

LEGAL ASPECTS OF BUSINESS

Week 1_The Companies Act, 2013_Part I

Content

- Introduction to The Companies Act, 2013
- Characteristics
- Lifting of Corporate Veil
- Kinds of Companies

Introduction to The Companies Act, 2013

Meaning

A company means an association of individual formed for some common purpose. But it is a voluntary association of persons. It has capital divisible into parts, known as shares, an artificial person created by a process of law and it has a perpetual succession and a common seal.

Definition

According to **Prof. Lindley**, company is defined as, “An association of many persons who contribute money or money’s worth to a common stock, and employ it in some common trade or business (i.e., for a common purpose), and who share the profit or loss (as the case may be) arising therefrom. The common stock so contributed is denoted in money and it 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”.

Characteristics of a Company

1. Separate Legal Entity

A company formed and registered under the companies act is a distinct legal entity. It is a creation of law and is sometimes called artificial person having invisible and intangible. It is a fiction of law with legal, but no natural or physical existence.

Case of Salomon Vs Salomon Co Ltd: S Sold his boots business to a newly formed company for \$30, 000. His wife, one daughter and four sons took up one share of \$ 1 each. S took 23, 000 shares of \$ 1 each and \$ 10, 000 debentures in the company. The debentures gave S a

charge over the assets of the company as the consideration for the transfer of the business. Subsequently when the company was wound up, its assets were found to be worth \$6, 000 and its liabilities amounted to \$ 17, 000 of which \$ 10, 000 were due to S (secured by debentures) and \$ 7, 000 due to unsecured creditors.

The unsecured creditors claimed that S and the company were one and the same person and that the company was a mere agent for S and hence they should be paid in priority to S. Held, the company was, in the eyes of the law, a separate person independent from S and was not his agent. S, though virtually the holder of all the shares in the company, was also a secured creditor and was entitled to repayment in priority to the unsecured creditors.

2. Perpetual Succession

Unlike a natural person a company never dies. It is an entity with a perpetual succession. Its existence is not affected by the death, lunacy and insolvency of its members.

3. Limited Liability

Limited liability of members is another one important characteristics of a company. Their liability is limited to the face value of shares subscribed by them. If the shares are fully paid up, their liability is nil.

4. Common seal

As a company is an artificial person it cannot sign its name on a contract. Common seal is used as a substitute for its signature. Every company must have a seal with its name engraved on it.

5. Transferability of shares

The shares of a company are freely transferred and can be sold or purchased in the share market.

6. Capacity to sue and be sued

On incorporation, a company acquires separate and independent legal personality. As a legal person, it can sue and be sued in its name.

7. Separate Property

As a legal person, a company can own, enjoy and dispose of any property in its own name. No member can claim himself to be the owner of the company property. The property of the company is not the property of the shareholders; it is the property of the company.

LIFTING THE CORPORATE VEIL

A company is a legal person distinct from its members. This principle may be referred to as 'the veil of incorporation'. The effect of this principle is that there is a veil between the company and its members i.e., the company has a corporate personality which is distinct from its members.

But over a period, the abuses of this corporate personality became apparent. Thus it became necessary for the court to break through or lift the corporate veil or crack the shell of corporate personality and look at the persons behind the company who are the real beneficiaries of the corporate fiction.

Exceptions

1. Protection of Revenue

The courts may ignore the corporate entity of a company where it is used for tax evasion. Tax planning may be legitimate provided it is within framework of law. Colourable devices can't be part of tax planning.

Case: Sir Dinshaw Maneckjee Petit, (1927), D an assessee, who was receiving huge dividend and interest income, transferred his investments to 4 private companies formed for the purpose of reducing his tax liability. These companies transferred the income to D as a pretended loan. Held, the companies were formed by D purely and simply as a means of avoiding tax obligation and the companies were nothing more than the assessee himself. They did no business but were created simply as legal entities to ostensibly receive the dividends and interest and to hand them over to D as pretended loans.

2. Prevention of fraud or improper conduct

The legal personality of a company may also be disregarded in the interest of justice where the machinery of incorporation has been used for some fraudulent purpose like defrauding creditors or defeating or circumventing law.

Case: *Jones V. Lipman (1962), L agreed to sell a certain land to J. he subsequently changed his mind and to avoid the specific performance of the contract, he sold it to a company which was formed specifically for the purpose. The company had L and a clerk of his solicitors as the only members. J brought an action for the specific performance against L and the company. The Court looked to the reality of the situation, ignored the transfer, and ordered that the company should convey the land of J.*

3. Determination of character of a company whether it is enemy

A company may assume an enemy character when persons in de facto control of its affairs are residents in an enemy country. In such a case, the Court may examine the character of persons in real control of the company, and declare the company to be an enemy company.

Case: *Daimler Co. Ltd V. Continental Tyre & Rubber Co. Ltd (1916)*. A company was incorporated in England for the purpose of selling in England tyres made in Germany by a German company which held the bulk of shares in the English Company. The holders of the remaining shares, except one, and all the directors were Germans, resident in Germany. During the First World War, the English company commenced an action for recovery of a trade debt. Held, the company was an alien company and the payment of debt to it would amount to trading with the enemy, and therefore the company was not allowed to proceed with the action.

4. Where the company is a sham

The Courts (NCLT) also lift the veil where a company is a mere cloak or sham (hoax).

Case: *Gilford Motor Co. Ltd V. Horne (1933)*, a former employee of a company, was subject to a covenant not to solicit its customers. He formed a company to carry on a business which, if he had done so personally, would have been a breach of the covenant. An injunction was granted both against him and the company to restrain them from carrying on the business. The company was described in this judgment as “a device, a stratagem”, and as “a mere cloak or sham for the purpose of enabling the defendant to commit a breach of his covenant against solicitation”.

5. Company avoiding legal obligations

Where the use of an incorporated company is being made to avoid legal obligations, the court may disregard the legal personality of the company and proceed on the assumption as if no company existed.

6. Company acting as agent or trustee of the shareholders

Where a company is acting as agent for its shareholders, the shareholders will be liable for the acts of the company. It is a question of fact in each case whether the company is acting as agent for its shareholders. There may be an express agreement to this effect or an agreement may be implied from the circumstances of each particular case.

7. Avoidance of welfare legislation

Avoidance of welfare legislation is as common as avoidance of taxation and the approach of the courts in considering problems arising out of such avoidance is generally the same as avoidance of taxation. It is the duty of the courts in every case where ingenuity is expended to avoid welfare legislation to get behind the smoke screen and discover the true state of affairs.

8. Protecting public policy

The Courts invariably lift the corporate veil to protect the public policy and prevent transactions contrary to public policy. Thus where there is a conflict with public policy, the Courts (now NCLT) ignore the form and take into account the substance.

Statutory exception

1. Number of members below statutory minimum

Sec.45, if a company carries on business for more than 6 months after the number of its members has been reduced below 7 in case of a public company or 2 in case of private company, every person who knows this fact and is a member during the time that the company so carries on business after the six months, is severally liable for the whole of the debts of the company contracted during that time, i.e., after six months. It may be noted that in such a case the continuing members (i.e., those who continue to be members after six months).

- a. Can be sued and not those who have withdrawn from the membership;
- b. Shall be liable only if they are aware of the fact of the member falling below the statutory minimum.

2. Failure to refund application money

Sec.69 (5), the directors of a company are jointly and severally liable to repay the application money with interest if the company fails to refund the application money of those applicants who have not been allotted shares, within 130 days of the date of issue of the prospectus.

3. Misdescription of company's name

Sec.147 (4) where an officer or agent of a company does any act or enters into a contract without fully or properly mentioning the company's name and the address of its registered office, he shall be personally liable. Thus where a bill of exchange, hundi or

promissory note is signed by an officer of a company or any other person on its behalf, without mentioning this fact that he is signing on behalf of the company; he is personally liable to the holder of the instrument unless the company has already paid the amount.

4. Fraudulent Trading

Sometimes in the course of the winding up of a company it may appear that some business of the company has been carried on with intent to defraud creditors of the company, or any other person or for any fraudulent purpose. In such a case, the court may declare that any persons who were knowingly parties to the carrying on of the business in this way are personally liable without any limitations of liability for all or any of the debts or other liabilities of the company as the court may direct. The court may do so on the application of the official liquidator, or the liquidator or any creditor or contributory of the company.

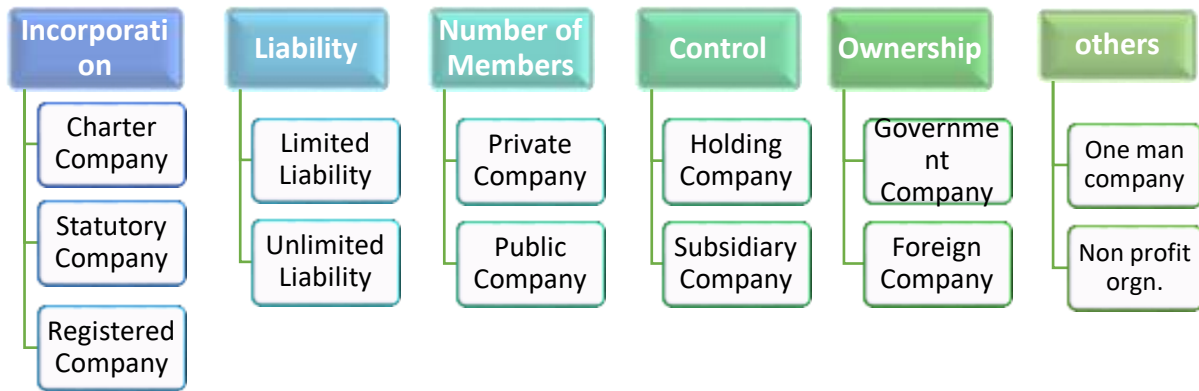
5. Holding and Subsidiary Companies

In the eyes of the law, the holding company and its subsidiaries (for definition of holding and subsidiary companies) are separate legal entities. But in the following two cases, a subsidiary company may lose its separate identity to a certain extent:

- i) Where at the end of its financial year, a company has subsidiaries, it must lay before its members in general meeting not only its own accounts, but also a set of group accounts showing the profit or loss earned or suffered by the holding company and its subsidiaries collectively and their collective state of affairs at the end of the year.
- ii) The court may, on the facts of a case, treat a subsidiary company as merely a branch or department of one large undertaking owned by the holding company.

KINDS OF COMPANIES

Joint Stock Companies can be classified on the basis of incorporation, nature of liability, Number of members, control, ownership, etc. let us examine briefly the different kinds of companies.



I. On the Basis of Incorporation

Any company is to be incorporated under an Act. The provision of the particular Act under which it is established governs its working. Companies of this kind are of three types. They are;

a. Statutory Companies

These are the companies which are created by a special act of the Parliament or State Legislature, e.g., the Reserve Bank of India, the State bank of India, the Life Insurance Corporation, etc. these are mostly concerned with public utilities, e.g., railways, tramways, electricity companies and enterprise of national importance.

b. Registered Companies

Companies which are registered under the Companies Act, 1956, or were registered under any of the earlier companies Acts are called registered companies. A vast majority of companies we come across belong to this category. Tata Motors Limited, Reliance Telecommunication Limited, EID Parry Limited, etc belong to this category.

c. Chartered Companies

Companies established as a result of a charter granted by the King or Queen of a country is known as chartered companies. The charter issued, governs their functioning. In other words, The Crown, in the exercise of the royal prerogative has power to create a corporation by the grant of a charter to persons assenting to be incorporated. **Example** – Bank of England, East India Company, etc.

II. On the Basis of Liability

On the basis of the extent of liabilities of the shareholders such companies are divided into three categories.

a. Companies Limited by Share

Where the liability of the members of a company is limited to the amount unpaid on the shares such a company is known as a company limited by shares. If the shares are fully paid, the liability of the members holding such shares is nil.

b. Companies Limited by Guarantee

In a company limited by guarantee the liability of a shareholder is limited to the amount he has voluntarily undertake to contribute to meet any deficiency at the time of its winding up. Such a company may or may not have a share capital. If it has a share capital a member's liability is limited to the amount remaining unpaid on his share plus the amount guaranteed by him. This type of company is started with the object of promoting science, arts, sports, charity, etc. it is clear that its objective is not profit earning. It gets subscription from its members and donations and endowments from philanthropists.

c. Unlimited Liability

A company without limited liability is known as an unlimited liability. In case of such a company, every member is liable for the debts of the company, as in an ordinary partnership, is proportion to his interest in the company. In other words, their liability extends to their private properties also in the event of winding up. Unlimited companies are almost non-existent.

III. On the Basis of Number of Members

a. Private Company

A private company means a company which by its articles

- i. restricts the rights to transfer its shares
- ii. Limits the number of its members minimum 2 and maximum number of members 200 (excluding the employees)
- iii. Prohibits any invitation to the public to subscribe for any shares or debentures of the company.

The name of the company must end with the words 'private limited'.

b. Public Company

The public is invited to subscribe to the shares of the company usually by issuing a prospectus. Shares are easily transferable. A public company must have at least 7 persons to form and no maximum limit as to its number of shareholders or members. The name must end with the word 'limited'.

IV. On the Basis of Control

Holding Company and Subsidiary Company

A company is known as the holding company of another company if it has control over that other company. A company becomes a holding company of another

- i) if it can appoint or remove all or majority of the directors of the latter company or
- ii) if it holds more than 50% of the equity share capital of the latter or
- iii) if it can exercise more than 50% of the total voting power of the latter.

A company is known as a Subsidiary of another company when control is exercised by the latter (called holding company). Over the former called a subsidiary company.

V. On the Basis of Ownership

a. Government Companies

A Government company is one in which not less than 51% of the paid up capital is held by the Central Government or by any one or more State Governments or partly by the Central Governments and partly by one or more State Governments. Examples: Bharath Heavy Electricals Limited, Steel Authority of India Limited, etc

A subsidiary of a Government company is also treated as a Government company. A Government company also enjoys a separate corporate existence. It should not be identified with the Government and its employees are not Government employees.

b. Foreign Company

It means any company incorporated outside India which has an established place of business in India. Where a minimum of 50 percent of the share capital of a foreign company is held by one or more citizens of India or and by one or more bodies corporation incorporated in India.

Foreign company means a company incorporated outside India but having a place of business of India. It has to furnish to the authorities the full address of the registered or principal office of the company or a list of its directors or names and addresses of the residents in India authorized to receive notices, documents, etc.

VI. Other forms of company

a. One man company

These are companies in which one man holds virtually the whole of the share capital with a few extra members holding the remainder who may be his relations or nominees.

b. Association for Non-Profit

With the approval of Central Government by granting license to an association (Commerce, Science, Charity, etc.)

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