopped in transit, the trustee could not claim them. [Bathell *v.* Clark 19 Q.B.D. 553]

Duration of transit

The right of stoppage in transit can be exercised so long as the goods are in transit. It becomes important, therefore, to know as to what is the duration of transit, i.e., when transit begins and when it comes to an end. Section 51 provides rules regarding the same. According to sub section (1) the goods are deemed to be in the course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer. The transit continues until the buyer or his agent in that behalf takes delivery of them from such carrier or other bailee. It means that so long as the goods are with a carrier the transit continues.

In order that the right of stoppage in transit can be validly exercised the carrier carrying the goods must be a middleman rather than either the buyer's agent or seller's agent. If the carrier is the buyer's agent, delivery of the goods to him would defeat the right of stoppage in transit. On the other hand, if he is the seller's agent, the possession of the seller's agent is the possession of the seller and he can even exercise the right of lien over those goods. It is only when the carrier has the capacity of a carrier that the goods are deemed to be in transit for the purpose of the exercise of this right.

Section 51, sub section (5) provides that when the goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of each case whether they are in the possession of the master as a carrier or as agent of the buyer. In Schotmans v. Lancashire & Yorkshire Ry. Co. there was delivery of the goods by the seller on board a ship belonging to the buyer. The bill of lading was also taken in buyer's order. It was held that in this case it amounted to the delivery of the goods to the buyer so that the seller was precluded from exercising his right of stoppage in transit.

In Turner v. The Trustees of Liverpool Docks the cargo of cotton was put on the board of the vessel belonging to the buyers, but the goods were made deliverable to the sellers or their order. Patterson J. giving judgement of the court observed that "there is no doubt that the delivery of goods on board of the purchaser's own ship is a delivery to him, unless the vendor protects himself by special terms, restraining the effect of such delivery. In the present case the vendors by the terms of the bill of lading, made the cotton deliverable at Liverpool, to their order or assigns, and there was not, therefore, a delivery of the cotton to the purchasers as owners, although there was a delivery on board their ship. The vendors still reserved to themselves, at the time of delivery to the captain, the jus disponendi of the goods, which he by signing the bill of lading acknowledged.

The transit is deemed to be at an end and the seller cannot exercise his right of stoppage in the following cases :

(i) When the buyer or his agent takes delivery after the goods have reached destination.

(ii) When the buyer or his agent obtains delivery of the goods before their arrival at the appointed destination.

(iii) When the goods have arrived at their destination and the carrier acknowledges to the buyer or his agent that he holds the goods on his behalf.

(iv) When the goods have arrived at their destination but the buyer instead of taking delivery requests the carrier to carry the goods to some further destination and the carrier agrees to take them to the new destination.

(v) When the carrier wrongfully refuses to delivery the goods to the buyer or his agent.

(vi) When part delivery of the goods has been made to the buyer with an intention of delivering the whole of the goods, transit will be at an end for the remainder of the goods also which are yet in the course of the transit.

The unpaid seller may exercise his right of stoppage in either of the following ways :

(a) By actually taking possession of the goods, or

(b) By giving notice of his claim to

 (i) the carrier, or

 (iii) other bailee in whose possession the goods are.

Such notice can be given either to the person in actual possession of the goods or to his principal. When the notice is given to the principal, the notice, to be effectual, must be given at such time and in such circumstances that the principal, by the exercise of reasonable diligence, may communicate it to the servant or agent in time to prevent a delivery to the buyer.

When notice of stoppage in transit is given by the seller to the carrier or other bailee in possession of the goods, he shall deliver the goods to, or according to the directions of the seller. It may be noted that the expenses of such recovery shall be borne by the seller (Section 52).

Wrongful refusal by the Carrier

If, even after a proper notice by the seller to the carrier for stopping the goods in transit, the carrier delivers them to the buyer, he shall be liable to the seller for conversion, i.e., wrongful appropriation of the goods to another. If after the transit has ended and the carrier wrongfully returns the goods to the seller, he is liable to the buyer for conversion.

Lien and Stoppage in Transit Distinguished

The points of distinction between these rights of an unpaid seller are stated as under :

1. The seller's lien attaches when the buyer is in default whether he be solvent or insolvent, while the right of stoppage in transit arises only when the buyer is insolvent.

2. Lien is exercisable only when the goods are in actual possession of the unpaid seller, while stoppage in transit is available only after the seller has parted with the possession of the goods but are still passing through channels of communication for the purpose of reaching the hands of the vendee, i.e. they are in custody of an independent carrier.

3. The right of lien consists in retaining the possession of the goods, while the right of stoppage in transit consists in regaining the possession of the goods.

4. Lien ends where the right of stoppage commences. It means when the seller hands over the possession of goods to the carrier, his lien ends and the right of stoppage in transit commences.

Effect of Sub-Sale or Pledge By Buyer (Section 53)

The general rule is that the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer may have made. However, there are two exceptions to this general rule. They are stated below :

1. When the seller has assented to the sale or other disposition with the buyer may have made.

Example : A sold to B 80 maunds of grain out of a grainary. B then sold (out of these 80 maunds) 60 maunds to C. C after receiving from B the delivery order presented it to A. A told C that the grains would be delivered in due course, B then became insolvent. A's right against the 60 maunds is not lost since A recognised the title of C the sub-buyer (Knigths v. Wiffen).

2. When a document of title to goods (e.g., a bill of lading or railway receipt) has been issued or transferred to a buyer, and the buyer transfers the document to a person who takes the document in good faith and for consideration, then

(a) If such last mentioned transfer was by way of sale, the unpaid seller's right of lien or stoppage in transit is defeated, and

(b) If such last mentioned transfer was by way of pledgee, the unpaid seller's right of lien or stoppage in transit can only be exercised, subject to the rights of the pledge. But in this case the unpaid seller may require the pledgee to satisfy his claim against the buyer first out of any other goods or securities of the buyer in the hands of the pledge.

(c) **Right of Resale**

An unpaid seller can resale the goods under the following three circumstances :

(i) Where the goods are of a perishable nature.

(ii) Where the seller expressly reserves right of resale if the buyer commits a default in making the payment.

As a result of this resale, the original contract will be terminated but the seller will have a right to claim damages [Section 54 (4)].

(iii) Where the unpaid seller who has exercised his right of lien or stoppage in transit gives a notice to the buyer about his intention to resell and buyer does not pay or tender within a reasonable time.

Effects of resale with or without Notice (Sections 54 (2) and (3)] : The effects of resale with or without notice are summarized as under :

Rights	In case of resale after notice	In case of resale without notice
I Unpaid seller's right to recover the loss on the sale	available	not available
II Original buyer's right to recover the profit on resale	not available	available
III New buyer's (who buys in resale) right to acquire a good title	available	available

Example : X sold 10 tons of rice to Y at a rate of Rs. 40,000 per ton on a credit of one month. One month expired but Y did not pay. State the legal position in each of the following alternative cases :

(a) If X resold 10 tons of rice to Z at a rate of Rs. 50,000 per ton after giving a notice of resale Y.

(b) If X resold 10 tons of rice to Z at a rate of Rs. 30,000 per ton after giving a notice of resale Y.

(c) If X resold 10 tons of rice to Z at a rate of Rs. 50,000 per ton without giving a notice of resale to Y.

(d) If X resold 10 tons of rice to Z at a rate of Rs. 30,000 per ton without giving a notice of resale to Y.

Solution

(a) X is entitled to keep the profit of Rs, 1,00,000 with himself because the buyer cannot be allowed to take advantage of his own wrong i.e, breach of contract [Section 54 (2)]. Z shall get a good title against Y [Section 54 (3)].

(b) X is entitled to recover the loss of Rs. 1,00,000 from Y [Section 54(2)]. Z shall get a good title against Y [Section 54(3)].

(c) Y is entitled to the profit of Rs. 1,00,000 [Section 54(2). However, Z shall get a good title against Y [Section 54(3)].

(d) X is not entitled to recover the loss of Rs. 1,00,000 [Section 54(2)]. However, Z shall get a good title against Y [Section 54(3)].

2. Rights against the Goods where the Property in the Goods has not passed to the Buyer [Section 46(2)]

Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and coextensive with his rights of lien and stoppage in transit where the property has passed to the buyer [Section 46(2)].

14.2.2 Rights against the buyer personally

The unpaid seller, in addition to the rights against the goods as discussed above, has the following rights of action against the buyer personally.

(a) Suit for Price (Section 55)

Where under a contract of sale, the property in the goods has passed to the buyer and the goods have actually come into his possession, the unpaid seller's only remedy is a suit for the price.

Where under a contract of sale, the price is payable on a day certain irrespective of delivery and the buyer wrongfully neglects or refuses to pay the price, the seller may institute a suit for the recovery of the same, although the property in the goods may not have passed.

The right of the seller to recover the price, after the property has passed to the buyer, can be exercised irrespective of the fact that no delivery of the goods has yet been made to the buyer. In Dunlop v. Graot there was a contract for the sale of a certain quantity of iron and the delivery was to be made, if the buyer so required, between 3rd March and 30th April. The price was agreed to be paid by 30th April. By 30th April delivery of only a portion of the iron was made, as the buyer did not require the delivery of the remainder. It was held that the seller was entitled to recover the price of the whole of the iron and he was not required to show that he had appropriated any specific quantity of iron to the contract for completing the delivery of the remaining iron. When the buyer has obtained the possession of the goods the seller's sole remedy is an action for price. On the other hand, if the goods have not yet reached the actual possession of the buyer, the seller has, in addition to the right of recovery of price under Section 55 certain rights against the goods.

(b) **Suit for Damages for non-acceptance (Section 56)**

Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages (and not for full price) for non-acceptance. Now the question arises as to what shall be the basis or principles of estimating the damages to the claimed. The answer is provided by Section 73 of the Indian Contract Act. According to Section 73, the measure of damages is the estimated loss arising directly and naturally from the buyer's breach of contract.

The seller's remedy under the present section is a suit for damages rather than an action for the price of the goods. In Bungo Steal furniture v. Union of India there was a contract for the supply of steel bins to the Govt. of India by the appellants. The Government wrongfully terminated the contract before the bins had been actually manufactured. It was held that, in this case, since, the property in the goods had not yet passed to the buyer (Govt.) the case was not covered by Section 55 and an action for the recovery of the price could not lie but appellants were entitled to recover damages from the Govt. for wrongfully refusing to accept the goods.

The calculation of damage in different situations is discussed below:

When the Goods have a Ready Market : We can discuss the question of damages when they have a ready market under the following two headings :

(i) *The Buyer resells the Goods* : Where the goods have a ready market, the principle application is that the buyer will have to pay the loss that the seller has sustained on reselling of the goods on the day of the breach.

Example : If the difference between the contract price and the market price on the date of breach is nil, the seller can get only nominal damages (Charter v. Sullivan).

(ii) *The seller does not Resell* : If the seller does not resell, the difference between the contract price and market price on the day of breach is adopted as a measure of damages. This rule will apply even if the seller has actually incurred no loss or earned a lot, after selling it on a day other than the day of breach of contract (Bungo Steel Furniture v. Union of India).

Where Goods have no Ready Market : Where, however, the goods are of the type which have no ready market, the measure of damages shall depend upon the facts of each case.

Example : T Ltd., a car dealer, contracted to supply a motor-car to R. R refused to accept delivery. The market price in fact had fallen too much. Head that T Ltd. was entitled to damages for the loss of their bargain, viz., the profit they would have earned by selling that car (Thompson Ltd., v. Robinson).

Goods Deliverable in Instalments

Where the goods are deliverable in instalments, and the buyer refuses to accept one or the other or all the instalments, the difference in prices is to be reckoned for purposes of calculating damages on the day that a particular instalment was to be delivered.

(c) Suit for damages for Repudiation of the contract (Section 60)

Where buyer repudiates the contract before the due date of delivery, the seller may either treat the contract as subsisting and wait till the due date of delivery or he may treat the contract as rescinded and sue for damages for the breach.

(d) **Suit for Interest (Section 61)**

Where under a contact of sale, the seller tenders the goods to the buyer and the buyer wrongfully refuses to accept and pay for them, the court may award interest on the price from the date of the tender of the goods or from the date when the price is payable. If the goods are sold on credit, interest will run from the expiry of the credit. The rate of interest to be awarded is discretionary with the court. It may be noted that the seller can only recover interest when he is in a position to recover the price. When he only sue for damages, for breach of contract, he is not entitled to interest.

14.3 SUMMARY

A seller who has received only a part of the price is an unpaid seller. The rights of an unpaid seller is against the goods and against the buyer personally. On the transfer of the ownership of the goods to the buyer, an unpaid seller has right of lien, right of stoppage in an unpaid seller also has certain rights against the buyer. These rights are sit for price, suit for damages, suit for interest and suit for interest and suit for reputation of contract.

14.4 KEYWORDS

Unpaid Seller: A person who has sold goods to another person but has not been paid for the goods, or has been paid partially is called an unpaid seller.

Right of Lien: When the seller of goods has not been paid and the ownership of goods has been transferred to the buyer but the goods are in the possession of the seller, the seller has the right of retain the goods till he receives the price of goods from the buyer.

Stoppage in Transit: It means the stopping of the goods while they are in the course of transit.

Breech of Contract of Sale: When the buyer fails to pay the price or accept the goods, or the seller fails to deliver the goods, the breach is said to have occurred.

14.5 SELF ASSESSMENT QUESTIONS

1. When is a seller of the goods deemed to be an unpaid seller ? What are the rights against the goods and the buyer personally ?

2. Compare and contrast the unpaid seller's right of lien and stoppage in transit. Do you agree that right of stoppage in transit is an extension of right of lien ?

3. Describe the law relating to the right of resale available to an unpaid seller in the Sales of Goods Act, 1930.

4. "Sub sale by the buyer does not extinguish unpaid seller's right to the lien. "Comment.

5. What is meant by the right of stoppage in transit in respect of sale of goods ? When is the this right lost ? How is this right effected or exercised ?

Practical Problems

Decide the following problems, giving reasons:

1. X sells goods to Y. Y pays to X through a cheque. Before Y could obtain the delivery of goods, his cheque has been dishonoured by the bank. X, therefore, refuses to give the delivery of goods until paid. Is X's action justified?

2. A sells to B 80 quintals of grain out of a large quantity lying in his granary. B sells 60 quintals, out of those, the goods having not yet been certained, to C. Then C having a delivery order from B forwards it to A, who informs C that he will send the grain in due course. B then becomes solvent. Can A refuse to deliver the 60 quintals of grain to C? Give reasons for your answer.

3. A is the owner for specific goods lying in N's warehouse. A sells those goods to B and takes from B a bill exchange for the price and hands over to B a delivery order addressed to N. B resells the goods to C and gives a delivery order but before C can obtain possession of the goods B becomes insolvent and A warns N not to deliver to anyone without A's order. Is A entitled to retain goods against C? Give reasons.

4. A sells to B a quantity of sugar in A's warehouse. It is agreed that B shall get two months credit. B allows the sugar to remain in A's warehouse. B becomes insolvent before the expiry of the two months, and the Official Receiver demands delivery of the sugar without offering to pay. What are the rights of A?

14.6 SUGGESTED READINGS

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LESSON NO. : 15

CONDITIONS AND WARRANTIES, DOCTRINE OF CAVEAT EMPTOR

STRUCTURE

15.0 OBJECTIVE

After reading this lesson you should be able to

a) Define the condition and warranty and differentiate between them.

b) State the circumstances in which a condition is reduced to the status of a warranty.

c) Discuss the implied conditions and warranties recognized by the Sales of Goods Act.

d) Explain the rule of Caveat Emptor.

15.1 INTRODUCTION

A contract of sale of goods is made by an offer by the seller and its acceptance by the buyer. When forming a contract, a party may make a statement with a view to inducing the other party to enter into the contract. Such statements when made before entering into the contract are known as representations. Such representations are generally about the nature, quality and fitness of goods. Such a representation may be a mere expression of an opinion of the seller and may not form a part of the contract of sale. For example, where a jewellery seller, while praising a particular diamond ring, states that the diamond is very lucky and anyone who shall purchase it must become wealthy, his statement, being commendatory in nature, does not form part of the contract and its breach does not give rise to any legal consequences. On the other hand, when a representation forms a part of the contract of sale and the other party relies upon it, such a representation is called a stipulation within the meaning of Section 12 of the Sale of Goods Act. However, all stipulations are not of equal importance. Some of these stipulations may go to the very root of the contract and their breach may frustrate the very purpose of the contract, while others are not so vital that their breach may seem to be a breach of the contract as such.

15.2 CONDITION

The term ‘condition’ is defined under Section 12(2) of the Sale of Goods Act, which reads as under:

“A condition is a stipulation essential to the main purpose of the contract, the breach of which gives the aggrieved party a right to treat the contract as repudiated”.

Thus, a conditions is an important representation made by the seller the non-fulfillment of which defeats the very purpose of the buyer and he/she has the right to terminate the contract.

Example: A consulted B, a car dealer, and told him that he wanted to purchase a car 'suitable for touring purpose'. B, suggested that a 'Bugatti' car would be fit for the purpose. Relying upon this statement, A bought a 'Bugatti' car. Later on, the car turned out to be unfit for the touring purpose. A wanted to reject the car and demanded the refund of the price. It was held that A was entitled to reject the car and to have the refund of the price. In this case, the suitability of the car, for touring purpose, was a condition of the contract. It was so important that its non-fulfillment defeated the very purpose for which A bought the car.

15.3 WARRANTY

According to Section 12(3) of the Act, a warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not a right to reject the goods and treat the contract as repudiated or broken. Thus, a warranty is not of that importance as a condition. It is not essential to the main purpose of the contract of sale. It is only collateral to the main purpose of the contract. Even if it turns out to be untrue, the buyer cannot put an end to the contract. The remedy available is to claim damages from the seller.

In brief, where the fulfillment of the main purpose of the contract depends on the fulfillment of the stipulation, the stipulation is condition and where it is not so, the stipulation is only a warranty. There is no specific rule as to which stipulation is a condition and which one is a warranty. Section 12(4) of the Act states “whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract as a whole. The court is not guided by the terminology used by the parties to the contract. A stipulation may be a condition though called a warranty in the contract”. Thus the court has to look to the intention of the parties by referring to the terms of the contract, its construction and surrounding circumstances to judge whether a stipulation was a condition or a warranty.

Examples

(a): A person purchases a vehicle which is warranted quiet and smooth to drive. If the vehicle turns out to be noisy and inconvenient to drive, the buyer's only remedy is to claim damages. But if instead of buying a particular vehicle, a person asks a dealer to supply him with a quiet and smooth vehicle and the dealer supplies the person with a noisy one, the stipulation is a condition, and the buyer can return the vehicle. Besides, the buyer can also claim damages for breach of the contract.

(b): A made a contract for the sale of cashew-nuts. According to the terms of sale, the total bad nuts shall not exceed 20 per cent of the total. The purchaser entered into the contract relying upon the description. The above term being a basic element of the description of the goods agreed to be supplied, the purchaser was entitled to reject the goods if the bad nuts exceeded the stipulated percentage. He could also claim back the part of price paid to the seller. [Antony Thomas v Ayuppuni Mani; 1959 Kerala LT 1271]

From the above examples, it is clear that an exactly similar term may be a condition in one contract and a warranty in another, depending upon the construction of the contract as a whole.

15.4 DISTINCTION BETWEEN A CONDITION AND WARRANTY

The points of distinction between a Condition and a Warranty may be summed up as under :-

1. A condition is a stipulation which is essential to the main purpose of the contract. A warranty is a stipulation which is collateral to the main purpose of the contract.

2. A breach of condition gives right to repudiate or rescind the contract and also a right to claim damages. Breach of warranty provides right to claim damages only. A breach of warranty does not entitle a buyer to reject the goods.

3. A breach of condition may be treated as a breach of warranty by the aggrieved party and accordingly the aggrieved party may not repudiate the contract. But a breach of warranty cannot be treated as a breach of condition.

15.5 CHANGE OF A CONDITION INTO A WARRANTY

Section 13 deals with cases where breach of condition would be treated as a breach of warranty only and as a consequence, a contract is not avoided. The buyer has to be contended with a claim for damages only. These cases are as follows :

I. Where the buyer elects to treat breach of condition as a breach of warranty. This is to say, he only claims damages and does not elect to repudiate the contract.

II. Where the buyer altogether waives the performance of the condition. Once the buyer has waived his right, he cannot afterwards insist on its fulfillment. Waiver may be express or implied.

III. Where the contract of sale is non-severable/indivisible and the buyer has accepted either the whole goods or any part thereof. In such a case, a breach of any condition by seller can only be treated as a breach of warranty, unless there is a term of the contract, express or implied, to the contrary. Indivisible contracts are those where price for a lot, comprising goods of different qualities, as such is fixed and not fixed per unit or per bag or per ton, etc.

Taking possession or delivery of the goods does not amount to their acceptance. According to Section 42, the buyer is deemed to have accepted the goods:

a) when the seller is intimated by him about the acceptance of goods; or

b) When he does any act in relation to goods which is inconsistent with the ownership of the seller, e.g. the buyer puts his mark on goods; or

c) When he continues to retain the goods even after the lapse of reasonable time without intimating the seller that he has rejected them.

d) Where the fulfillment of any condition or warranty is excused by law by reason of impossibility or otherwise.

15.6 STIPULATION AS TO TIME

The stipulations as to time may be of two types :

i) As to time of payment;

ii) Other stipulations as to time e.g., with regard to the performance of the contract.

Regarding the importance of various stipulations as to time Section 11 of the Act provides as under :

Unless a different intention appears from the terms of the contract, stipulation as to time of payment are not deemed to be of the essence of a contract of sale. Whether any other stipulation as to time is of the essence of the contract or not depends on the terms of the contract.

It may be noted that the general rule stated in Section 11 is that the time of payment of the price is not deemed to be of the essence of the contract. Therefore, in case of delay in the payment of the price by the buyer, the seller cannot avoid the contract for that reason but he can only claim compensation for the same. The parties are, however, free to express a different intention in their contract. They may make the time of the payment of the price as of the essence of the contract.

Stipulations as to time, except as regards time of payment are usually of the essence of the contract. Where the parties to the contract stipulate that time as regards delivery of goods, payment or any other factor shall form the essential terms of the contract, time shall than be regarded as a condition in construction of a contract for sale of the goods, breach of which shall provide right to the aggrieved party to cancel the contract. Example (a) : A sold certain goods to B. The payment was to be made on delivery of goods. B failed to pay after the goods had been in part delivered. A did not send further deliveries. It was held that delivery was subject to the condition of payment and the condition being broken, A had the right to bring an action for the recovery of goods. [Bishop v Shillitoz Band A 329]

A contract was made for the sale of goods c.i.f. Antwerp. The delivery was required to be given in October. However, due to a strike in the port of loading the goods were not shipped until November. It was held that the buyer could refuse to take delivery of goods. [J. Aron & Co. v Comptoir Wegimont. (1921) 3 K.B. 435]

15.7 EXPRESS AND IMPLIED CONDITIONS AND WARRANTIES (SECTION 14-17)

In a contract of sale of goods, conditions and warranties may be either (1) express or (2) implied. Parties may expressly provide any conditions or warranties in their contract. Besides, certain conditions and warranties, as provided in Section 14 to 17, are impliedly there in every contract of sale of goods unless the parties agree to the contrary. Implied conditions and warranties are enforced on the ground that the law presumes that the parties have incorporated them into their contract though they have not put them into it in express words. The implied conditions and warranties provided in the Act are binding in every contract of sale unless they are inconsistent with any express conditions are warranties agreed to by the parties. The implied conditions and warranties recognized by the Act are as follow :

Implied Conditions

1. Condition as to Title (Section 14 (a))

In a contract of sale, unless the circumstances of the contract are such as to show a different intention, there is an implied condition on the part of the seller that-

(a) in the case of sale, he has a right to sell the goods, and

(b) in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass.

Example: R bought a car from D and used it for four months. D had no title to the car and consequently R had to hand it over to the true owner. Held, R could recover the purchase money (Rowland v Divall, (1923) 2 K.B.500).

Want of title to the goods is not the only factor because of which the seller may not have a right to sell the goods. If a vendor can be stopped by process of law from selling, he has not the right to sell. If the goods sold bear labels infringing the trade mark of a third person, the seller has no right to sell them. In Niblett v Confectioners' materials Co. the sellers sold to the buyers tins of condensed milk c.i.f from New York to London. Some of the tins were bearing the labels marked "Nissly Brand" which was the trade mark of a third person, Nestle Co. At the instance of the Nestle Co. the Commissioners of Customs detained the goods. The buyers had to remove those labels before taking delivery of those tins of condensed milk. Having suffered a loss, by selling the tins of condensed milk without proper labels at a lower price, the buyers sued the sellers to claim compensation. The Court of Appeal held that the sellers had made a breach of condition that they had a right to sell the goods and as such they were bound to pay damages for the loss suffered by the buyers.

It may further be noted that where a seller having no title to the goods at the time of the sale, subsequently acquires the title (e.g. by paying off the true owner) before the buyer seeks to repudiate the contract, that title feeds the defective titles of both the original and subsequent buyers and it will then be too late for the buyer to repudiate the contract (Patten vs Thomas Motors).

2 Condition as to Description (Section 15)

Sometimes, the goods are sold by description. In such cases, the implied condition is that the goods shall correspond with the description. The term 'correspondence with description' means that the goods purchased by the buyer must be the same which were described by the seller. If subsequently, it is discovered that the goods do not correspond with the description, the buyer may reject the goods and claim the refund of the price, if already paid.

Example: A purchased from B a car, which he had never seen. B described the car as a 'brand new'. However, on delivery, A found that the car was used and repainted. And thus A returned the car to B. It was held that the sale was by description and the car did not correspond with the description. In this case, A was entitled to reject the car. (Based on Varley v whipp (1900) 1 Q.B.513)

It may, however, be noted that the buyer can reject the goods only if the sale is by description, and the goods do not correspond with the description. The buyer is given the right to reject the goods because a person cannot be compelled to buy a thing different from the thing he contracted to buy. In Bower v Shand (1877) 2 AC 455, Lord Blackburn emphasized this condition in the following words:

"If you contract to sell peas you cannot oblige a party to take beans. If the description of articles tendered is different in any respect it is not the article, bargained, and the other party is not bound to take it."

It will be interesting to know, that the term 'sale by description' has not been defined in the Sale of Goods Act. However, it generally means the sale when the goods are described in the contract as of particular kind or class, e.g., Basmati Rice, Long staple Cotton, Desi Wheat, etc. The sale will also be by description when the identity or quality of the thing is describe, e.g., Brand New Car, Maruti 85 Model etc. The term 'sale by description' includes the following situations:

(a) Sometimes, the buyer has never seen the goods but he buys on the basis of description given by the seller. In such cases the goods must correspond with the description given by the seller.

Example: A purchased a sewing machine which he had never seen. The seller (B) described the machine as "Brand New". But on delivery, A found that the machine was extremely old. In this case, the sale is by description, and A is entitled to reject the machine as it does not correspond with the description given by the seller.

Where the buyer has seen the goods but he relies not on what he has seen but what was stated to him and the deviation of the goods from the description is not apparent.

Example: In an auction sale of a set of napkins and table cloths, these were described as "dating from the seventeenth century". The buyer bought the set after seeing it. Subsequently he found the set to be an eighteenth century set. Held he could reject the set (Nicholson & Venn v Smith Marriott, (1947) 177 L.T. 189).

Example: A advertised his car for sale as a "Herald Convertible, white 1961 Model". B examined the car and bought it. Subsequently, B discovered that the car was made of two parts which had been welded together. And only one part was of 1961 Model, whereas the other part was of old model. It was held that the sale was by description and B could reject the car as it did not correspond with the description. In this case, although B has examined the car, but he relied upon the description given by the seller (A). (Beale v Taylor (1967) 1 WLR 1193))

Example: A sold to B, 3000 tins of Australian fruits which were agreed to be packed in cases each containing 30 tins. A delivered the substantial portion of the fruits in cases containing 24 tins. It was held that the method of packing was of part of the description. Therefore, B was entitled to reject all the goods. [Moore & Co. v Londover Co. (1921) 2 KB 519 CA].

Thus, once it is proved that the sale is by description, then the goods must correspond with the description. If they do not correspond, the buyer may reject them and the seller cannot take the defence by saying that they will serve the buyer's purpose.

But where the goods correspond with the description, the buyer is bound to take the delivery for whatever worth they may be otherwise.

3. **Sale by Sample (Sec 17)**

The sale is by sample where there is a term in the contract express or implied to that effect. There are three implied conditions when the goods are supplied according to the sample-

i) that the bulk shall correspond with the sample in quality;

ii) that the buyer shall have a reasonable opportunity of comparing the bulk with the sample;

Example: A agreed to sell to B two parcels of wheat. The sample of wheat was shown to B. The buyer (B) went to A's warehouse to examine the wheat. One parcel, which was lying in the seller's (A's) warehouse, was shown to B. But A refused to show the other parcel to B, which was not in the warehouse. It was held that the buyer could put an end to the contract. [Lorymere v Smith (1822) 1 B & C 1].

Example: Some mixed worsted coatings were sold by sample. The goods when supplied corresponded to the sample but it was found that owing to a latent defect in the cloth, coats made out of it would not stand ordinary wear and were therefore, unsaleable. The same defect existed in the sample also but could not be detected on a reasonable examination. Held, the buyer was entitled to reject the cloth (Drummond & Sons v Van Ingen).

4. **Sale by Sample as well as Description (Section 15)**

When the goods are sold by sample as well as description it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description. Sometimes there may be a difference between the sample and the description of the goods. In such a case, the fact that the goods supplied conform to the sample but do not agree with the description entitle the buyer to reject the goods because the fundamental condition in every contract is that the goods should correspond to the description.

In Wallis v Pratt there was a contract of sale by sample of seed described as "English Sainfoin". but the "seller giving no warranty express or implied as to growth, description, or any other matters." The seed was sown and when the crop was ready it was discovered the seed supplied and the sample shown were not of "English Sainfoin" seed but of "giant sainfoin" seed. It was held that there was a breach of condition and the buyer was entitled to recover damages.

In Nichol v Godts there was sale of "foreign refined rape oil, warranted only equal to samples". The oil supplied though corresponded with the sample, was adulterated with hemp oil. The jury found that the admixture was not commercially known as "foreign refined rape oil" and therefore, it was held that since the oil supplied was not in accordance with the description, the buyer was entitled to reject the same.

5. Condition as to quality or fitness (Section 16)

Normally, in a contract of sale, there is no implied condition as to quality or fitness of the goods for a particular purpose. The buyer must examine the goods thoroughly before he buys them in order to satisfy himself that the goods will be suitable for the purpose for which he is buying them.

The implied condition as to quality or fitness will operate if the following conditions are satisfied.

1. The buyer requires the goods for a particular purpose.
2. The buyer makes known to the seller that particular purpose.
3. the seller's business is to sell such goods, whether the he is the actual producer or not.

The particular purpose for which the goods, are required has to be made known to the seller. This may be done either expressly or impliedly. A particular purpose is the purpose expressly or impliedly communicated to the seller, for which the buyer buys the goods. Where an article is fit for one particular purpose alone, and turns out to be unsuitable for that purpose, when used, it is easy to see that the condition as to fitness has been broken. But where an article is capable of being applied to a variety of purposes,. the buyer must notify the specific purpose he has in mind, and if this is not shown, the buyer will have no remedy because it was unfit for that purpose.

Example: (a) A who had no special knowledge of hot water bottles went to the shop of a chemist and asked for a hot water bottle. He was shown a bottle which the chemist said will not stand boiling water but was intended to hold hot water. A bought the bottle. After a few days, while using it, it burst and injured his wife. It was found that the bottle was not fir for use as a hot water bottle and therefore, the chemist was liable for damages. [Priest v Last (1903) 2 KB 148]

Example: (b) A bought a set of false teeth from B, a dentist. But the set was not fit for A's mouth. A rejected the set of teeth and claimed the refund of price. It was held that A was entitled to do so as the only purpose for which he wanted the set of teeth was not fulfilled.

Example: (c) A bought a tweed coat from B. After wearing the coat for sometime, A developed a dermatitis (skin trouble). It was discovered that coat was fit for the use of a normal man. And A's skin trouble was due to his oversensitive skin. The court held that the implied condition as to fitness for buyer's purpose was not broken, as the coat was fit for the use of a normal man. In this case, it was A's duty to disclose the fact of this oversensitiveness to the seller at the time of sale.

Where, however, the goods are sold under its patent or trade name, there is no implied condition as to its fitness for any particular purpose. Thus, when a patent smoke consuming furnace was ordered by the plaintiff by its patent name, for his brewery and the same being forwarded to him proved useless, it was held that the buyer had no cause of action against the seller. But the situation will be quite different where the buyer asks the seller to supply an article of a named make and indicates to the seller that he relies on his skill and judgement, for its being fit for a particular purpose. Implied condition as to quality or fitness will apply even though the article is described in the contract by its trade name.

Example: P applied to D for a motor car suitable for touring. D said that the Bugatti car, their speciality would suit, and showed P a specimen. P then ordered for a Bugatti car. The car delivered proved to be unsuitable for touring purposes. P was entitled to reject the car and could recover back the purchase money [Baldry v Marshall (1925) 1 KB 260].

6. Implied Condition of Merchantable Quality

Section 15 provides that when the goods are bought by description there is an implied condition that the goods supplied shall answer that description. According to this Sub Section, there is a further implied condition in such a case that the goods supplied shall be of merchantable quality . Where;

1. the goods are bought by description
2. from a seller who deals in the goods of that description
   (whether he is the manufacturer/producer or not)

There is an implied condition that the goods shall be of merchantable quality. The term 'merchantable quality' has not been defined in the Act. It means that the article is of such quality and in such condition that a reasonable man acting reasonable would after a full examination accept it under the circumstances of the case in performance of his offer to buy that article, he buys for his own use or to sell again.

The goods should be immediately saleable under the description by which they are known in the market. Merchantability, however, does not mean that the goods should be of first quality.

Goods may be unmerchantable not only because of some defect in their physical condition, but also, because of some other circumstances as for example;

1. where they infringe a trade mark, or
2. the use of them is dangerous or injurious in a way not to be expected from goods of the kind, or
3. they are unfit for use.

Examples: (a) P asked for a bottle of Stone's Ginger Wine at D's restaurant. While P was drawing the cork, with a cork screw, the bottle broke at the neck and injured him. It was held that the sale was by description and since the bottle was not of merchantable quality. P was entitled to recover damages. [Morelli v Fitch and Gibbons (1928), 2 KB 636]

(b) A manufacturer supplied 600 horns under contract. The horns were found to be dented, scratched and otherwise of faulty manufacturer. Held, they were not of merchantable quality and therefore, the seller's suit for price was dismissed [Jackson v Rotax Motor & Cycle Co. (1910) 2 k.b. 397).

(c) A radio set was sold to a layman. The set was defective form the beginning and it did not work in spite of repairs. Held, the purchaser could return the set and claim refund [R.S.Thakur v H.G.E.Corp, AIR (1971) Bom. 971]

All such defects as make the goods unmerchantable are of two kinds, called patent defects and latent defects. Patent defects are those which can be found on examination by a person of ordinary intelligence with the exercise of due care. Latent defects are those which cannot be discovered on such examination. There is an implied condition on the seller's part that the goods are free from latent defects.

In case of patent defects where an opportunity is afforded to the buyer to examine the goods, but the buyer makes only a casual examination of the goods, this will amount to an examination within the meaning of this section, and the seller would not be liable to for the defects which such an examination ought to have revealed.

Example: B went to T's warehouse to buy some glue. The glue was stored in barrels and every facility was given to B for its inspection. B did not have any of the barrels opened, but only looked at the outside. He then purchased the glue. Held, as an examination of the inside of the barrels would have revealed the nature of the glue, and as B had an opportunity of making the examination, there was no condition as to merchantable quality [thornett & Fehr v Beers & Sons, 1919 1 K.B. 486]. Comparison between the condition as to the fitness of goods for buyer's purpose, and condition as to merchantability. The following table gives the comparison between the two:

Sr No.	Condition as to Fitness of Goods for Buyer's Purpose	Condition as to Merchantability
1.	The buyer must rely on the skill and judgement of the seller	The buyer is not required to rely on the skill and judgement of the seller.
2.	When the goods are sold under patent or trade name then the condition as to fitness for buyer's purpose is not applicable i.e., it is excluded.	When the goods are sold under patent or trade name, then the condition as to merchantability is applicable, i.e. it is not excluded
3.	There may be cases in which the goods are not fit for buyer's use but they may be merchantable.	There may not be such cases.

7. Condition as to Wholesomeness

In the case of eatables and provisions, in addition to the implied condition as to merchantability, there is another implied condition that the goods shall be wholesome.

Example: F bought milk from A. The milk contained germs of typhoid fever. F's wife took the milk and got infection as a result of which she died. Held, F could recover damages [Frost v Aylesbury Dairy Co Ltd., (1905) 1 K.B. 608]

Condition implied by Custom

An implied condition as to quality or fitness for a particular purpose may also be annexed by the usage of trade in the locality concerned [Sec. 16 (3)].

Implied Warranties

It is a warranty which the law implies into the contract of sale. In other words it is the stipulation which has not been included in the contract of sale in express words. But the law presumes that the parties have incorporated it into their contract. It will be interesting to know that implied warranties are read into every contract of sale unless they are expressly excluded by the express agreement of the parties. These may also be excluded by the course of dealings between the parties or by usage of trade [Section 62]. It may be noted that sometimes there is conflict between the express and implied warranties. In such cases, the express terms shall prevail and the implied terms shall not be considered.

1. Warranty of Quiet Possession: [Sec. 14(b)]

In every contract of sale the first implied warranty on the part of the seller is that "the buyer shall have and enjoy quiet possession of the goods." If the quiet possession of the buyer is in any way disturbed by a person having a superior right than that of the seller, the buyer can claim damages from the seller. Since disturbance of quiet possession is likely to arise only where the seller's title to goods is defective, this warranty may be regarded as an extension of the implied condition of the provided for by Section 14 (a).

In the case of Mason v Bhumingham, the plaintiff purchased a second hand typewriter for pound 20 from the defendant. She thereafter spent a sum pound 11-

10sh., for getting it overhauled and putting in order. Unknown to the parties the typewriter had been stolen and the plaintiff was compelled to return the same to its true owner. In an action by the plaintiff against the defendant it was held that the defendant had made a breach of warranty implied in a contract of sale of goods that the buyer shall have and enjoy quiet possession of the goods. The plaintiff was entitled to recover not only the sum of pound 11-10sh, the amount spent on overhauling, as the same was the loss arising naturally in the usual course of things.

2. Implied Warranty of Freedom from Encumbrances

There is an implied warranty on the part of the seller that the goods are free from any charge or encumbrance. A breach of this warranty will occur when the buyer discharges the amount of encumbrance. This warranty will not apply where such Encumberances are declared to the buyer when the contract is made or he has notice of them. Where there is a breach of this implied warranty, the remedy of the buyer is to sue for damages.

Example: A, the owner of the watch pledges it with B. After a week, A obtains possession of the watch from B for some limited purpose and sells it to C. B approaches C and tells him about the pledge affair. C has to make payment of the pledge amount to B. There is breach of this warranty and C is entitled to claim compensation A.

Disclosure of Dangerous Nature of Goods

There is another implied warranty on the part of the seller that in case the goods are inherently dangerous or they are likely to be dangerous to the buyer and the buyer is ignorant of the danger, the seller must warn the buyer of the probable danger. If there is a breach of this warranty, the seller will be liable in damages.

In Clarke v Army and navy Co-operative Society Ltd. (1903) 1 K.B. 155, C purchased a tin of disinfectant powder from A. A knew that the tin was to be opened with special care otherwise it might prove dangerous. He also knew that C was ignorant about it but did not warn C. C opened the tin whereupon the disinfectant powder flew into her eyes causing injury. Held, A was liable in damages to C as he should have warned C of the probable danger.

15.8 DOCTRINE OF CAVEAT EMPTOR (BUYER BEWARE)

Caveat Emptor means "let the buyer beware", i.e. the buyer must take care. As a general rule, the buyer purchased goods after satisfying himself as to quality and fitness and, therefore, the buyer purchases the goods at his own risk, relying upon his own skill and judgement. In a contract for sale of goods there is no implied warranty or condition as to quality or fitness for any particular purpose of goods and therefore, the buyer purchased the goods at his risk relying on his own skill and judgement (Section 16)

Example : A purchase a horse from B. A needed the horse for riding but he did not mention this fact to B. The horse is not suitable for riding but is suitable only for being driven in the carriage. Caveat emptor being the rule. A can neither reject the horse nor can he claim any compensation from B.

This rule applies to the purchase of specific goods, for example, a horse or a picture where the buyer can exercise his own judgement it applies also whenever the buyer voluntarily chooses what he buys. But it has no application in any case, in which the seller has undertaken and the buyer has left it to the seller, to supply goods to be used for a purpose known to both parties at the time of the same.

Example: There was sale by sample by a woolen manufacturer of cloth to merchant who was also a tailor. The buyer required the cloth for making special uniforms but this fact was not made known to the seller. Owing to latent defect in the cloth which was also there in the sample, it was unfit for the purpose. But there was nothing to show that it was unfit for other purposes. It was held that the buyer was without remedy. [Jones v Padgelt, (1890). 24 Q.B.D. 650]

Exception to the 'Doctrine of Caveat Emptor'

In certain circumstances however, the doctrine has no application. They are as follows :

i) If the seller has made a false representation relating to the goods and the buyer has relied upon it to his detriment.

ii) when the seller has deliberately concealed a defect which is not apparent on the reasonable examination of the goods.

Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which he requires the goods and 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, the seller must supply the goods which shall be fit for the buyer's purpose [Sec. 16 (1)]

In the case of a contract for the sale of a specified article under its patent or other trade name, there is no implied condition that the goods shall be reasonably fit for any particular purpose (Proviso to Sec. 16 (1)]

Where the trade usage attaches an implied condition or warranty as to quality or fitness and the seller deviates from that, the doctrine of caveat emptor does not apply and the seller is liable in damages [Sec. 16 (3)]

Where goods are bought by description from a seller who deals in such goods, there is an implied condition that the goods shall be of 'merchantable quality'. Where, however, the buyer has examined the goods there is no such implied condition as regards defects which such examination could have revealed.

In Jackson v Rotex Motor and Cycle Co. (1910-2 K.B.), where a person ordered motor horns from a manufacturer of horns and the horns were damaged, it was held that the buyer was entitled to reject the horns.

It should be noted that goods are merchantable if they are fit for any one of the several purposes for which the goods may ordinarily be used.

15.9 SUMMARY

A condition is defined as a representation made by the seller which is so important that its non-fulfillment defeats the very purpose of the buyer. Warranty is a representation made by the seller which is not of that importance as a condition. Sometimes, a condition is changed to the status of a warranty and in such cases, the buyer loses the right to reject the goods on the ground of breach of condition. The importance of time in a contract of sale is contained in Section 11 of the Sale of Goods Act. In a contract of sale of goods, conditions and warranties may be either express or implied. Implied conditions and warranties are enforced on the ground that the law presumes that the parties have incorporated them into their contract though they have not put them into it in express words. In a contract of sales of goods, there is no implied condition or warranty as to quality or fitness for any particular purpose of goods and therefore, the buyer purchased the goods at his risk relying on his own skill and judgement.

15.10 KEYWORDS

Condition: It is defined as a representation made by the seller which is so important that its non-fulfillment defeats the very purpose of the buyer.

Warranty: Warranty may be defined as a representation made by the seller which is not of that importance as a condition.

Cavet Emptor: It means that a buyer purchases the goods at his own risk.

Implied Condition: It is a condition, which the law implies into the contract of sale.

Express Warranty: It is a warranty which has been expressly agreed upon by both the parties at the time of contract of sale.

15.11 SELF ASSESSMENT QUESTIONS

1. Define the term 'condition' and 'Warranty'. Explain the difference between the two.

2. Discuss the provision of the sales of Goods Act relating to the implied conditions in a contract of sale by sample.

3. "Let the buyer beware" - Comment.

4. State the conditions in a contract for the sale of goods (i) by description (ii) required for a particular purpose.

15.12 SUGGESTED READINGS

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