

CHAPTER 7

FORMATION OF A COMPANY

The formation of a company involves three distinct stages; which are

- A) Promotion
- B) Incorporation
- C) Subscription of capital
- D) Commencement of Business

PROMOTION

Promotion is the first stage in the formation of a company. It means the sum total of all activities which are necessary for bringing the company into existence. It begins with somebody having discovered a potential business idea.

Promoter

The person who takes the initiative to form a company is called the promoter. A promoter is said to be the one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose.

Legal Status of a Promoter

In the eyes of law, he is neither an agent nor a trustee of the company. They are personally liable for all the contracts which are entered by them, for the company before its incorporation, in case the same is not ratified by the company, later on. He stands in a fiduciary (a person who talks on behalf of the company) relationship with the company.

Functions of a Promoter

Following are the functions of a promoter:

1. Identification of Business Opportunity

The first function of a promoter is to identify a business opportunity. The opportunity may be in respect of producing a new product or service or making some product available through a different channel etc.

2. Feasibility Studies

The promoter then undertakes a detailed feasibility study to investigate all aspects of the business idea. It involves the following:

a) Technical Feasibility

Sometimes an idea may be good but technically not feasible to execute. It may be due to the required raw material or technology is not easily available.

b) Financial Feasibility

The promoter has to find out the fund requirement of the identified business opportunity. If the funds required for the project cannot be easily arranged, the project has to be given up.

c) Economic Feasibility

Sometimes a project is technically viable and financially feasible but it may not be profitable. In such cases, the idea may have to be abandoned. Promoters usually take the help of experts to conduct these studies.

3. Name Approval

After deciding on the project, the promoter has to select a name for the company. He then submits an application for name approval to the Registrar of Companies of the State in which the company is to be formed. Three names in the order of their priority are given in the application to the Registrar.

4. Fixing up Signatories to the Memorandum of Association

Promoters have to decide the members who have to sign the Memorandum of Association of the proposed company. The people signing the memorandum are also the first directors of the company.

5. Appointment of Professionals

Certain professionals such as Merchant Bankers, Auditors, etc. are appointed by promoters to assist them in the preparation of necessary documents to be filed with the Registrar.

6. Preparation of Necessary Documents

The promoter takes steps to prepare certain legal documents to be filed with the Registrar. These include the Memorandum of Association, Articles of Association, and consent of directors.

Memorandum of Association

It is the most important document of a company. It defines the objectives and powers of a company. It describes the relationship of the company with the outsiders. No company can legally undertake activities that are not contained in its Memorandum of Association. Memorandum of Association is called the Charter or Magna Carta of a company.

Contents or clauses of Memorandum of Association

Memorandum of Association has SIX clauses which are stated below:

1. Name Clause

This clause contains the name of the company with which it is registered. The name should not be similar to the name of an existing company.

2. Registered Office (Domicile) Clause

This clause contains the name of the state in which the registered office of the company is proposed to be situated.

3. Objects Clause

This is probably the most important clause of the memorandum. It defines the objectives for which the company is formed. A company cannot undertake an activity that is beyond the objects stated in this clause.

4. Liability Clause

This clause limits the liability of the members to the amount unpaid on the shares owned by them. Eg: If a person purchased 100 shares of Rs.10 each and has already paid Rs.7 per share, his liability is limited to Rs. 3 per share.

5. Capital Clause

This clause specifies the maximum capital which the company is authorised to raise through the issue of shares. The authorised capital of the company along with its division into the number of shares having a fixed face value is specified in this clause. For example, the authorised share

capital of the company may be Rs. 25 lakhs which is divided into 2.5 lakh shares of Rs.10 each.

6. Association Clause

In this clause, the persons who signed the Memorandum of Association state their intention to be associated with the company and also give their consent to purchase qualification shares. The Memorandum of Association must be signed by at least seven persons in the case of a public company and by two persons in the case of a private company.

Articles of Association

It is a document containing the rules regarding the internal management of a company. These rules are subsidiary to the Memorandum of Association and hence, should not contradict or exceed anything stated in the Memorandum of Association. A public company needs not have its own articles. It may adopt the model set of Articles given in the Table F, G, H, I and J in the Companies Act, as may be applicable to such company.

Contents of Articles of Association

The Articles generally contains the following matters:

1. Number and value of shares.

2. Issue of preference shares.
3. Allotment of shares.
4. Calls on shares.
5. Transfer of shares.
6. Forfeiture of shares.
7. Alteration of capital.
8. Buyback.
9. Share certificates.
10. Voting rights.
11. Meetings and rules regarding committees.
12. Directors, their appointment, and delegations of powers.
13. Issue of Debentures and stocks.
14. Common Seal.
15. Remuneration of directors.
16. General meetings.
17. Directors meetings.
18. Winding up.

Differences between Memorandum of Association and Articles of Association

Basis	Memorandum of Association	Articles of Association
1. Objectives	It defines the objectives for which the company is formed.	It contains the rules for internal management of the company.
2. Position	It is the main document.	It is a subsidiary document.
3. Relationship	It defines the relationship of the company with outsiders.	It defines the relationship of the company and its members.
4. Validity	Acts beyond the Memorandum of Association are invalid.	Acts that are beyond Articles can be ratified by the members.
5. Necessity	Every company has to file Memorandum.	It is not compulsory for a public Ltd. company to file Articles of Association. It may adopt Table F.

INCORPORATION

After completing the aforesaid formalities promoter makes an application for incorporation of the company to Registrar of Companies of the State in which the registered office of the company is to be situated. The application must be accompanied by the following documents

1. The Memorandum of Association duly stamped, signed, and witnessed. It must be signed by at least

seven members in the case of a public company and two members in the case of a private company.

2. The Articles of association duly stamped, signed, and witnessed as in the case of the Memorandum of Association.
3. Written consent of the proposed directors to act as directors.
4. The agreement, if any, with the proposed Managing Director, Manager, etc.
5. A copy of the Registrar's letter approving the name of the company.
6. A statutory declaration that all legal formalities for registration have been complied with.
7. A notice about the exact address of the registered office of the company.
8. Documentary evidence of payment of registration fees.

Then the Registrar will scrutinize the documents and the statutory declaration he will grant registration to the company by entering the name of the company in the register concerned and giving a CIN (Corporate Identity Number). After registration, the Registrar of Companies will

issue a certificate of incorporation. It is called the **birth certificate** of the company.

The Certificate of Incorporation once issued, is a conclusive evidence of the existence of the company. On the issue of Certificate of Incorporation, a private company can immediately commence its business, but a public company has to undergo two more stages in its formation.

Effect of Certificate of Incorporation

A Certificate of Incorporation is a conclusive proof of the registration of the company. A company is legally born on the date printed on the Certificate of Incorporation. It becomes a separate legal entity with perpetual succession on such a date.

CAPITAL SUBSCRIPTION

The following steps are required to raise funds from the public:

1. SEBI Approval

Prior approval of SEBI is required to raise funds from the public.

2. Filing of Prospectus

A prospectus should be filed with the Registrar of Companies. A prospectus is an invitation to the public to

apply for shares or debentures of the company or to make deposits in the company.

3. Appointment of Bankers, Brokers, etc.

The company has to appoint bankers to receive the application money on shares or debentures. Brokers are also appointed to sell shares or debentures by distributing application forms.

4. Minimum Subscription

The minimum amount of capital to be subscribed by the public before a public company can allot shares is called minimum subscription. As per SEBI guidelines, the minimum subscription is 90% of the issued amount.

5. Application to Stock Exchange

An application is to be made to at least one stock exchange for permission to deal with its shares or debentures.

6. Allotment of Shares

Allotment means giving shares to the applicants for shares. Allotment letters are issued to applicants to whom shares are allotted.

Preliminary Contracts

Contracts signed by promoters with third parties before the incorporation of company.

Provisional Contracts

Contracts are signed after incorporation but before the commencement of business.

Prospectus

The prospectus is any notice, circular, advertisement, or any other document inviting public to subscribe to the shares or debentures of the company or to make deposits in the company. A prospectus or a statement in lieu of prospectus should be filed with the Registrar to raise funds. A public company that decides to raise their funds from some private sources need not issue a prospectus. They should file a statement in lieu of prospectus.