Master of Business Administration
317 23
BUSINESS LAW
II - Semester
### SYLLABI-BOOK MAPPING TABLE

#### Business Laws

<table>
<thead>
<tr>
<th>Syllabi</th>
<th>Mapping in Book</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BLOCK - I: BASICS OF BUSINESS LAW</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Unit 1:</strong> Indian Contract Act 1872: Contract - Meaning - Essential</td>
<td>Unit 1: Indian Contract Act, 1872 (Pages 1-10)</td>
</tr>
<tr>
<td>Classifications of Contracts on the Basis of Validity, Formation and</td>
<td></td>
</tr>
<tr>
<td>Performance-Offer and Acceptance</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 2:</strong> Offer and Acceptance: Introduction - Proposal - Acceptance</td>
<td>Unit 2: Offer and Acceptance (Pages 11-22)</td>
</tr>
<tr>
<td>- Communications of Offer, Acceptance and Revocations - Offer and</td>
<td></td>
</tr>
<tr>
<td>Acceptance by Post.</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 3:</strong> Consideration: Definitions, Types of Consideration -</td>
<td>Unit 3: Consideration (Pages 23-45)</td>
</tr>
<tr>
<td>Essentials of Consideration - Privity of Contracts: Exceptions -</td>
<td></td>
</tr>
<tr>
<td>Capacity: Consent - Legality of Object - Quasi Contract Discharge</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 4:</strong> Special Contracts: Contract of Indemnity and Guarantee -</td>
<td>Unit 4: Special Contracts (Pages 46-59)</td>
</tr>
<tr>
<td>Bailment and Pledge - Law of Agency-Definition - Rights of Surety -</td>
<td></td>
</tr>
<tr>
<td>Discharge of Surety - Bailment and Pledge: Introduction, Classifications, Duties and Rights of Bailer and Bailee - Termination of Bailment.</td>
<td></td>
</tr>
<tr>
<td><strong>BLOCK - II: PARTNERSHIP AND COMPANY ACT</strong></td>
<td></td>
</tr>
<tr>
<td>Contract of Sale - Conditions and Warranties - Transfer of Property -</td>
<td>(Pages 60-80)</td>
</tr>
<tr>
<td>Performance of the Contract: Essentials of Valid Tender Performance,</td>
<td></td>
</tr>
<tr>
<td>Performance Reciprocal Promise - Rights of an Unpaid Seller</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 6:</strong> Laws on Carriage of Goods: Duties, Rights and Liabilities of</td>
<td>Unit 6: Laws on Carriage of Goods (Pages 81-102)</td>
</tr>
<tr>
<td>Common Carriers Under: (i) The Carriers Act, 1865. (ii) The</td>
<td></td>
</tr>
<tr>
<td>Railways Act, 1989, (iii) The Carriage of Goods by Sea Act, 1925,</td>
<td></td>
</tr>
<tr>
<td>(iv) The Carriage by Air Act, 1972 and (v) The Carriage By Road Act,</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 7:</strong> Negotiable Instruments Act, 1881: Negotiable Instruments -</td>
<td>Unit 7: Negotiable Instruments Act, 1881 (Pages 103-132)</td>
</tr>
<tr>
<td>Features - Types - Parties - Material Alteration - Parties to</td>
<td></td>
</tr>
<tr>
<td>Negotiable Instruments - Presentations of Negotiable Instrument.</td>
<td></td>
</tr>
<tr>
<td><strong>Unit 8:</strong> Insurance: Definition and Sources of Law - Judicial Set up</td>
<td>Unit 8: Insurance (Pages 133-159)</td>
</tr>
</tbody>
</table>
BLOCK - III: HPR AND IT


Unit 10: Partners Relations: Introduction - Eligibility to be a Partner - Registration of Change in Partner - Limited Liabilities of Partnership - Dissolution of Firms - Characteristics - Kinds - Incorporation of Companies - Memorandum of Association - Articles of Association.


Unit 9: Indian Partnership Act, 1932 (Pages 160-175)

Unit 10: Partners Relations (Pages 176-207)

Unit 11: The Companies Act, 1956 (Pages 208-233)

BLOCK - IV: MSME


Unit 14: Protection of Minority Interest: Introduction - Methods of Winding-Up - The Right to Information Act, 2005 Right to Know, Salient Features of the Act, Obligation of Public Authority, Designation of Public Information Officer, Request for Obtaining Information.

Unit 12: Formation of a Company (Pages 234-256)

Unit 13: Law of Information Technology, 2000 (Pages 257-278)

Unit 14: Company Law and the Right to Information Act, 2005 (Pages 279-294)
3.11 Self Assessment Questions and Exercises
3.12 Further Readings

UNIT 4  SPECIAL CONTRACTS  46-59

4.0 Introduction
4.1 Objectives
4.2 Contract of Indemnity and Guarantee, Rights and Discharge of Surety
   4.2.1 Contracts of Indemnity
   4.2.2 Contracts of Guarantee
   4.2.3 Discharge of Surety from Liability
4.3 Bailment and Pledge: An Overview
   4.3.1 Classifications of Bailements
   4.3.2 Duties and Rights of Bailor and Bailee
   4.3.3 Termination of Bailment
4.4 Law of Agency
   4.4.1 General Rules of Agency
4.5 Answers to Check Your Progress Questions
4.6 Summary
4.7 Key Words
4.8 Self Assessment Questions and Exercises
4.9 Further Readings

BLOCK II: PARTNERSHIP AND COMPANY ACT

UNIT 5  FORMATION OF CONTRACT UNDER SALE OF GOODS ACT, 1930  60-80

5.0 Introduction
5.1 Objectives
5.2 Contract of Sale: An Overview
5.3 Conditions and Warranties
5.4 Transfer of Title and Property
   5.4.1 Rules Regarding Transfer of Property
5.5 Rights of an Unpaid Seller
5.6 Performance of Contract of Sale
5.7 Answers to Check Your Progress Questions
5.8 Summary
5.9 Key Words
5.10 Self Assessment Questions and Exercises
5.11 Further Readings

UNIT 6  LAWS ON CARRIAGE OF GOODS  81-102

6.0 Introduction
6.1 Objectives
6.2 The Carriers Act, 1865
6.3 The Railways Act, 1890
   6.3.1 Duties of Railway Administration
   6.3.2 Liabilities of Railway Administration
   6.3.3 Notification of Claims (Sec. 78b)
6.4 The Carriage of Goods by Sea Act, 1925
   6.4.1 Contract of Affreightment
   6.4.2 Duties of a Carrier by Sea
   6.4.3 Liabilities of Carrier by Sea
   6.4.4 Ship-Owner’s Lien and Maritime Lien
6.5 The Carriage by Air Act, 1972
   6.5.1 Right of the Consignor and the Consignee
   6.5.2 Liability of the Carrier
9.2 Meaning and Test of Partnership
   9.2.1 Essential Elements of Partnership
   9.2.2 Test of Partnership
   9.2.3 Formation and Registration of Firms
9.3 Life Insurance Corporation Act, 1956
   9.3.1 General Insurance Business Nationalization Act, 1973
   9.3.2 Functions of Corporation
   9.3.3 Functions of Acquiring Companies
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions And Exercises
9.8 Further Readings

UNIT 10 PARTNERS RELATIONS 176-207
10.0 Introduction
10.1 Objectives
10.2 Limited Liability Partnership Act
   10.2.1 Limited Liability Partnership Act, 2008
10.3 Partners Relations: Introduction, Eligibility and Registration of Change in Partner
   10.3.1 Designated Partners (Sec. 7)
   10.3.2 Dissolution of Firms
10.4 Incorporation of Companies
   10.4.1 Characteristics of Company
10.5 Memorandum of Association
   10.5.1 Contents of Memorandum
   10.5.2 Alteration of Memorandum
10.6 Articles of Association
   10.6.1 Obligation to Register Articles
10.7 Answers to Check Your Progress Questions
10.8 Summary
10.9 Key Words
10.10 Self Assessment Questions and Exercises
10.11 Further Readings

UNIT 11 THE COMPANIES ACT, 1956 208-233
11.0 Introduction
11.1 Objectives
11.2 Nature And Kinds Of Companies
11.3 Prospectus and Disclosure Needs
   11.3.1 Contents of a Prospectus
11.4 Management and Administration: Director’s Appointment, Powers and Duties
   11.4.1 Appointment of Directors
   11.4.2 Powers of Directors
   11.4.3 Duties of Directors
   11.4.4 Other Managerial Personnel
11.5 Answers to Check Your Progress Questions
11.6 Summary
11.7 Key Words
11.8 Self Assessment Questions and Exercises
11.9 Further Readings
BLOCK IV: MSME

UNIT 12 FORMATION OF A COMPANY 234-256
12.0 Introduction
12.1 Objectives
12.2 Formation of a Company: Introduction and Process
   12.2.1 Promotion Stage
   12.2.2 Registration and Incorporation Stage
   12.2.3 Commencement of Business Stage
12.3 Meetings: Types and Requirements
   12.3.1 AGM and EGM
   12.3.2 Extraordinary or Emergency General Meeting (EGM)
   12.3.3 Board Meeting
   12.3.4 Requirements
   12.3.5 Minutes and Resolutions
   12.3.6 E-Fillings of Documents under Ministry of Corporate Affairs (MCA) 21
12.4 Answers to Check Your Progress Questions
12.5 Summary
12.6 Key Words
12.7 Self Assessment Questions and Exercises
12.8 Further Readings

UNIT 13 LAW OF INFORMATION TECHNOLOGY, 2000 257-278
13.0 Introduction
13.1 Objectives
13.2 Overview of the Indian IT Act
   13.2.1 Rationale behind the IT Act, 2000
   13.2.2 Commencement of Information Technology Act, 2000
   13.2.3 Scheme of the IT Act, 2000
   13.2.4 Digital Signature
13.3 Attribution, Acknowledgement and Dispatch of Electronic Records
13.4 Regulation of Certifying Authorities
   13.4.1 Powers of Controller of Certifying Authorities
   13.4.2 Duties of Certifying Authority
   13.4.3 Digital Signature Certificates
13.5 Answers to Check Your Progress Questions
13.6 Summary
13.7 Key Words
13.8 Self Assessment Questions and Exercises
13.9 Further Readings

UNIT 14 COMPANY LAW AND THE RIGHT TO INFORMATION ACT, 2005 279-294
14.0 Introduction
14.1 Objectives
14.2 Companies Act: Protection of Minority Interest
14.3 Companies Act: Methods of Winding Up
14.4 The Right to Information Act, 2005
   14.4.1 Right to Know and Salient Features
   14.4.2 Obligation of Public Authority
   14.4.3 Designation of Public Information Officer
   14.4.4 Request for Obtaining Information
14.5 Answers to Check Your Progress Questions
14.6 Summary
14.7 Key Words
14.8 Self Assessment Questions and Exercises
14.9 Further Readings
The term ‘Business Law’ may be defined as that branch of law which comprises laws concerning trade, industry and commerce. It is an ever growing branch of law with the changing circumstances of trade and commerce.

With the increasing complexities of the modern business world, the scope of Business Law has enormously widened. It is generally understood to include the laws relating to Contracts, Sale of Goods, Partnership, Companies, Negotiable Instruments, Insurance, Insolvency, Carriage of Goods and Arbitration.

The need for the knowledge of law cannot be over-emphasized. It is common knowledge that ignorance of law is no excuse, which implies that it is not open to a person committing the breach of law to plead ignorance of law. The breach of law is omission to do something for which the law casts an obligation upon the person to do or doing something which the law refrains. That is why it is generally known and accepted that every person is presumed to know the law. As such it is indispensable for the people engaged in economic and commercial pursuits to acquaint themselves with the general principles of the basic business laws.

Prior to the enactment of the various Acts constituting Business Law, business transactions were regulated by the personal laws of the parties to the suit. The rights of Hindus and Muslims were governed by their respective laws and usages. Where both parties were Hindus, they were regulated by the Hindu Law and where both parties were Muslims, the Mohammadan Law was applied. In cases where one party was a Hindu and the other was a Muslim, the personal law of the defendant was applied. In case of persons other than Hindus and Muslims, and also where laws and usages of Hindus or Muslims were silent on any point, the courts generally applied the principles of English Law. Gradually, the need for the enactment of a uniform law regulating the contracts was realized and this gave birth to the Indian Contract Act, 1872. Since then, a number of statutes have been enacted, viz., The Negotiable Instruments Act, 1881; The Sale Goods Act, 1930; The Indian Partnership Act, 1932; The Insurance Act, 1938, etc.

This book, Business Law, introduces the students to the various laws which play an essential role in the business environment. This book has been written in the self-instructional mode (SIM) wherein each unit begins with an ‘Introduction’ to the topic followed by an outline of the ‘Objectives’. The detailed content is then presented in a simple and an organized manner, interspersed with ‘Check Your Progress Questions’ to test the understanding of the students. A ‘Summary’ along with a list of ‘Key Words’ and a set of ‘Self-Assessment Questions and Exercises’ is also provided at the end of each unit for effective recapitulation.
BLOCK - I
BASICS OF BUSINESS LAW

UNIT 1 INDIAN CONTRACT ACT, 1872

Structure
1.0 Introduction
1.1 Objectives
1.2 Nature, Elements and Formation of Contract
1.2.1 Nature
1.2.2 Essential Elements
1.2.3 Classification of Contracts: Validity, Formation and Performance
1.3 Answers to Check Your Progress Questions
1.4 Summary
1.5 Key Words
1.6 Self Assessment Questions and Exercises
1.7 Further Readings

1.0 INTRODUCTION

The Indian Contract Act envisages the way we enter into a contract. The basic framework of contracting is covered in the Indian Contract Act and it is an important area of law. An agreement enforceable by law is a contract. Thus, in a contract there must be: an agreement and the agreement must be enforceable by law. An agreement comes into existence whenever one or more persons promise to one or others, to do or not to do something. If an agreement is incapable of creating a duty enforceable by law, it is not a contract. This means that an agreement is a wider term than a contract. ‘All contracts are agreements but all agreements are not contracts.’ Agreements of moral, religious or social nature are not contracts because they are not likely to create a duty enforceable by law.

To make a contract valid, it needs to have the essential elements. There must be a ‘lawful offer’ and a ‘lawful acceptance’ of the offer, thus resulting in an agreement. There must be an intention among the parties that the agreement should be attached by legal consequences and create legal obligations. 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.’ Free consent of all the parties to an agreement is another essential element of a valid contract. There are numerous types of contracts based on enforceability, mode of creation and the extent of execution.
This unit aims at analysing nature, elements and types of contract as codified in Indian Contract Act, 1872.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning of contract
- Enumerate the nature and formation of contract
- Learn the essential elements of contract
- Know the classification of contract
- Understand the types of contracts on the basis of enforceability
- Explain the types of contracts on the basis of mode of creation
- Know the types of contracts on the basis of the extent of execution
- Learn the formation and performance

1.2 NATURE, ELEMENTS AND FORMATION OF CONTRACT

1.2.1 Nature

The law of contract in India is contained in the Indian Contract Act, 1872. It extends to the whole of India except the state of Jammu and Kashmir and came into force on 1 September 1872. The Act is not exhaustive. It does not deal with all the branches of the law of contract. There are separate Acts that deal with contracts relating to negotiable instruments, transfer of property, sale of goods, partnership, insurance, etc. Again, 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.

According to Section 2 (h) of the Indian Contract Act: ‘An agreement enforceable by law is a contract.’ A contract, therefore, is an agreement the object of which is to create a legal obligation, i.e., a duty enforceable by law.

From the above definition, we find that a contract essentially consists of two elements: (1) An agreement, and (2) Legal obligation, i.e., a duty enforceable by law. We shall now examine these elements in detail.

1. Agreement: As per Section 2(e), ‘Every promise and every set of promises, forming the consideration for each other, is an agreement.’ 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 signs 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’.

2. Legal obligation: As stated above, an agreement to become a contract must give rise to a legal obligation, i.e., a duty enforceable by law. If an agreement is incapable of creating a duty enforceable by law, it is not a contract. Thus an agreement is a wider term than a contract. ‘All contracts are agreements but all agreements are not contracts.’ Agreements of moral, religious or social nature, such as a promise to lunch together at a friend’s house or to take a walk together are not contracts because they are not likely to create a duty enforceable by law for the simple reason that the parties never intended that they should be attended by legal consequences.

In business agreements, the presumption is usually that the parties intend to create legal relations. Thus, an agreement to buy certain specific goods at an agreed price e.g., 100 bags of wheat at ₹ 430 per bag is a contract because it gives rise to a duty enforceable by law, and in case of default on the part of either party, an action for breach of contract could be enforced through a court provided other essential elements of a valid contract as laid down in Section 10 are present, namely, if the contract was made by free consent of the parties competent to contract, for a lawful consideration and with a lawful object.

Thus, it may be concluded that the act restricts the use of the word ‘contract’ to only those agreements that give rise to legal obligations between the parties.

1.2.2 Essential Elements

A contract has been defined in Section 2(h) as ‘an agreement enforceable by law’. To be enforceable by law, an agreement must possess the essential elements of a valid contract as contained in Sections 10, 29 and 56. According to Section 10, all agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration, with a lawful object, are not expressly declared by the Act to be void, and, where necessary, satisfy the requirements of any law as to writing or attestation or registration. We now will discuss the essential features of a contract 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 dine 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) *M* promised his wife *N* to get her a saree if she would sing a song. *N* sang the song but *M* did not bring the saree for her. *N* could not 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 Sri Lanka. He and his wife were enjoying leave in England. When the defendant was due to return to Sri Lanka, his wife could not accompany him because of her health. The defendant agreed to send her £30 a month as maintenance expenses during the time they were 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. *(Balfour vs Balfour)*

3. **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 exceptions, 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.

4. **Capacity of parties:** The parties to an agreement must be competent to contract, otherwise it cannot be enforced by a court of law. In order to be competent to contract the parties must be of the age of majority and of sound mind and must not be disqualified from contracting by any law to which they are subject (Sec. 11).

5. **Free consent:** Free consent of all the parties to an agreement is another essential element of a valid contract. ‘Consent’ means that the parties must have agreed upon the same thing in the same sense (Sec. 13). There is absence of ‘free consent’ if the agreement is induced by (i) coercion, (ii) undue influence, (iii) fraud, (iv) misrepresentation, or (v) mistake (Sec. 14).

6. **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 of the reasons mentioned above the agreement is void. Thus, when a landlord knowingly lets a house to a prostitute to carry on prostitution, he cannot recover the rent through a court of law.

7. **Writing and registration:** 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 an out of 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.

8. **Certainty**: Section 29 of the Contract Act provides that ‘Agreements, the meaning of which is not certain or 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 ascertaining 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.

9. **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.

10. **Not expressly declared void:** The agreement must not have been expressly declared to be void under the Act. Sections 24–30 specify certain types of agreements which have been expressly declared to be void. For example, an agreement in restraint of marriage, an agreement in restraint of trade, and an agreement by way of wager have been expressly declared void under Sections 26, 27 and 30, respectively.
Before dealing with the various essentials of a valid contract one by one in detail, it will be appropriate to discuss the 'kinds of contracts', first, because we shall be using the terms like 'voidable contract', 'void contract', 'void agreement', etc., very often in the course of our discussion.

1.2.3 Classification of Contracts: Validity, Formation and Performance

A. Types of Contracts on the Basis of Enforceability

On the basis of enforceability, a contract may be valid or voidable or void or unenforceable or illegal.

1. **Valid contract**: A valid contract is an agreement enforceable by law. An agreement becomes enforceable by law when all the essential elements of a valid contract are present.

2. **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.

3. **Void contract**: Literally the word ‘void’ means ‘not binding in law’. Accordingly the term ‘void contract’ implies a useless contract which has no legal effect at all. Such a contract is a nullity, as there has been no contract at all. Section 2(j) defines: ‘A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable.’ It follows from the definition that a void contract is not void from its inception and that it is valid and binding on the parties when originally entered into but subsequently, it becomes invalid and destitute of legal effect because of certain reasons.

4. **Unenforceable contract**: An unenforceable contract is one which is valid in itself, but is not capable of being enforced in a court of law because of some technical defect such as absence of writing, registration, requisite stamp, etc., or time barred by the law of limitation. For example, an oral arbitration agreement is unenforceable because the law requires an arbitration agreement to be in writing.

5. **Illegal or unlawful contract**: The word ‘illegal’ means ‘contrary to law’ and the term ‘contract’ means ‘an agreement enforceable by law.’ As such, to speak of an ‘illegal contract’ involves a contradiction in terms, because it means something like this—an agreement enforceable by law and contrary to law. There is an apparent contradiction in terms. Moreover, being of unlawful nature, such an agreement can never attain the status of a contract. Thus, it will be proper if we use the term ‘illegal agreement’ in place of ‘illegal contract’. An illegal agreement is void *ab-initio*. 
B. Types of Contracts on the Basis of Mode of Creation

Contracts, on the basis of mode of creation, may be express or implied or constructive.

1. **Express contract**: When both the offer and the acceptance constituting an agreement are enforceable by law are made in words spoken or written, it is an express contract. For example, when A tells B on telephone that he offers to sell his car for ₹ 20,000 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 by law are made other than in words, i.e., by acts and conduct of the parties, it is an implied contract. Thus, where A, a coolie in uniform, takes 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 this is an implied contract.

3. **Constructive or quasi-contract**: The term ‘constructive or quasi-contract’ is a misnomer. The cases grouped under this type of contracts have little or no affinity with a contract. Such a contract does not arise by virtue of any agreement, express or implied, between the parties but the law infers or recognizes a contract under certain special circumstances. For example, the obligation of the finder of lost goods to return them to the rightful owner or liability of a person to whom money is paid by mistake to repay, it cannot be said to arise out of a contract even in its remotest sense, as there is neither offer and acceptance nor consent, but these are covered under quasi-contracts as per Sections 71 and 72. The Contract Act has rightly named such contracts as ‘certain relations resembling those created by contract’.

A quasi-contract is based upon the equitable principle that a person shall not be allowed to retain unjust benefit at the expense of another. Sections 68–72 of the Contract Act describe the cases which are to be deemed ‘quasi-contracts’.

C. Types of Contracts on the Basis of the Extent of Execution

On the basis of the extent of execution, a contract may be executed or executory.

1. **Executed contract**: A contract is said to be executed when both the parties to a contract have completely performed their share of obligations and nothing remains to be done by either party under the contract. For example, when a bookseller sells a book on cash payment it is an executed contract because both the parties have done what they were to do under the contract.

2. **Executory contract**: It is a contract in which both the obligations are outstanding, either party to the contract, either wholly or in part, at the time of the formation of the contract. In other words, a contract is said to be executory when either both the parties to a contract have still to perform their share of obligations in toto, or there remains something to be done under the contract on both sides.
NOTES

Check Your Progress
1. What do you mean by the term ‘contract’?
2. What are the two essential elements of a contract?
3. List types of contracts on the basis of enforceability.
4. What is quasi-contract?
5. When is a contract said to be executory?

1.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. According to section 2 (b) of the Indian Contract Act: ‘an agreement enforceable by law is a contract,’ a contract, therefore, is an agreement the object of which is to create a legal obligation, i.e., a duty enforceable by law.

2. A contract essentially consists of two elements: (1) an agreement, and (2) legal obligation, i.e., a duty enforceable by law.

3. On the basis of enforceability, a contract may be: i.) valid, ii.) voidable, iii.) void, iv.) unenforceable or v.) illegal.

4. The term ‘constructive or quasi-contract’ is a misnomer. The cases grouped under this type of contracts have little or no affinity with a contract. Such a contract does not arise by virtue of any agreement, express or implied, between the parties but the law infers or recognizes a contract under certain special circumstances. A quasi-contract is based upon the equitable principle that a person shall not be allowed to retain unjust benefit at the expense of another. Sections 68–72 of the Contract Act describe the cases which are to be deemed ‘quasi-contracts’.

5. A contract is said to be executory when either both the parties to a contract have still to perform their share of obligations in toto, or there remains something to be done under the contract on both sides.

1.4 SUMMARY

- A contract essentially consists of two elements: (1) an agreement, and (2) legal obligation, i.e., a duty enforceable by law.
- 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.
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).

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.

A valid contract is an agreement enforceable by law. An agreement becomes enforceable by law when all the essential elements of a valid contract are present.

Literally the word ‘void’ means ‘not binding in law’. Accordingly the term ‘void contract’ implies a useless contract which has no legal effect at all. Such a contract is a nullity, as there has been no contract at all. Section 2(j) defines: 'A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable.'

The word ‘illegal’ means ‘contrary to law’ and the term ‘contract’ means ‘an agreement enforceable by law.’ As such, to speak of an ‘illegal contract’ involves a contradiction in terms, because it means something like this—an agreement enforceable by law and contrary to law.

When both the offer and the acceptance constituting an agreement are enforceable by law are made in words spoken or written, it is an express contract.

Where both the offer and acceptance constituting an agreement enforceable by law are made other than in words, i.e., by acts and conduct of the parties, it is an implied contract.

The term ‘constructive or quasi-contract’ is a misnomer. The cases grouped under this type of contracts have little or no affinity with a contract.

A quasi-contract is based upon the equitable principle that a person shall not be allowed to retain unjust benefit at the expense of another. Sections 68–72 of the Contract Act describe the cases which are to be deemed ‘quasi-contracts’.

A contract is said to be executed when both the parties to a contract have completely performed their share of obligations and nothing remains to be done by either party under the contract.

1.5 KEY WORDS

- The Indian Contract Act, 1872: This act prescribes the law relating to contracts in India. It is applicable to all the States of India except the state of Jammu and Kashmir.
Section 2(h) of the Indian Contract Act: According to this Act, an agreement enforceable by law is a contract.

Void contract: Accordingly the term ‘void contract’ implies a useless contract which has no legal effect at all.

Implied contract: Where both the offer and acceptance constituting an agreement enforceable by law are made other than in words, i.e., by acts and conduct of the parties, it is an implied contract.

Executed contract: A contract is said to be executed when both the parties to a contract have completely performed their share of obligations.

1.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions
2. Write a brief about the formation of Indian Contract Act.
3. Write in short the essential elements of contract.
4. Write in brief about valid contract.
5. Write a brief note on types of contracts on the basis of the extent of execution.

Long-Answer Questions
1. Analyse the significance of agreement as enunciated in Indian Contract Act.
2. Discuss the main features of contract.
3. Analyse the types of contracts on the basis of mode of creation.
4. Discuss the role of legal relationship in contract.

1.7 FURTHER READINGS

UNIT 2  OFFER AND ACCEPTANCE

Structure
2.0 Introduction
2.1 Objectives
2.2 Offer and Acceptance: An Overview
  2.2.1 Offer (Proposal)
  2.2.2 Legal Rules Regarding a Valid Offer
  2.2.3 Lapse and Revocation of Offer
  2.2.4 Acceptance
  2.2.5 Legal Rules Regarding a Valid Acceptance
  2.2.6 Communications of Offer, Acceptance and Revocations
2.3 Answers to Check Your Progress Questions
2.4 Summary
2.5 Key Words
2.6 Self Assessment Questions and Exercises
2.7 Further Readings

2.0 INTRODUCTION

The Indian Contract Act, 1872 defines ‘offer’/’proposal’ and ‘acceptance’ in Section 2 (a) and 2 (b). When one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other person either to such act or abstinence, he is said to make a proposal. Section 2(b) states that ‘A proposal when accepted becomes a promise’ and defines ‘acceptance’ as ‘when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted’. The person making the ‘proposal’ or ‘offer’ is called the ‘promisor’ or ‘offeror’, the person to whom the offer is made is called the ‘offeree,’ and the person accepting the offer is called the ‘promisee’ or ‘acceptor’.

If the offer does not intend to give rise to legal consequences, it is not a valid offer in the eye of the law. If the terms of the offer are not definite and certain, it does not amount to a lawful offer. An offer is effective only when it is communicated to the offeree. Until the offer is made known to the offeree, there can be no acceptance and no contract. An offer lapses if acceptance is not communicated within the time prescribed in the offer, or if no time is prescribed, within a reasonable time. An offer may be revoked, at any time before acceptance, by the communication of notice of revocation by the offeror to the other party.

An offer can be accepted only by the person or persons to whom it is made and with whom it imports an intention to contract; it cannot be accepted by another person without the consent of the offeror. An offer lapses if it has been rejected by the offeree. The rejection may be express, i.e., by words spoken or written, or
Offer and Acceptance

implied. If the offeror prescribes no mode of acceptance, the acceptance must be communicated according to some usual and reasonable mode. The usual modes of communication are by word of mouth, by post and by conduct.

This unit aims at discussing various rules regarding offer and acceptance. It also explains communications of offer, acceptance and revocations.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the concept and meaning of proposal and offer
- Learn the legal rules regarding a valid offer
- Know the importance of lapse and revocation of offer
- Understand the rules regarding a valid acceptance
- Enumerate Communications of offer, acceptance and revocations

2.2 OFFER AND ACCEPTANCE: AN OVERVIEW

2.2.1 Offer (Proposal)

The words ‘proposal’ and ‘offer’ are synonymous and are used interchangeably. Section 2(a) of the Indian Contract Act defines a ‘proposal’ as ‘when one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal’. This definition reveals the following three essentials of a ‘proposal’. These are as follows:

(i) It must be an expression of the willingness to do or to abstain from doing something.

(ii) The expression of willingness to do or to abstain from doing something must be to another person. There can be no ‘proposal’ by a person to himself.

(iii) The expression of willingness to do or to abstain from doing something must be made with a view to obtaining the assent of the other person to such act or abstinence. Thus a casual enquiry — ‘Do you intend to sell your motorcycle?’ — is not a ‘proposal’. Similarly, a mere statement of intention — ‘I may sell my motorcycle if I can get ₹14,000 for it’ — is not a ‘proposal’. But if M says to N, ‘Will you buy my motorcycle for ₹14,000,’ or ‘I am willing to sell my motorcycle to you for ₹14,000,’ we have a ‘proposal’ as it has been made with the objective of obtaining the assent of N.

The person making the ‘proposal’ or ‘offer’ is called the ‘promisor’ or ‘offeror’, the person to whom the offer is made is called the ‘offeree,’ and the person accepting the offer is called the ‘promisee’ or ‘acceptor’. 
2.2.2 Legal Rules Regarding a Valid Offer

A valid offer must be in conformity with the following rules:

1. **An offer may be ‘express’ or ‘implied’**: An offer may be made *either* in words *or* by conduct. An offer which is expressed in words, spoken or written, is called an ‘express offer’ and the one, which is inferred from the conduct of a person or the circumstances of the case, is called an ‘implied offer’.

2. **An offer must contemplate giving rise to legal consequences and be capable of creating legal relations**: If the offer does not intend to give rise to legal consequences, it is not a valid offer in the eye of the law. An offer to a friend to dine at the offeror’s place, or an offer to one’s wife to show her a movie is not a valid offer and as such cannot give rise to a binding agreement, even though it is accepted and there is consideration, because in social agreements or domestic arrangements, the presumption is that the parties do not intend legal consequences to follow the breach of agreement. But in the case of agreements regulating business transactions, the presumption is just the other way. In business agreements it is taken for granted that parties intend legal consequences to follow.

3. **The terms of the offer must be certain and not loose or vague**: If the terms of the offer are not definite and certain, it does not amount to a lawful offer. L.J. Maugham has rightly observed: ‘Unless all the material terms of the contract are agreed, there is no binding obligation.’ Thus an agreement to agree in future is not a contract, because the terms of agreement are uncertain as they are yet to be settled.

4. **An invitation to offer is not an offer**: An offer must be distinguished from an ‘invitation to receive an offer’ or as it is sometimes expressed in judicial language an ‘invitation to treat.’ In the case of an ‘invitation to receive an offer’, the person sending out the invitation does not make an offer but only invites the other party to make an offer. His object is merely to circulate information that he is willing to deal with anybody who, on such information, is willing to open negotiations with him. Therefore, such invitations for offers are not offers in the eye of the law and do not become agreements by their acceptance. Likewise, quotations, catalogues of prices or display of goods with prices marked thereon do not constitute an offer. They are instead an invitation for offer, and hence if a customer asks for goods or makes an offer, the shopkeeper is free to accept the offer or not.

5. **An offer may be ‘specific’ or ‘general’**: An offer is said to be ‘specific’ when it is made to a definite person or persons. Such an offer can be accepted only by the person or persons to whom it is made. Thus, where M makes an offer to N to sell his bicycle for ₹200, there is a specific offer and N alone can accept it. A ‘general offer’, on the other hand, is one which is made to the world at large or public in general and may be accepted by any
person who fulfils the requisite conditions. The leading case on the subject of ‘general offer’ is that of Carlill vs Carbolic Smoke Ball Co.

6. **An offer must be communicated to the offeree:** An offer is effective only when it is communicated to the offeree. Until the offer is made known to the offeree, there can be no acceptance and no contract. Doing anything in ignorance of the offer can never be treated as its acceptance, for, there was never a *consensus* of wills. This applies to both ‘specific’ and ‘general’ offers.

7. **An offer should not contain a term the non-compliance of which would amount to acceptance:** Thus an offeror cannot say that if acceptance is not communicated up to a certain date, the offer would be presumed to have been accepted. If the offeree does not reply, there is no contract, because no obligation to reply can be imposed on him, on the grounds of justice.

8. **An offer can be made subject to any terms and conditions:** An offeror may attach any terms and conditions to the offer he makes. He may even prescribe the mode of acceptance. The offeree will have to accept all the terms of the offer. There is no contract unless all the terms of the offer are complied with and accepted in the mode prescribed.

9. **Two identical cross-offers do not make a contract:** When two parties make identical offers to each other, in ignorance of each other’s offer, the offers are ‘cross-offers’. ‘Cross-offers’ do not constitute acceptance of one’s offer by the other and as such there is no completed agreement.

### 2.2.3 Lapse and Revocation of Offer

An offer lapses and becomes invalid (i.e., comes to an end) in the following circumstances:

1. **An offer lapses after a stipulated or reasonable time:** An offer lapses if acceptance is not communicated within the time prescribed in the offer, or if no time is prescribed, within a reasonable time [Sec. 6 (2)]. Reasonable time depends upon the circumstances of each case. For example, an offer made by telegram suggests that a reply is required urgently and if the offeree delays the communication of his acceptance even by a day or two, the offer will be considered to have lapsed.

2. **An offer lapses by not being accepted in the mode prescribed, or if no mode is prescribed, in some usual and reasonable manner:** But, according to Section 7, if the offeree does not accept the offer according to the mode prescribed, the offer does not lapse automatically. It is for the offeror to insist that his proposal be accepted only in the prescribed manner, and if he fails to do so he is deemed to have accepted the acceptance.

3. **An offer lapses by rejection:** An offer lapses if it has been rejected by the offeree. The rejection may be express, i.e., by words spoken or written,
or implied. Implied rejection is one: (a) where either the offeree makes a counter offer; or (b) where the offeree gives a conditional acceptance.

4. **An offer lapses by the death or insanity of the offeror or the offeree before acceptance:** If the offeror dies or becomes insane before acceptance, the offer lapses provided that the fact of his death or insanity comes to the knowledge of the acceptor before acceptance [Sec. 6 (4)]. From the language of the Section, it may be inferred that an acceptance in ignorance of the death or insanity of the offeror is a valid acceptance, and gives rise to a contract. Thus the fact of death or insanity of the offeror would not put an end to the offer until it comes to the notice of the acceptor before acceptance. An offeree’s death or insanity before accepting the offer puts an end to the offer and his heirs cannot accept for him (*Reynolds vs Atherton*).

5. **An offer lapses by revocation:** An offer is revoked when it is retracted by the offeror. An offer may be revoked, at any time before acceptance, by the communication of notice of revocation by the offeror to the other party [Sec. 6 (1)]. For example, at an auction sale, A makes the highest bid. But he withdraws the bid before the fall of the hammer. There cannot be a concluded contract because the offer has been revoked before acceptance.

6. **Revocation by non-fulfilment of a condition precedent to acceptance:** An offer stands revoked if the offeree fails to fulfil a condition precedent to acceptance [Sec. 6 (3)]. Thus, where A offers to sell his scooter to B for ₹ 4,000, if B joins the Lions Club within a week, the offer stands revoked and cannot be accepted by B, if B fails to join the Lions Club.

7. **An offer lapses by subsequent illegality or destruction of subject matter:** An offer lapses if it becomes illegal after it is made, and before it is accepted. Thus, where an offer is made to sell 10 bags of wheat for ₹ 6,500, and before it is accepted, a law prohibiting the sale of wheat by private individuals is enacted, the offer comes to an end. In the same manner, an offer may lapse if the substance, which is the subject matter of the offer, is destroyed or substantially impaired before acceptance.

### 2.2.4 Acceptance

A contract, as already observed, emerges from the acceptance of an offer. Section 2(b) states ‘A proposal when accepted becomes a promise’ and defines ‘acceptance’ as ‘when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted’. Thus, ‘acceptance’ is the manifestation by the offeree of his assent to the terms of the offer.

### 2.2.5 Legal Rules Regarding a Valid Acceptance

A valid acceptance must be in conformity with the following rules:

1. **Acceptance must be given only by the person to whom the offer is made:** An offer can be accepted only by the person or persons to whom it
Offer and Acceptance

NOTES

1. Offer and Acceptance is made and with whom it imports an intention to contract; it cannot be accepted by another person without the consent of the offeror. The rule of law is clear that ‘if you propose to make a contract with A, then B can’t substitute himself for A without your consent’. An offer made to a particular person can be validly accepted by him alone. Similarly an offer made to a class of persons (i.e., teachers) can be accepted by any member of that class. An offer made to the world at large can be accepted by any person who has knowledge of the existence of the offer.

2. Acceptance must be absolute and unqualified [Sec. 7 (1)]: In order to be legally effective, it must be an absolute and unqualified acceptance of all the terms of the offer. Even the slightest deviation from the terms of the offer makes the acceptance invalid. In effect, a deviated acceptance is regarded as a counter offer in law.

3. Acceptance must be expressed in some usual and reasonable manner, unless the proposal prescribes the manner in which it is to be accepted [Sec. 7 (2)]: If the offeror prescribes no mode of acceptance, the acceptance must be communicated according to some usual and reasonable mode. The usual modes of communication are by word of mouth, by post and by conduct. When acceptance is given by words spoken or written or by post or telegram, it is called an express acceptance. When acceptance is given by conduct, it is called an implied or tacit acceptance. Implied acceptance may be given either by doing some required act, for example, tracing the lost goods for the announced reward, or by accepting some benefit or service, for example, stepping in a public bus by a passenger.

It should be noted that the law does not allow an offeror to prescribe ‘silence’ as the mode of acceptance. Thus, a person cannot say that if within a certain time acceptance is not communicated the offer would be considered as accepted. Similarly, a trader who, of his own without receiving any order, sends goods to some person with a letter saying ‘If I do not hear from you by the next Monday, I shall presume that you have bought the goods’, cannot impose a contract on the unwilling recipient. It is so because in the absence of such a rule the offerees will be at the mercy of offerors, unless they reply all such offers in negative which will certainly be causing a lot of inconvenience and financial burden to them.

Mental acceptance is ineffectual: Mental acceptance or quiet assent not evidenced by words or conduct does not amount to a valid acceptance; and this is so even where the offeror has said that such a mode of acceptance will suffice. Acceptance must be communicated to the offeror, otherwise it has no effect.

4. Acceptance must be communicated by the acceptor: For an acceptance to be valid, it must not only be made by the offeree but must also be
5. **Acceptance must be given within a reasonable time and before the offer lapses and/or is revoked:** To be legally effective, acceptance must be given within the specified time limit, if any, and if no time is stipulated, acceptance must be given within a reasonable time because an offer cannot be kept open indefinitely. Again, the acceptance must be given before the offer is revoked or lapses by reason of offeree’s knowledge of the death or insanity of the offeror.

6. **Acceptance must succeed the offer:** Acceptance must be given after receiving the offer. It should not precede the offer. In a company, shares were allotted to a person who had not applied for them. Subsequently, he applied for shares being unaware of the previous allotment. It was held that the allotment of shares previous to the application was invalid.

7. **Rejected offers can be accepted only if renewed:** Offer once rejected cannot be accepted again unless a fresh offer is made.

### 2.2.6 Communications of Offer, Acceptance and Revocations

When the contracting parties are face to face and negotiate in person, there is instantaneous communication of offer and acceptance, and a valid contract comes into existence the moment the offeree gives his absolute and unqualified acceptance to the proposal made by the offeror. The question of revocation of either offer or acceptance does not arise, for, in such cases a definite offer is made and accepted instantly at one and the same time.

But where services of the post office are utilized for communicating among themselves by the contracting parties because they are at a distance from one another, it is not always easy to ascertain the exact time at which an offer or-and an acceptance is made or revoked. In these cases the following rules, as laid down in Sections 4 and 5, will be applicable:

1. **Communication of an offer:** The communication of an offer is complete when it comes to the knowledge of the person to whom it is made, i.e., when the letter containing the offer reaches the offeree.

2. **Communication of an acceptance:** The communication of an acceptance has two aspects, viz., as against the proposer and as against the acceptor. The communication of an acceptance is complete (a) as against the proposer, when it is put in a course of transmission to him, so as to be out of power of the acceptor, and (b) as against the acceptor, when it comes to the knowledge of the proposer, i.e., when the letter of acceptance is received by the proposer.

3. **Communication of a revocation:** The communication of a revocation is complete: (a) as against the person who makes it, when it is put into
Offer and Acceptance

NOTES

a course of transmission to the person to whom it is made, so as to be
out of the power of the person revoking, i.e., when the letter of revocation
is posted, and (b) as against the person to whom it is made, when it
comes to his knowledge, i.e., when the letter of revocation is received
by him.

Effect of delay or loss of letter of acceptance in postal transit: So
far as the offeror is concerned, he is bound by the acceptance the
moment the letter of acceptance is posted, although the letter is delayed
or wholly lost through an accident of the post and the letter never, in
fact, reaches him. So far as the acceptor is concerned, he is not bound
by the letter of acceptance till it reaches the offeror. Until the letter of
acceptance reaches the offeror, the contract remains voidable at the
instance of the acceptor. He can compel the offeror to enforce the
contract or he may revoke his acceptance by communicating his
revocation at any time before the letter reaches the offeror. Thus, the
acceptor is at an advantage if the letter is delayed or lost in transit.

Check Your Progress

1. What do you mean by offer/proposal as defined in Indian Contract Act?
2. List the three essentials of a ‘proposal’.
3. What is ‘acceptance’?
4. List some of the legal rules of a valid acceptance.
5. When is the communication of a revocation complete?

2.3 ANSWERS TO CHECK YOUR PROGRESS

QUESTIONS

1. The words ‘proposal’ and ‘offer’ are synonymous and are used
   interchangeably. Section 2(a) of the Indian Contract Act defines a ‘proposal’
   as ‘when one person signifies to another his willingness to do or to abstain
   from doing anything, with a view to obtaining the assent of that other to
   such act or abstinence, he is said to make a proposal’.
2. The three essentials of a ‘proposal’ are as follows:
   (i) It must be an expression of the willingness to do or to abstain from
doing something.
   (ii) The expression of willingness to do or to abstain from doing something
   must be to another person. There can be no ‘proposal’ by a person to
   himself.
(iii) The expression of willingness to do or to abstain from doing something must be made with a view to obtaining the assent of the other person to such act or abstinence.

3. A contract, as already observed, emerges from the acceptance of an offer. Section 2(b) states that ‘A proposal when accepted becomes a promise’ and defines ‘acceptance’ as ‘when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted’. Thus, ‘acceptance’ is the manifestation by the offeree of his assent to the terms of the offer.

4. A valid acceptance must be in conformity with the following rules:
   i. Acceptance must be given only by the person to whom the offer is made: An offer can be accepted only by the person or persons to whom it is made and with whom it imports an intention to contract; it cannot be accepted by another person without the consent of the offeror.
   ii. Acceptance must be absolute and unqualified [Sec. 7 (1)]: In order to be legally effective, it must be an absolute and unqualified acceptance of all the terms of the offer.
   iii. Acceptance must be expressed in some usual and reasonable manner, unless the proposal prescribes the manner in which it is to be accepted [Sec. 7 (2)]: If the offeror prescribes no mode of acceptance, the acceptance must be communicated according to some usual and reasonable mode.
   iv. Acceptance must be communicated by the acceptor: For an acceptance to be valid, it must not only be made by the offeree but must also be communicated by, or with the authority of, the offeree (or acceptor) to the offeror.
   v. Acceptance must be given within a reasonable time and before the offer lapses and/or is revoked: To be legally effective acceptance must be given within the specified time limit, if any, and if no time is stipulated, acceptance must be given within a reasonable time because an offer cannot be kept open indefinitely.
   vi. Acceptance must succeed the offer: Acceptance must be given after receiving the offer. It should not precede the offer.

5. The communication of a revocation is complete: (a) as against the person who makes it, when it is put into a course of transmission to the person to whom it is made, so as to be out of the power of the person revoking, i.e., when the letter of revocation is posted, and (b) as against the person to whom it is made, when it comes to his knowledge, i.e., when the letter of revocation is received by him.
2.4 SUMMARY

- Section 2(a) of the Indian Contract Act defines a ‘proposal’ as ‘when one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal’.
- An offer which is expressed in words, spoken or written, is called an ‘express offer’ and the one, which is inferred from the conduct of a person or the circumstances of the case, is called an ‘implied offer’.
- An offer is said to be ‘specific’ when it is made to a definite person or persons. Such an offer can be accepted only by the person or persons to whom it is made.
- When two parties make identical offers to each other, in ignorance of each other’s offer, the offers are ‘cross-offers’. ‘Cross-offers’ do not constitute acceptance of one’s offer by the other and as such there is no completed agreement.
- According to Section 7, if the offeree does not accept the offer according to the mode prescribed, the offer does not lapse automatically.
- An offer may be revoked, at any time before acceptance, by the communication of notice of revocation by the offeror to the other party [Sec. 6 (1)].
- An offer lapses if it becomes illegal after it is made, and before it is accepted.
- An offer can be accepted only by the person or persons to whom it is made and with whom it imports an intention to contract; it cannot be accepted by another person without the consent of the offeror.
- When acceptance is given by conduct, it is called an implied or tacit acceptance. Implied acceptance may be given either by doing some required act, for example, tracing the lost goods for the announced reward, or by accepting some benefit or service, for example, stepping in a public bus by a passenger.
- Mental acceptance or quiet assent not evidenced by words or conduct does not amount to a valid acceptance; and this is so even where the offeror has said that such a mode of acceptance will suffice. Acceptance must be communicated to the offeror, otherwise it has no effect.
- To be legally effective, acceptance must be given within the specified time limit, if any, and if no time is stipulated, acceptance must be given within a reasonable time because an offer cannot be kept open indefinitely.
- When the contracting parties are face to face and negotiate in person, there is instantaneous communication of offer and acceptance, and a valid contract
comes into existence the moment the offeree gives his absolute and unqualified acceptance to the proposal made by the offeror.

- The communication of an acceptance has two aspects, viz., as against the proposer and as against the acceptor.
- Until the letter of acceptance reaches the offeror, the contract remains voidable at the instance of the acceptor. He can compel the offeror to enforce the contract or he may revoke his acceptance by communicating his revocation at any time before the letter reaches the offeror.

2.5 KEY WORDS

- **Cross-offers**: When two parties make identical offers to each other, in ignorance of each other’s offer, the offers are ‘cross-offers’.
- **Conditional Acceptance**: A conditional acceptance, sometimes called a qualified acceptance, occurs when a person to whom an offer has been made tells the offeror that he or she is willing to agree to the offer provided that some changes are made in its terms or that some condition or event occurs.
- **Express acceptance**: When acceptance is given by words spoken or written or by post or telegram, it is called an express acceptance.
- **Implied acceptance**: When acceptance is given by conduct, it is called an implied or tacit acceptance.
- **Revocation of Offer**: The Indian Contract Act lays out the rules of revocation of an offer in Section 5.

2.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on the legal rules regarding a valid offer.
2. Write in brief about cross-offers.
3. Write in short the circumstances wherein an offer lapses and becomes invalid.
4. Write in brief about significance of time limit in acceptance.
5. Write a brief note on aspects of communication of an acceptance.

**Long-Answer Questions**

1. “If the offer does not intend to give rise to legal consequences, it is not a valid offer.” Justify this statement with relevant illustrations.
2. Discuss some of legal rules regarding a valid acceptance.
3. Analyse in detail communications of offer, acceptance and revocations.

2.7 FURTHER READINGS

UNIT 3  CONSIDERATION

3.0  INTRODUCTION

In Indian Contract Act, consideration is meant to be the exchange of one thing of value for another. It is one of the important elements that must be present for a contract to be legally enforceable. Under Section 10 of the Contract Act, a lawful consideration is included among other requirements to constitute a valid contract. Simply put, consideration means something in return of a promise which may either be gained by one party or something lost by the other. For anything done by a party under the agreement, there is a corresponding benefit to the other party. In order to constitute legal consideration, the act must be done at the desire or request of the promisor. The other essential of valid consideration, as contained in the definition of consideration in Section 2 (d), is that consideration need not move from the promisee alone but may proceed from a third person.

This unit aims at analysing the essentials of consideration and explains various kinds of contract as enunciated in Indian Contract Act, 1872.

3.1  OBJECTIVES

After going through this unit, you will be able to:

- Understand the meaning main components, and essential element of consideration
3.2 CONSIDERATION: DEFINITIONS, TYPES AND ESSENTIALS

Section 2(d) of the Indian Contract Act defines consideration as follows: ‘When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise.’

An analysis of the above definition will show that a consideration consists of the following four components:

(a) The act or abstinence or promise which forms the consideration for the promise, must be done at the desire of the promisor;
(b) It must be done by the promisee or any other person;
(c) It may have been already executed or is in the process of being done or may be still executory;
(d) It must be something to which the law attaches a value.

3.2.1 The Essentials of Valid Consideration

The four component parts of the definition of consideration may well be described as the essentials of valid consideration. We shall now discuss these essentials one by one in detail. These are as follows:

1. Consideration 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 a 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 a person might be subjected, if he were obliged to pay for services which he does not need or require.

2. Consideration may move from the promisee or any other person: The second essential of valid consideration, as contained in the definition of consideration in Section 2 (d), is that consideration need not move from the promisee alone but may proceed from a third person. Thus, as long as there is consideration for a promise, it is immaterial who has furnished it. It may move from the promisee or from any other person. This means that even a stranger to the consideration can sue on a contract, provided he...
is a party to the contract. This is sometimes called ‘Doctrine of Constructive Consideration’.

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 sue, 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).

3. Consideration may be past, present or future: The words, ‘has done or abstained from doing; or does or abstains from doing; or promises to do or to abstain from doing,’ used in the definition of consideration, 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.

4. Consideration must be ‘something of value’: The fourth and last essential of valid consideration is that it must be ‘something’ to which the law attaches a value. The consideration need not be adequate to the promise for the validity of an agreement. The law only insists on the presence of consideration and not on the adequacy of it. It leaves the people free to make their own bargains.

3.2.2 Privity of Contracts and Exceptions to the Rule

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 [Sec. 25 (1)]: 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.

2. Agreement to compensate for past voluntary service [Sec. 25 (2)]: A promise made without consideration is also valid, if it is a promise to compensate, wholly or in part, a person who has already voluntarily done something for the promisor, or done something which the promisor was legally compelled to do.
3. **Agreement to pay a time-barred debt [Sec. 25 (3)]**: Where there is an agreement, made in writing and signed by the debtor or by his authorised agent, to pay wholly or in part 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.

4. **Completed gift**: A gift (which is not an agreement) does not require consideration in order to be valid. ‘As between the donor and the donee, any gift actually made will be valid and binding even though without consideration’ [Explanation 1 to Section 25]. In order to attract this exception, there need not be natural love and affection or nearness of relationship between the donor and donee. The gift must, however, be complete.

5. **Contract of agency**: Section 185 of the Contract Act lays down that no consideration is necessary to create an agency.

6. **Remission by the promisee, of performance of the promise**: For compromising a due debt, i.e., agreeing to accept less than what is due, no consideration is necessary. In other words, a creditor can agree to give up a part of his claim and there need be no consideration for such an agreement. Similarly, an agreement to extend time for performance of a contract need not be supported by consideration (Sec. 63).

7. **Contribution to charity**: A promise to contribute to charity, though gratuitous, would be enforceable, if on the faith of the promised subscription, the promisee takes definite steps in furtherance of the object and undertakes a liability, to the extent of liability incurred, not exceeding the promised amount of subscription.

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### Check Your Progress

1. What do you mean by the term ‘consideration’?
2. List the essentials of valid consideration.
3. How is completed gift treated under the valid contract?

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### 3.3 Capacity and Consent

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 this Section declares that a person is incompetent to contract under the following circumstances:
1. If he is a minor, according to the law to which he is subject,
2. If he is of unsound mind, and
3. If he is disqualified from contracting by any law to which he is subject.

1. Minor and minor’s agreements

According to Section 3 of the Indian Majority Act 1875, as amended by the Majority (Amendment) Act, 1999, a person, domiciled in India, who is under 18 years of age is a minor. Accordingly every person who has completed the age of 18 years becomes a major. The law regarding a minor’s agreements may be summed up as under:

- An agreement by a minor is absolutely void and inoperative as against him
- Beneficial agreements are valid contracts
- No ratification on attaining the age of majority
- The rule of estoppel does not apply to a minor
- Minor’s liability for necessaries

Specific performance: Specific performance means the actual carrying out of the contract as agreed. Since an agreement by a minor is absolutely void, the court will never direct ‘specific performance’ of such an agreement by him.

Minor partner: 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’ with the consent of all the partners by an agreement executed through his lawful guardian with the other partners.

- A minor can be an agent (Sec. 184).
- A minor cannot be adjudicated an insolvent, for he is incapable of contracting debts.

Contract by a 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).

Surety for a minor: Where in a contract of guarantee an adult stands surety for a minor, the adult is liable under the contract, although the minor is not (as for there is a direct contract between the surety and the third party) (Kashiha vs Shripat).

Position of a minor’s parents: The parents of a minor are not liable for agreements made by a minor, whether the agreement is for the purchase of necessaries or not. The parents can be held liable only when the child is contracting as an agent for the parents.
- A minor, being incompetent to contract, cannot be a shareholder of a company.
- Minor’s liability in tort

### 2. Persons of Unsound Mind

As stated earlier, as per Section 11 of the Contract Act, for a valid contract it is necessary that each party to it must be of ‘sound mind’.

**What is a ‘sound mind’?** Section 12 of the Contract Act defines the term ‘sound mind’ as follows: ‘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 judgment as to its effects upon his interests.’

According to this Section, therefore, the person entering into the contract must be a person who understands what he is doing and is able to form a rational judgment as to whether what he is about to do is to his interest or not. 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 judgment as to its effect on his interest, cannot enter a contract in such a state.

**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). 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.

### 3. 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’. Thus:

(a) **Alien enemies:** An alien (citizen of a foreign country) living in India can enter into contracts with citizens of India during peace time only, and that too subject to any restrictions imposed by the Government in that respect. On the declaration of a war between his country and India, he becomes an alien enemy and cannot enter into contracts. ‘Alien friend can contract but an alien enemy can’t contract’. Contracts entered into before the declaration of the war stand suspended and cannot be performed during the course of
war; of course, they can be revived after the war is over provided they have not already become time-barred.

(b) **Foreign sovereigns and ambassadors:** One has to be cautious while entering into contracts with foreign sovereigns and ambassadors, because though they can sue others to enforce the contracts entered upon with them, they cannot be sued without obtaining the prior sanction of the Central Government. Thus they are in a privileged position and are ordinarily considered incompetent to contract.

(c) **Convict:** A convict is one who is found guilty and is imprisoned. 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.

(d) **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 his property for necessaries supplied to her, if he fails to provide her with these.

(e) **Insolvent:** An adjudged insolvent (before an ‘order of discharge’) is competent to enter into certain types of contracts, i.e., he can incur debts, purchase property or be an employee but he cannot sell his property which vests in the Official Receiver. Before ‘discharge’ he also suffers from certain disqualifications, e.g., he cannot be a magistrate or a director of a company or a member of local body, but he has the contractual capacity except with respect to his property. After the ‘order of discharge,’ he is just like an ordinary citizen.

(f) **Joint-stock company and corporation incorporated under a special Act:** 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.

3.3.1 **Consent and Free Consent**

According to Section 10, ‘free consent’ of all the parties to an agreement is one of the essential elements of a valid contract. Section 13 of the Contract Act defines the term ‘consent’ and lays down that ‘two or more persons are said to consent when they agree upon the same thing in the same sense’. Thus, consent involves identity of minds or consensus ad-idem i.e., agreeing upon the same thing in the same sense. If, for whatever reason, there is no consensus ad-idem among the contracting parties, there is no real consent and hence no valid contract.
Section 14 lays down that '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. Misrepresentation, as defined in Section 18, or
4. Fraud, as defined in Section 17, or
5. Mistake, subject to the provisions of Sections, 20, 21 and 22.'

When consent to an agreement is caused by coercion, undue influence, misrepresentation or fraud, there is 'no free consent' and the contract is voidable at the option of the party whose consent was so caused (Sections 19 and 19A). But when consent is caused by 'bilateral mistake' as to a matter of fact essential to the agreement, the agreement is void (Sec. 20). In such a case there is 'no consent' at all.

Check Your Progress
4. List a few of circumstances wherein a person is incompetent to contract.
5. Which section of the Indian Contract Act defines ‘free consent’?

3.4 LEGALITY OF OBJECT

‘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 the law such an agreement is no agreement at all from its very inception.

You have already read the following types of void agreements in the preceding chapters, and will not therefore discuss them here again:
1. Agreements by a minor or a person of unsound mind (Sec. 11).
2. Agreements made under a bilateral mistake of fact material to the agreement (Sec. 20).
3. Agreements of which the consideration or object is unlawful (Sec. 23).
4. Agreements made without consideration (Sec. 25).

3.4.1 Expressly Declared Void Agreements

The last essential of a valid contract as declared by Section 10 is that it must not be one which is ‘expressly declared’ to be void by the Act. Thus, there arises a question, as to what are ‘expressly declared’ void agreements? The following agreements have been ‘expressly declared’, to be void by the Indian Contract Act:
1. Agreements in restraint of marriage (Sec. 26)
2. Agreements in restraint of trade (Sec. 27)
3. Agreements in restraint of legal proceedings (Sec. 28)
4. Agreements the meaning of which is uncertain (Sec. 29)
5. Agreements by way of wager (Sec. 30)
6. Agreements contingent on impossible events (Sec. 36)
7. Agreements to do impossible acts (Sec. 56)

At the very outset, it may be borne in mind that the law declares these agreements void ab-initio and not illegal, and therefore, transactions collateral to such agreements are not made void. In fact, it is for this reason that these agreements have not been discussed in the preceding unit dealing with ‘unlawful or illegal agreements’, because otherwise, in effect, these agreements are also ‘unlawful agreements’ as they are expressly declared void by the Contract Act. It may be recalled that in the case of illegal agreements, transactions collateral to them are also tainted with illegality and hence void. Let us discuss these void agreements in detail. These are as follows:

1. **Agreements in Restraint of Marriage:** Every individual enjoys the freedom to marry and so according to Section 26 of the Contract Act, ‘every agreement in restraint of the marriage of any person, other than a minor, is void’. The restraint may be general or partial but the agreement is void, and therefore, an agreement agreeing not to marry at all, or a certain person, or a class of persons, or for a fixed period, is void. However, an agreement restraining the marriage of a minor is valid under the section.

   It is interesting to note that a promise to marry a particular person does not imply any restraint of marriage, and is, therefore, a valid contract.

2. **Agreements in Restraint of Trade:** The Constitution of India guarantees the freedom of trade and commerce to every citizen and therefore Section 27 declares ‘every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void’. Thus no person is at liberty to deprive himself of the fruit of his labour, skill or talent, by any contract that he enters into.

   It is to be noted that whether restraint is reasonable or not, if it is in the nature of restraint of trade, the agreement is void always, subject to certain exceptions provided for statutorily.

   But agreements merely restraining freedom of action necessary for the carrying on of business are not void, for the law does not intend to take away the right of a trader to regulate his business according to his own discretion and choice.

3. **Agreements in Restraint of Legal Proceedings:** Section 28, as amended by the Indian Contract (Amendment) Act, 1996, declares the following three kinds of agreements void:

   a. An agreement by which a party is restricted absolutely from taking usual legal proceedings, in respect of any rights arising from a contract.
(b) An agreement which limits the time within which one may enforce his contract rights, without regard to the time allowed by the Limitation Act.

(c) An agreement which provides for forfeiture of any rights arising from a contract, if suit is not brought within a specified period, without regard to the time allowed by the Limitation Act. These are subject to contain conditions as provided in the Act.

4. Uncertain Agreements: ‘Agreements, the meaning of which is not certain, or capable of being made certain, are void’ (Sec. 29). Through Section 29, the law aims to ensure that the parties to a contract should be aware of the precise nature and scope of their mutual rights and obligations under the contract. Thus, if the words used by the parties are vague or indefinite, the law cannot enforce the agreement.

Further, an agreement ‘to enter into an agreement in future’ is void for uncertainty unless all the terms of the proposed agreement are agreed expressly or implicitly. Thus, an agreement to engage a servant sometime next year, at a salary to be mutually agreed upon is a void agreement.

5. Wagering Agreements: What is a wager? Literally the word ‘wager’ means ‘a bet’: something stated to be lost or won on the result of a doubtful issue, and, therefore, wagering agreements are nothing but ordinary betting agreements.

In Thacker vs Hardy, L.J. Cotton, described a ‘wager’ as follows: ‘The essence of gaming and wagering is that one party is to win and the other to lose upon a future event which at the time of the contract is of an uncertain nature — that is to say, if the event turns out one way A will lose; but if it turns out the other way he will win.’

Essential features of a wager: The essentials of a wagering agreement may thus be summarized as follows:

(a) There must be a promise to pay money or money’s worth.

(b) The promise must be conditional on an event happening or not happening.

(c) The event must be an uncertain one. If one of the parties has the event in his own hands, the transaction is not a wager.

(d) Each party must stand to win or lose under the terms of agreement. An agreement is not a wager if one party may only win and cannot lose, or if the may lose but cannot win, or if he can neither win nor lose.

(e) No party should have a proprietary interest in the event. The stake must be the only interest which the parties have in the agreement.

Agreements by way of wager are void: Section 30 lays down that, ‘Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or
entrusted to any person to abide the result of any game or other uncertain event on which any wager is made.

The Section makes an exception in favour of certain prizes for horse racing by providing further that, 'This Section shall not be deemed to render unlawful a subscription, or contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize or sum of money, of the value or amount of five hundred rupees or upwards, to be awarded to the winner or winners of any horse race.'

It is important to note that in the states of Maharashtra and Gujarat wagering agreements are, by a local statute, not only void but also illegal. As a result in these states the collateral transactions to wagering agreements become tainted with illegality and hence are void.

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

7. **Agreements to do Impossible Acts:** 'An agreement to do an act impossible in itself is void.' (Sec. 56 Para 1)

**No Restitution:** The term 'restitution' means 'return' or 'restoration' of the benefit received from the plaintiff under the agreement. As per Section 65, no restitution of the benefit received is allowed in the case of expressly declared void agreements.

### Check Your Progress

6. What do you mean by a void agreement?
7. Under what condition is an agreement to 'enter into an agreement in future' not considered void?

### 3.5 DISCHARGE OF CONTRACT

When the rights and obligations arising out of a contract are extinguished, the contract is said to be discharged or terminated. A contract may be discharged in any of the following ways:

1. By performance: actual or attempted.
2. By mutual consent or agreement.
3. By subsequent or supervening impossibility or illegality.
4. By lapse of time.
5. By operation of law.
1. Discharge by performance

Performance of a contract is the principal and most usual mode of discharge of a contract. Performance may be: (1) Actual performance; or (2) Attempted performance or Tender.

1. Actual performance: When each party to a contract fulfils his obligation arising under the contract within the time and in the manner prescribed, it amounts to actual performance of the contract and the contract comes to an end or stands discharged. But if one party only performs his promise, he alone is discharged. Such a party gets a right of action against the other party who is guilty of breach.

2. Attempted performance or tender: When the promisor offers to perform his obligation under the contract, but is unable to do so because the promisee does not accept the performance, it is called ‘attempted performance’ or ‘tender’. Thus ‘tender’ is not actual performance but is only an ‘offer to perform’ the obligation under the contract. A valid tender of performance is equivalent to performance.

(a) Essentials of a valid tender: A valid tender or offer of performance must fulfil the following conditions. These are: It should be unconditional, made at proper time and place, must be of whole obligation, give a reasonable opportunity to promise of inspection of goods, must be made by a relevant person, made to a proper person, and with exact amount.

(b) Effect of refusal to accept a valid tender: The effect of refusal to accept a properly made ‘offer of performance’ is that the contract is deemed to have been performed by the promisor, i.e., tenderer, and the promisee can be sued for breach of contract. A valid tender, thus, discharges the contract. (Section 38).

Exception. Tender of money, however, does not discharge the contract. The money will have to be paid even after the refusal of tender, of course without interest from the date of refusal. In case of a suit, cost of defence can also be recovered from the plaintiff, if tender of money is proved (Jagat Tarini vs Naba Gopal).

2. Discharge by mutual consent or agreement

Since a contract is created by means of an agreement, it may also be discharged by another agreement between the same parties. Sections 62 and 63 deal with this subject and provide for the following methods of discharging a contract by mutual agreement:

1. 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 discharge of the old contract. If parties are not changed then the nature of the obligation (i.e., material terms of the
contract) must be altered substantially in the new substituted contract, for a mere variation of some of the terms of a contract, while the parties remain the same, is not ‘novation’ but ‘alteration’. When the parties to a contract agree for ‘novation’, the original contract is discharged and need not be performed.

2. **Alteration**: Alteration of a contract means change in one or more of the material terms of a contract. If a material alteration in a written contract is done by mutual consent, the original contract is discharged by alteration and the new contract in its altered form takes its place. A material alteration is one which alters the legal effect of the contract, e.g., a change in the amount of money to be paid or a change in the rate of interest. Immaterial alteration, e.g., correcting a clerical error in figures or the spelling of a name, has no effect on the validity of the contract and does not amount to alteration in the technical sense.

3. **Rescission**: A contract may be discharged, before the date of performance, by agreement between the parties to the effect that it shall no longer bind them. Such an agreement amounts to ‘rescission’ or cancellation of the contract, the consideration for mutual promises being the abandonment by the respective parties of their rights under the contract. An agreement of rescission releases the parties from their obligations arising out of the contract. Such agreements are to be distinguished from ‘agreements in restraint of legal proceedings’ which are void as per Section 28. Law cannot force the parties to take a legal action for breach of contract and, therefore, if they consent to treat non-performance or part performance of a contract equivalent to full performance or discharge of the contract, it is perfectly alright.

4. **Remission**: Remission may be defined ‘as the acceptance of a lesser sum than what was contracted for or a lesser fulfilment of the promise made’. Section 63 deals with remission of performance and lays down that a promisee may remit or give up wholly or in part, the performance of the promise made to him, and a promise to do so is binding even though there is no consideration for it. The Section further provides that an agreement to extend the time for the performance of a promise also does not require consideration to support it on the ground that it is a partial remission of performance.

5. **Waiver**: Waiver means the deliberate abandonment or giving up of a right which a party is entitled to under a contract, whereupon the other party to the contract is released from his obligation. Strictly speaking, there is no need of an agreement for a waiver but because we are discussing it as a method of discharge under ‘mutual consent’, we presume that the other party consents to it.
3. Discharge by Subsequent or Supervening Impossibility or Illegality

i. Impossibility at the time of contract: There is no question of discharge of a contract which is entered into to perform something that is *obviously impossible*, e.g., an agreement to discover treasure by magic, because, in such a case there is no contract to terminate, it being an agreement void *ab initio* by virtue of Section 56, Para I, which provides: ‘an agreement to do an act impossible in itself is void.’ Notice that this paragraph of the Section speaks of something which is impossible inherently or by its very nature and which may or may not be known to both the parties at the time when the contract is made.

ii. Subsequent impossibility: In fact it is this case, where the impossibility supervenes after the contract has been made, which is material to our study of discharge of contracts. In this connection, Section 56, Para 2, declares: ‘A contract to do an 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’. These are subject to certain conditions.

iii. Cases where the doctrine of supervening impossibility applies: A contract will be discharged on the ground of supervening impossibility in the following cases:

   1. Destruction of subject-matter.
   2. Failure of ultimate purpose.
   3. Death or personal incapacity of promisor.
   5. Outbreak of war.

iv. Cases not Covered by Supervening Impossibility

“He that agrees to do an act must do it or pay damages for not doing it”, is the general rule of the law of contract. Thus, unless the performance becomes absolutely impossible (as discussed above), a person is bound to perform any obligation which he has undertaken, and cannot claim to be excused by the mere fact that performance has subsequently become unexpectedly burdensome, more difficult or expensive. Some of the cases where impossibility of performance is not an excuse are as follows:

   1. Difficulty of performance
   2. Commercial impossibility
   3. Impossibility due to the default of a third person
   4. Strikes and lock-outs
   5. Failure of one of the objects
4. Discharge by Lapse of Time

The Limitation Act lays down that, in case of breach of a contract, legal action should be taken within a specified period, called the period of limitation, otherwise the promisee is debarred from instituting a suit in a court of law and the contract stands discharged. Thus, in certain circumstances lapse of time may also discharge a contract. For example, the period of limitation for simple contracts is three years under the Limitation Act, and therefore, on default by a debtor, if the creditor does not file a suit of recovery against him within three years of default, the debt becomes time-barred on the expiry of three years and the creditor will be deprived of his remedy at law. This in effect implies discharge of contract.

5. Discharge by Operation of Law

A contract terminates by operation of law in the following cases:
(a) Death
(b) Insolvency
(c) Merger
(d) Unauthorized material alteration

6. Discharge by Breach of Contract

Breach of contract by a party thereto is also a method of discharge of a contract, because ‘breach’ also brings to an end the obligations created by a contract on the part of each of the parties. Of course the aggrieved party, i.e., the party not at fault can sue for damages for breach of contract as per law; but the contract as such stands terminated. Remember, the sections you have studied and are going to study are subject to specific detailed conditions specified in the Act.

Check Your Progress
8. List the various ways in which a contract may be discharged.
9. What is actual performance of the contract?

3.6 BREACH OF CONTRACT AND ITS REMEDIES

Breach of contract, as you are aware, may be of two kinds: (1) Anticipatory breach and (2) Actual breach.

1. Anticipatory breach: An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived. It may take place in two ways:
   (a) Expressly by words spoken or written
   (b) Impliedly by the conduct of one of the parties
Section 39 of the Contract Act deals with anticipatory breach of contract and provides as follows: 'When a party to a contract has refused to perform, or disabled himself from performing, his promise in its entirety, the promisee may put an end to the contract, unless he has signified, by words or conduct, his acquiescence in its continuance.'

2. **Actual breach:** Actual breach may also discharge a contract. It occurs when a party fails to perform his obligation upon the date fixed for performance by the contract, as for example, where on the appointed day, the seller does not deliver the goods or the buyer refuses to accept the delivery. It is important to note that there can be no actual breach of contract by reason of non-performance so long as the time for performance has not yet arrived. Actual breach entitles the party not in default to elect to treat the contract as discharged and to sue the party at fault for damages for breach of contract.

### Remedies of Breach of Contract

Whenever there is breach of a contract, the injured party becomes entitled to any one or more of the following remedies against the guilty party:

1. Rescission of the contract
2. Suit for damages
3. Suit upon *quantum meruit*
4. Suit for specific performance of the contract
5. Suit for an injunction

As regards the last two remedies stated above, the law is regulated by the Specific Relief Act, 1963.

**1. Rescission of the Contract**

When there is a breach of contract by one party, the other party may rescind the contract and need not perform his part of obligations under the contract and may sit quietly at home if he decides not to take any legal action against the guilty party. But in case the aggrieved party intends to sue the guilty party for damages for breach of contract, he has to file a suit for rescission of the contract. When the court grants rescission, the aggrieved party is freed from all his obligations under the contract; and becomes entitled to compensation for any damage which he has sustained through the non-fulfilment of the contract (Sec. 75).

Thus, applying to the court for ‘rescission of the contract’ is necessary for claiming damages for breach or for availing any other remedy. In practice a ‘suit for rescission’ is accompanied by a ‘suit for damages,’ etc., in the same plaint.

**2. Suit for Damages**

Damages are a monetary compensation allowed to the injured party for the loss or injury suffered by him as a result of the breach of contract. The fundamental
principle underlying damages is not punishment but compensation. By awarding damages the court aims to put the injured party into the position in which he would have been, had there been performance and not breach, and not to punish the defaulter party. As a general rule, ‘compensation must be commensurate with the injury or loss sustained, arising naturally from the breach.’ ‘If actual loss is not proved, no damages will be awarded.’

There are four kinds of damages. These are:
- Ordinary (Sec. 73)
- Special damages (Sec. 73)
- Exemplary, Punitive or Vindicitive damages
- Nominal damages

**Liquidated Damages and Penalty:** Let us first know what we mean by the two terms. ‘Liquidated damages’ means a sum fixed up in advance, which is a fair and genuine pre-estimate of the probable loss that is likely to result from the breach. ‘Penalty’ means a sum fixed up in advance, which is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

Under the Indian Law, Section 74 does away with the distinction between liquidated damages’ and ‘penalty’. This Section lays down that the courts are not bound to treat the sum mentioned in the contract, either by way of liquidated damages or penalty, as the sum payable as damages for breach. Instead the courts are required to allow reasonable compensation so as to cover the actual loss sustained, not exceeding the amount so named in the contract.

**Exception:** There is, however, one exception provided for by Section 74 to the above rule. When any person enters into any bailbond, recognizance or other instrument of the same nature, or under the provisions of any law or under the orders of the Government, gives any bond for the performance of any public duty or act in which the public are interested, he shall be liable to pay the whole sum mentioned therein upon breach of the condition of any such instrument.

**Cost of suit:** The aggrieved party is entitled, in addition to the damages, to get the costs of getting the decree for damages from the defaulter party. The cost of suit for damages is in the discretion of the court.

3. **Suit Upon Quantum Meruit**

The third remedy for a breach of contract available to an injured party against the guilty party is to file a suit upon quantum meruit. The phrase quantum meruit literally means ‘as much as is earned’ or ‘in proportion to the work done.’ A right to sue upon quantum meruit usually arises where after part performance of the contract by one party, there is a breach of contract, or the contract is discovered void or becomes void.
4. Suit for Specific Performance

Specific performance means the actual carrying out of the contract as agreed. Under certain circumstances an aggrieved party may file a suit for specific performance, i.e., for a decree by the court directing the defendant to actually perform the promise that he has made.

A decree for specific performance is not granted for contracts of every description. It is only where it is just and equitable so to do, i.e., where the legal remedy is inadequate or defective, that the courts issue a decree for specific performance. It is usually granted in contracts connected with land, buildings, rare articles and unique goods having some special value to the party suing because of family association. Notice that in all these contracts, monetary compensation is not an adequate relief because the injured party will not be able to get an exact substitute in the market.

Specific performance is not granted, as a rule, in the certain cases:

4. Suit for an Injunction

‘Injunction’ is an order of a court restraining a person from doing a particular act. It is a mode of securing the specific performance of the negative terms of the contract. To put it differently, where a party is in breach of negative term of the contract, i.e., where he is doing something which he promised not to do, the court may, by issuing an injunction restrain him from doing, what he promised not to do. Thus ‘injunction’ is a preventive relief. It is particularly appropriate in cases of ‘anticipatory breach of contract’ where damages would not be an adequate relief.

Check Your Progress

10. What do you mean by anticipatory breach?
11. Who can file a suit upon quantum meruit?

3.7 QUASI-CONTRACTS

You already know that a contract is the result of an agreement enforceable by law. But in some cases, there is no offer, no acceptance, no consensus ad idem and, in fact, no intention on the part of parties to enter into a contract and still the law, from the conduct and relationship of the parties, implies a promise imposing obligation on the one party and conferring a right in favour of the other. In other words, under certain special circumstances, obligations resembling those created by a contract are imposed by law although the parties have never entered into a contract. Such obligations imposed by law are referred to as ‘Quasi-Contracts’, or ‘Constructive Contracts’ under the English law, and ‘certain relations resembling
those created by contracts' under the Indian law. The term ‘quasi-contract has been used because such a contract resembles a contract so far as result or effect is concerned, but it has little or no affinity with a contract in respect of its mode of creation.

3.7.1 Quasi-Contractual Obligations

‘Quasi-contractual obligations’ under Sections 68 to 72 are discussed below. These are:

1. Claim for necessaries supplied to a person incapable of contracting or on his account (Sec. 68)
2. Reimbursement of person paying money due by another, in payment of which he is interested (Sec. 69)
3. Obligation of person enjoying benefit of non-gratuitous act (Sec. 70)
4. Responsibility of finder of goods (Sec. 71)
5. Liability of person to whom money is paid, or thing delivered by mistake or under coercion

Check Your Progress

12. What do you mean by quasi-contract?
13. List a few of ‘quasi-contractual obligations.’

3.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 2(d) of the Indian Contract Act defines consideration as follows: ‘When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise.’

2. The essentials of valid consideration as are follows:
   i. Consideration must move at the desire of the promisor
   ii. Consideration may move from the promisee or any other person
   iii. Consideration may be past, present or future
   iv. Consideration must be ‘something of value’

3. Completed gift (which is not an agreement) does not require consideration in order to be valid. In order to attract this exception, there need not be natural love and affection or nearness of relationship between the donor
and donee. The gift must, however, be complete.

4. A person is incompetent to contract under the following circumstances:
   i. If he is a minor, according to the law to which he is subject,
   ii. If he is of unsound mind, and
   iii. If he is disqualified from contracting by any law to which he is subject.

5. Section 10 of the Indian Contract Act defines the term ‘free consent’

6. ‘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 the law such an agreement is no agreement at all from its very inception.

7. An agreement ‘to enter into an agreement in future’ is void for uncertainty unless all the terms of the proposed agreement are agreed expressly or implicitly.

8. A contract may be discharged in any of the following ways:
   i. By performance: actual or attempted.
   ii. By mutual consent or agreement.
   iii. By subsequent or supervening impossibility or illegality.
   iv. By lapse of time.
   v. By operation of law.
   vi. By breach of contract.

9. When each party to a contract fulfils his obligation arising under the contract within the time and in the manner prescribed, it amounts to actual performance of the contract and the contract comes to an end or stands discharged. But if one party only performs his promise, he alone is discharged. Such a party gets a right of action against the other party who is guilty of breach.

10. An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived. When there is an anticipatory breach of contract, the promisee is excused from performance or from further performance.

11. The phrase quantum meruit literally means ‘as much as is earned’ or ‘in proportion to the work done.’ A right to sue upon quantum meruit usually arises where after part performance of the contract by one party, there is a breach of contract, or the contract is discovered void or becomes void.

12. Under certain special circumstances, obligations resembling those created by a contract are imposed by law although the parties have never entered into a contract. Such obligations imposed by law are referred to as ‘Quasi-Contracts’, or ‘Constructive Contracts’ under the English law, and ‘certain relations resembling those created by contracts’ under the Indian law. The term ‘quasi-contract has been used because such a contract resembles a
Consideration so far as result or effect is concerned, but it has little or no affinity with a contract in respect of its mode of creation.

13. ‘Quasi-contractual obligations’ under Sections 68 to 72 are:
   i. Claim for necessaries supplied to a person incapable of contracting or on his account (Sec. 68).
   ii. Reimbursement of person paying money due by another, in payment of which he is interested (Sec. 69).
   iii. Obligation of person enjoying benefit of non-gratuitous act (Sec. 70).
   iv. Responsibility of finder of goods (Sec. 71).
   v. Liability of person to whom money is paid, or thing delivered by mistake or under coercion:

3.9 SUMMARY

- Section 2(d) of the Indian Contract Act defines consideration as follows: ‘When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise.’
- The consideration need not be adequate to the promise for the validity of an agreement. The law only insists on the presence of consideration and not on the adequacy of it. It leaves the people free to make their own bargains.
- 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’.
- Section 13 of the Contract Act defines the term ‘consent’ and lays down that ‘two or more persons are said to consent when they agree upon the same thing in the same sense’.
- ‘A contract is said to be induced by undue influence where, (i) 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 (ii) he uses the position to obtain an unfair advantage over the other.’
- When each party to a contract fulfils his obligation arising under the contract within the time and in the manner prescribed, it amounts to actual performance of the contract and the contract comes to an end or stands discharged. But if one party only performs his promise, he alone is discharged. Such a party gets a right of action against the other party who is guilty of breach.
- The Limitation Act lays down that, in case of breach of a contract, legal action should be taken within a specified period, called the period of
limitation, otherwise the promisee is debarred from instituting a suit in a
court of law and the contract stands discharged.

- Breach of contract by a party thereto is also a method of discharge of a
  contract, because ‘breach’ also brings to an end the obligations created by
  a contract on the part of each of the parties.

- Damages are a monetary compensation allowed to the injured party for the
  loss or injury suffered by him as a result of the breach of contract. The
  fundamental principle underlying damages is not punishment but
  compensation.

- The phrase quantum meruit literally means ‘as much as is earned’ or ‘in
  proportion to the work done.’ A right to sue upon quantum meruit usually
  arises where after part performance of the contract by one party, there is a
  breach of contract, or the contract is discovered void or becomes void.

- ‘If a person, incapable of entering into a contract, or any one whom he is
  legally bound to support, is supplied by another person with necessaries
  suited to his condition in life, the person who has furnished such supplies is
  entitled to be reimbursed from the property of such incapable person.

### 3.10 KEY WORDS

- **Supervening impossibility**: This is the impossibility arising after the
  formation of a contract. However, this arises at the time when the promisor’s
  performance is due.

- **Rescission**: In contract law, rescission has been defined as the unmaking
  of a contract between parties. Rescission is the unwinding of a transaction.
  This is done to bring the parties, as far as possible, back to the position in
  which they were before they entered into a contract.

- **Quantum meruit**: This is a Latin phrase meaning “what one has earned”.
  In the context of contract law, it means something along the lines of
  “reasonable value of services”. In the United States, the elements of quantum
  meruit are determined by state common law.

### 3.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on the various components of consideration.
2. Write in brief about minor’s agreements to protect their rights.
3. Write in brief about discharge by lapse of time.
4. Write a brief note on actual breach in contract.
5. Write a brief note on the relevance of quasi-contract.

**Long-Answer Questions**

1. “Consideration must be ‘something’ to which the law attaches a value.”
   Justify this statement.
2. Analyse the various ways in which a contract may be discharged or terminated.
3. Discuss in detail the numerous remedial measures when there is breach of a contract.

**3.12 FURTHER READINGS**

UNIT 4  SPECIAL CONTRACTS

4.0 INTRODUCTION

Indemnity and guarantee are the two different terms though they are often looked as the same. In a guarantee, the liability arises only when the debtor fails to fulfill his obligation, on the other hand, in the case of an indemnity, one assumes a direct and primary obligation on the basis of the occurrence of an event rather than a default. A contract of indemnity is really a part of the general class of ‘contingent contracts’. It is entered into with the object of protecting the promisee against anticipated loss. The person who gives the guarantee is called the ‘surety’; the person in respect of whose default the guarantee is given is called the ‘principal debtor’, and the person to whom the guarantee is given is called the ‘creditor’. A guarantee may be either oral or written. An ‘ordinary guarantee’ for a single specific debt or transaction cannot be revoked once it is acted upon. But a ‘continuing guarantee’ may at any time, be revoked by the surety as to future transactions, by giving notice to the creditor. It may be revoked in future transactions under numerous circumstances.

Section 148 of the Contract Act provides the scope of bailment and its essential features. In a contract of license the goods are not delivered to the licenser, while in bailment the goods are delivered to the bailee. A contract of bailment may be terminated under the various circumstances. Under a contract of agency, the agent is authorised to establish privity of contract between the principal (his employer) and a third party. As such the function of an agent is essentially to bring...
about contractual relations between the principal and third parties. In a way, therefore, an agent is merely a connecting link.

This unit aims at analysing special contracts like indemnity and guarantee and explains the functioning of bailment and agency in the Indian contract act.

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the contract of indemnity
- Enumerate the contract of guarantee
- Learn the rights and discharge of surety
- Know the bailment and pledge
- Understand difference between ‘bailment’ and ‘licence’
- Explain the duties and rights of bailer and bailee
- Know the general rules of agency

4.2 CONTRACT OF INDEMNITY AND GUARANTEE, RIGHTS AND DISCHARGE OF SURETY

In everyday language, indemnity may be used to imply compensation. The best example to explain a contract of indemnity would be an insurance policy. A person buying an insurance policy is actually insuring his property against damage. In case his property is damaged, he has the right to approach the insurer to pay him. ‘Indemnity’ and ‘Guarantee’ do not mean the same, as you may believe. In a guarantee, the liability arises only when the debtor fails to fulfill his obligation because responsibility is assumed for the obligation or debt of another person if he/she defaults. On the other hand, in the case of an indemnity, one assumes a direct and primary obligation on the basis of the occurrence of an event rather than a default. The two contracts are discussed here in detail.

4.2.1 Contracts of Indemnity

A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a ‘contract of indemnity’ (Section 124).

A contract of indemnity is really a part of the general class of ‘contingent contracts’. It is entered into with the object of protecting the promisee against anticipated loss. The contingency upon which the whole contract of indemnity depends is the happening of loss.

The person who promises to make good the loss is called the ‘indemnifier’ (promisor), and the person whose loss is to be made good is called the ‘indemnified or indemnity-holder’ (promisee).
A contract of indemnity, being a type of contract, must have all the essential elements of a valid contract; and an indemnity given under coercion or for an illegal object cannot be enforced. Further, a contract of indemnity may be express or implied. For example, there is an implied promise to indemnify the agent by the principal in a contract of agency. Similarly, when shares are transferred the transferee is impliedly bound to indemnify the transferor against future calls made before the registration of transfer.

4.2.2 Contracts of Guarantee

'A contract of guarantee is contract to perform the promise, or discharge the liability of a third person in case of his default' (Section 126). A contract of guarantee is entered into with the object of enabling a person to get a loan or goods on credit or an employment.

The person who gives the guarantee is called the ‘surety’; the person in respect of whose default the guarantee is given is called the ‘principal debtor’, and the person to whom the guarantee is given is called the ‘creditor’. A guarantee may be either oral or written (Section 126).

**Consideration for Guarantee:** A contract of guarantee, like every other contract, must also satisfy all the essential elements of a valid contract, e.g., genuine consent, legality of object, competency of parties, etc. It should also be supported by some consideration. But there need be no direct consideration between the surety and the creditor, and the consideration received by the principal debtor is sufficient for the surety. Section 127 expressly provides to this effect and states that ‘anything done, or any promise made, for the benefit of the principal debtor, may be a sufficient consideration to the surety for giving the guarantee.’

4.2.3 Discharge of Surety from Liability

A surety is freed from his obligation under a contract of guarantee under any one of the following circumstances:

1. **Notice of revocation (Sect. 130):** An ‘ordinary guarantee’ for a single specific debt or transaction cannot be revoked once it is acted upon. But a ‘continuing guarantee’ may at any time, be revoked by the surety as to future transactions, by giving notice to the creditor. Thus, in such a case, the liability of the surety comes to an end in respect of future transactions which may be entered into by the principal debtor after the surety has served the notice of revocation. The surety shall, however, continue to remain liable for transactions entered into prior to the notice.

2. **Death of surety (Sec. 131):** In case of a ‘continuing guarantee’, the death of a surety also discharges him from liability as regards transactions after his death, unless there is a contract to the contrary. The deceased surety’s estate will not be liable for any transaction entered into after the death, even if the creditor has no notice of the death.
3. **Variance in terms of contract** (Sec. 133): ‘Any variance, made without the surety’s consent in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance.’ Thus, a surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor (no matter whether the variation is beneficial to the surety or is made innocently or does not materially affect the position of the surety) because a surety is liable only for what he has undertaken in the contract.

4. **Release or discharge of principal debtor** (Sec. 134): This Section provides for the following two ways of discharge of surety from liability:
   - (a) The surety is discharged by *any contract* between the creditor and the principal debtor, by which the principal debtor is released. Any release of the principal debtor is a release of the surety also.
   - (b) The surety is also discharged by *any act or omission* of the creditor, the legal consequence of which is the discharge of the principal debtor.

5. **Arrangement by creditor with principal debtor without surety’s consent** (Sec. 135): Where the creditor, without the consent of the surety, makes an arrangement with the principal debtor for composition, or promises to give him time or not to sue him, the surety will be discharged. A surety is not discharged; where a contract to give time to the principal debtor is made by the creditor with a third person, and not with principal debtor, the surety is not discharged (Sec. 136).

6. **Creditor’s act or omission impairing surety’s eventual remedy** (Sec. 139): ‘If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged.’ In short, it is the duty of the creditor to do every act necessary for the protection of the rights of the surety and if he fails in this duty, the surety is discharged.

7. **Loss of security** (Sec. 141): If the creditor loses or, without the consent of the surety, parts with any security given to him, at the time of the contract of guarantee, the surety is discharged from liability to the extent of the value of security. The word ‘loss’ here means loss because of carelessness or negligence.

8. **Invalidation of the contract of guarantee**: A surety is also discharged from liability when the contract of guarantee (in between the creditor and the surety) is invalid. A contract of guarantee is invalid in the following cases:
   - (i) Where the guarantee has been obtained by means of misrepresentation or fraud or keeping silence as to material part of the transaction, by the creditor or with creditor’s knowledge and assent (Sections 142 and 143). Notice that under these sections the guarantee remains valid.
if the misrepresentation or concealment is done by the debtor without
the concurrence of the creditor.

(ii) Where a person gives a guarantee upon a contract that the creditor
shall not act upon it until another person has joined in it as co-surety,
the guarantee is not valid if that other person does not join (Sec. 144).

(iii) Where it lacks one or more essential elements of a valid contract,
e.g., surety is incompetent to contract or the object is illegal.

Check Your Progress

1. What do you mean by ‘contract of indemnity’?
2. What is a ‘contract of guarantee’?

4.3 BAILMENT AND PLEDGE: AN OVERVIEW

In this section, you will study the concept of bailment and pledge.

According to Section 148 of the Contract Act, ‘A bailment is the delivery of
goods by one person to another for some purpose, upon a contract that they shall,
when the purpose is accomplished, be returned or otherwise disposed of according
to the directions of the person delivering them’.

The person delivering the goods is called the ‘bailor’, the person to whom
they are delivered is called the ‘bailee,’ and the transaction is called the ‘bailment’.

A ‘bailment’ is thus a delivery of goods on condition that the recipient shall
ultimately restore them to the bailor or dispose of them according to the directions
of the bailor. Common examples of bailment are hiring of goods, furniture or a
cycle, delivering of cloth to a tailor for making a suit, delivering a watch or scooter
for repair, depositing goods for safe custody, etc.

4.3.1 Classifications of Bailments

Bailment may be classified from the point of view of (i) benefit, and (ii) reward to
the parties.

- From ‘benefit’ point of view: From ‘benefit’ point of view, bailments can
be grouped into three classes:

  (i) Bailment for the exclusive benefit of the bailor. e.g., bailor leaves
goods in the safe custody of the bailee without any compensation to
be paid.

  (ii) Bailment for the exclusive benefit of the bailee. e.g., a loan of
some article. Thus, where A borrows B’s fountain pen to use in the
examination hall, the bailment is for the sole benefit of A, the bailee.

  (iii) Bailment for the mutual benefit of the bailor and the bailee. It is
the most common type of bailment. Contracts for repair, hire, etc., fall
within this class, wherein the bailor receives the benefit of service and
the bailee benefits by the receipt of the agreed charges.

- **From ‘reward’ point of view**: Bailments may also be classified on the
  basis of ‘reward’ into:

  (i) **Gratuitous bailment**: It is one in which neither the bailor nor the
      bailee is entitled to any remuneration, e.g., loan of a book to a friend,
      depositing of goods for safe custody without any charge.

  (ii) **Non-gratuitous bailment**: It is also called as a ‘bailment for reward.’
      Here, either the bailor or the bailee is entitled to a remuneration, e.g.,
      motor car let out for hire, cloth given for tailoring for charges.

4.3.2 **Duties and Rights of Bailor and Bailee**

**A. Duties of Bailee**

A bailee is the person to whom the goods are delivered. His duties are as follows:

1. **Duty to take reasonable care of goods delivered to him** (Sec. 151): Section 151
   lays down this duty, thus, ‘In all cases of bailment the bailee is bound to
   take as much care of the goods bailed to him as a man of ordinary prudence
   would, under similar circumstances, take of his own goods of the same
   bulk, quality and value as the goods bailed’. In other words, the bailee must
   take reasonable care—namely the care which an average prudent
   man can be expected to take care of his own goods in similar circumstances.
   The bailee is not an insurer of goods bailed to him. If in spite of reasonable
   care, the goods are lost or destroyed or deteriorated, without any negligence
   on his part, he is not liable in respect of any damage to the goods.

2. **Duty not to make unauthorized use of goods entrusted to him** (Sec. 154): It is the duty of the bailee to use the goods strictly in accordance with
   the terms of the bailment. If he makes an unauthorised use of the goods, he
   is liable to make compensation to the bailor for any damage arising to the
   goods from or during such use of them. This liability is absolute. It arises
   even if the bailee is not guilty of any negligence, or the damage is the result
   of an act of God or inevitable accident. In addition, as per Section 153, the
   bailor can also terminate the bailment if the bailee makes an unauthorized
   use of goods.

3. **Duty not to mix goods bailed with his own goods** (Sec. 155): It is also
   the duty of a bailee that he should not mix his own goods with those of the
   bailor, without bailor’s consent. If the goods are mixed with the consent of
   the bailor, there is no breach of duty and the bailor and the bailee shall have
   an interest, in proportion to their respective shares, in the mixture thus
   produced. But if the bailee, without the consent of the bailor, mixes up his
   own goods with those of the bailor, whether intentionally or accidentally,
   the following rules apply:
(a) Where the goods can be separated or divided, the property in the goods remains in the parties respectively, but the bailee is bound to bear the expenses of separation as well as any damage arising from the mixture (Sec. 156).

(b) Where the goods mixed cannot be separated, the bailee must compensate the bailor for his loss (Sec. 157).

4. **Duty to return the goods**: Section 160 lays down this duty in the following terms: ‘It is the duty of the bailee to return, or deliver, according to the bailor’s directions the goods bailed, without demand, as soon as the time for which they were bailed has expired, or the purpose for which they were bailed has been accomplished.’ Where there are several joint bailors, the bailee may return the goods to any one of the joint owners (Sec. 165). When the bailee fails to return the goods at the proper time, he becomes responsible to the bailor for any loss, destruction or deterioration of the goods from that time (Sec. 161).

5. **Duty to deliver any accretion to the goods** (Sec. 163): It is the duty of the bailee to deliver to the bailor any natural increase or profit accruing from the goods bailed, unless there is a contract to the contrary.

**B. Duties of Bailor**

A bailor is the person who delivers the goods. His duties are as follows:

1. **Duty to disclose faults in goods bailed**: Section 150 lays down this duty. The Section makes a distinction between a gratuitous bailor and a bailor for reward and provides as follows:

   (a) A gratuitous bailor is bound to disclose to the bailee all those faults in the goods bailed, *of which he is aware* and which materially interfere with the use of them, or expose the bailee to extraordinary risks, and if he fails to do so, he will be liable to pay such damages to the bailee as may have resulted directly from the faults. A gratuitous bailor will not be liable for damages arising to the bailee from defects of which he was ignorant.

   (b) A bailor for reward is responsible for all defects in the goods bailed whether he is aware of the defects or not, if he does not disclose them to the bailee. Unlike a gratuitous bailor, ignorance of the defects is no defence for him.

2. **Duty to repay necessary expenses in case of gratuitous bailment** (Sec. 158): Where, by the conditions of the bailment, the goods are to be kept or to be carried or to have work done upon them by the bailee for the bailor, and the bailee is to receive no remuneration, it is the duty of the bailor to repay all the necessary expenses incurred by the bailee for the purpose of the bailment. Thus, where a horse is bailed without reward for safe custody, it is the duty of the bailor to reimburse the bailee for usual feeding expenses of the horse as well as for the medical expenses, if any.
3. **Duty to repay any “extraordinary” expenses in case of non-gratuitous bailment:** Where under the terms of the bailment, the bailee is to receive remuneration for his services, it is the duty of the bailor to bear *extraordinary expenses*, if any, incurred by the bailee in relation to the thing bailed. In such a bailment the bailor is not to bear the ordinary or usual expenses. Thus, where a horse is bailed for safe custody and the bailee is to receive ₹80 per day as custody charges, the bailor is not liable to repay the bailee the ordinary expenses of feeding the horse. But if during the bailee’s custody the horse falls ill without any negligence on his part, the bailor must repay the bailee the medical expenses incurred in connection with the treatment of the horse, these being extraordinary expenses.

4. **Duty to indemnify bailee (Sec. 164):** A bailor is also bound to indemnify the bailee for any loss suffered by the bailee, by reason of the fact that the bailor was not entitled to bail the goods because of the defective title.

5. **Duty to receive back the goods:** It is the duty of the bailor to receive back the goods when the bailee returns them after the time of bailment has expired or the purpose of bailment has been accomplished. If the bailor refuses to take delivery of goods when it is offered at the proper time, the bailee can claim compensation for all necessary expenses of, and incidental to, the safe custody.

C. **Rights of Bailee**

1. **Of bailor’s duties:** The duties of the bailor are the rights of the bailee. As such, the bailee can, by suit, enforce the duties of the bailor enumerated above.

2. **Right to deliver goods to one of several joint bailors (Sec. 165):** Where goods have been bailed by several joint owners, the bailee has a right to deliver them to, or according to the directions of, one joint owner without the consent of all, in the absence of any agreement to the contrary.

3. **Right to deliver goods, in good faith, to bailor without title (Sec. 166):** The bailee has a right to deliver the goods, in good faith, to the bailor without title, without incurring any liability towards the true owner.

4. **Right of lien:** The right to retain possession of the property or goods belonging to another until some debt or claim is paid, is called the right of lien. The right depends on possession and is lost as soon as possession of the goods is lost. As such it is also called as ‘possessory lien.’ Liens may be of two types—‘particular’ and ‘general.’

   ‘Particular lien’ means the right to retain only that particular property in respect of which the charge is due. ‘General lien’ means the right to retain all the goods of the other party until all the claims of the holder against the party are satisfied. In other words, this is a right to retain the goods of another as a security for a general balance of account.
**Bailee’s general lien**: A general lien is a right to retain the goods of another as a security for a general balance of account. In simple words, this right entitles a person to retain possession of any goods belonging to another for any amount due to him whether in respect of those goods or any other goods. For example, if two loans have been taken against two securities from a banker and the borrower repays one of these loans, the banker may detain both securities until his other loan is paid.

**D. Rights of Bailor**

1. **Enforcement of bailee’s duties**: The duties of the bailee are the rights of the bailor. The bailor can enforce by suit all the duties of the bailee (already discussed) as his rights. To recapitulate, the bailor has the following rights against the bailee (based on the bailee’s duties discussed earlier):
   (i) Right to claim damages for loss caused to the goods bailed by bailee’s negligence (Sec. 151).
   (ii) Right to claim compensation for any damage arising from or during unauthorised use of the goods bailed (Sec. 154).
   (iii) Right to claim compensation for any loss caused by the unauthorised mixing of goods bailed with his own goods (Sec. 155 and 56).
   (iv) Right to demand return of goods as soon as the time for which they were bailed has expired, or the purpose for which they were bailed has been accomplished (Sec. 160).
   (v) Right to claim any natural accretion to the goods bailed (Sec. 163).

2. **Right to terminate bailment if the bailee uses the goods wrongfully** (Sec. 153): The bailor has a right to terminate the bailment, if the bailee does, with regard to the goods bailed, any act which is inconsistent with the terms of the bailment, although the term of bailment has not expired or the purpose of bailment has not been accomplished.

3. **Right to demand return of goods at any time in case of gratuitous bailment** (Sec. 159): When the goods are lent without reward (i.e., gratuitously), the bailor can demand their return whenever he pleases, even though he lent them for a specified purpose or time and the bailee is not guilty of wrongful use. But if the premature return of goods causes the bailee loss in excess of benefit actually derived by him from the use of such goods, the bailor must indemnify the bailee for the amount in which the loss occasioned exceeds the benefit derived.

**4.3.3 Termination of Bailment**

A contract of bailment terminates under the following circumstances:

1. If the bailment is for a ‘specified period’ the bailment terminates as soon as the stipulated period expires.
2. If the bailment is for a 'specific purpose', the bailment terminates as soon as the purpose is fulfilled.

3. If the bailee does any act with regard to the goods bailed, which is inconsistent with the terms of bailment, the bailment may be terminated by the bailor even though the term of bailment has not expired or the purpose of bailment has not been accomplished (Sec. 153).

4. A gratuitous bailment can be terminated by the bailor at any time, even before the specified time or before the purpose is achieved, subject to the limitation that where such termination causes loss in excess of benefit actually derived by the bailee, the bailor must indemnify the bailee for the amount in which the loss occasioned exceeds the benefit derived (Sec. 159).

5. A gratuitous bailment is terminated by the death either of the bailor or of the bailee (Sec. 162).

Check Your Progress
3. What do you mean by bailment?
4. What is the difference between 'bailment' and 'licence'?

4.4 LAW OF AGENCY

The two terms 'agent' and 'principal' have been defined in Section 182 of the Contract Act as follows:

'An agent is a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done, or who is represented, is called the principal.'

It will be seen that under a contract of agency the agent is authorised to establish privity of contract between the principal (his employer) and a third party. As such the function of an agent is essentially to bring about contractual relations between the principal and third parties. In a way, therefore, an agent is merely a connecting link. After entering into a contract on behalf of the principal with a third party, the agent drops out and ceases to be a party to the contract and the contract binds the principal and the third party as if they have made it themselves.

4.4.1 General Rules of Agency

There are two important general rules regarding agency, namely,

1. Whatever a person competent to contract may do by himself, he may do through an agent, except for acts involving personal skill and qualifications. In fact, where the work to be done is obviously personal, no agent can be employed. For example, a person cannot marry through an agent, cannot paint a picture through an agent, and so on.
2. ‘He who does through another, does by himself.’ In other words, ‘the acts of the agent are, for all legal purposes, the acts of the principal.’

There are some others aspects of agency which need to be understood.

These are:

i. Who may employ an Agent?

According to Section 183, ‘any person who is of the age of majority according to the law to which he is subject, and who is of sound mind, may employ an agent’. As such any person competent to contract may employ an agent and a minor, a lunatic or a drunken person cannot employ an agent.

ii. Who may be an Agent?

Section 184 lays down in this regard that ‘as between the principal and third persons any person may become an agent’. Thus, even a minor or a person of unsound mind can be appointed as agent. It is so because the act of the agent is the act of the principal and therefore the principal is liable to third parties for the acts of a minor agent.

iii. No Consideration is Necessary

‘No consideration is necessary to create an agency’ (Sec. 185). The fact that the principal has agreed to be represented by the agent is a sufficient ‘detriment’ to the principal to support the contract of agency, i.e., to support the promise by the agent to act in that capacity.

Check Your Progress

5. What do you mean by the terms ‘agent’ and ‘principal’?
6. Who can be employed as an agent?

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a ‘contract of indemnity’ (Section 124). A contract of indemnity is really a part of the general class of ‘contingent contracts’. It is entered into with the object of protecting the promisee against anticipated loss.

2. ‘A contract of guarantee is contract to perform the promise, or discharge the liability of a third person in case of his default’ (Section 126). A contract of guarantee is entered into with the object of enabling a person to get a loan or goods on credit or an employment.
3. According to Section 148 of the Contract Act, ‘A bailment is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them’. The person delivering the goods is called the ‘bailor’, the person to whom they are delivered is called the ‘bailee,’ and the transaction is called the ‘bailment’.

4. In a contract of license the goods are not delivered to the licensor, while in bailment the goods are delivered to the bailee and the bailee is responsible for their safety.

5. The two terms ‘agent’ and ‘principal’ have been defined in Section 182 of the Contract Act as follows: ‘An agent is a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done, or who is represented, is called the principal.’

6. According to Section 183, ‘any person who is of the age of majority according to the law to which he is subject, and who is of sound mind, may employ an agent’. As such any person competent to contract may employ an agent and a minor, a lunatic or a drunken person cannot employ an agent.

4.6 SUMMARY

- ‘A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a ‘contract of indemnity’ (Section 124).
- The person who gives the guarantee is called the ‘surety’; the person in respect of whose default the guarantee is given is called the ‘principal debtor’, and the person to whom the guarantee is given is called the ‘creditor’. A guarantee may be either oral or written (Section 126).
- Where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that other person does not join (Sec. 144).
- According to Section 148 of the Contract Act, ‘A bailment is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them’.
- It is the duty of the bailee to deliver to the bailor any natural increase or profit accruing from the goods bailed, unless there is a contract to the contrary.
- The right to retain possession of the property or goods belonging to another until some debt or claim is paid, is called the right of lien. The right depends on possession and is lost as soon as possession of the goods is lost. As such it is also called as ‘possessory lien.’
• The bailor has a right to terminate the bailment, if the bailee does, with regard to the goods bailed, any act which is inconsistent with the terms of the bailment, although the term of bailment has not expired or the purpose of bailment has not been accomplished.

• If the bailee does any act with regard to the goods bailed, which is inconsistent with the terms of bailment, the bailment may be terminated by the bailor even though the term of bailment has not expired or the purpose of bailment has not been accomplished (Sec. 153).

• 'An agent is a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done, or who is represented, is called the principal.'

• The fact that the principal has agreed to be represented by the agent is a sufficient 'detriment' to the principal to support the contract of agency, i.e., to support the promise by the agent to act in that capacity.

4.7 KEY WORDS

• **Continuing guarantee**: When a guarantee extends to a series of distinct and separable transactions, it is called a 'continuing guarantee'

• **Pledge**: The bailment of goods as security for payment of a debt or performance of a promise is called ‘pledge’. The bailor in this case is called the ‘pawnor.’ The bailee is called the ‘pawnee.’

• **Right of lien**: The right to retain possession of the property or goods belonging to another until some debt or claim is paid, is called the right of lien

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on contracts of indemnity and guarantee.
2. Write in brief about the revocation of continuing guarantee.
3. Write in short about discharge of surety from liability.
4. Write a short note on general rules of agency.

**Long-Answer Questions**

1. Discuss the functioning of indemnity and guarantee.
2. Enumerate the duties and rights of bailor and bailee.
3. Analyse various steps of termination of agency by operation of law.
4.9 FURTHER READINGS

According to Sale of Goods Act, 1930, 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”. So, there must be two distinct parties to a contract of sale, viz., a buyer and a seller, as a person cannot buy his own goods. However, there may be a contract of sale between one part-owner and another. An essential element of a contract of sale of goods is the transfer of property in the goods. Every kind of movable property except actionable claim and money is regarded as ‘goods’. Goodwill, trademarks, copyrights, patents right, water, gas, electricity, decree of a court of law are all regarded as goods. Shares and stock are also included in goods. The Sale 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 money consideration for a sale of goods is known as ‘price’. The price should be paid or promised to be paid in legal tender money, unless otherwise agreed. It may be paid in the form of a cheque, hundi, bank deposit, etc.

A ‘condition’ forms the very basis of a contract of sale, the breach of which causes irreparable damage to the aggrieved party so as to entitle him even to repudiate the contract, whereas a ‘warranty’ is only of secondary importance; the
Section 13 deals with cases where a breach of condition is to be treated as a breach of warranty.

This unit aims at analysing contract of sale, conditions and warranty, transfer of title and property and rights of unpaid seller.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the Sale of Goods Act, 1930
- Enumerate the contract of sale
- Learn the kinds of goods
- Know the conditions and warranty
- Understand transfer of title and property
- Explain performance of the contract
- Know the rights of an unpaid seller

5.2 CONTRACT OF SALE: AN OVERVIEW

Section 4(1) of the Sale of Goods Act defines a contract of sale of goods as ‘a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price’. This definition reveals certain essential characteristics of a contract of sale of goods. These characteristics are as follows:

1. **Two parties**: The first essential is that there must be two distinct parties to a contract of sale, viz., a buyer and a seller, as a person cannot buy his own goods. However, there may be a contract of sale between one part-owner and another [Section 4(1)]. A partner may, therefore, buy the goods from the firm in which he is a partner and vice versa.

2. **Transfer of property**: Here, ‘property’ means ‘ownership’. In other words, an essential element of a contract of sale of goods is the transfer of property in the goods. However, the transfer of the possession of goods merely, cannot be termed as a ‘sale’. For it to be a contract of sale, it is mandatory that the seller either transfer or agree to transfer the property in the goods to the buyer.

3. **Goods**: The subject matter of the contract of sale must be ‘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’.
4. **Price**: The consideration for a contract of sale must be money consideration, which is called the ‘price’. If goods are sold or exchanged for other goods, the transaction is barter, governed by the Transfer of Property Act and not a sale of goods under this Act. But if goods are sold partly for goods and partly for money, the contract is one of sale (*Aldridge vs Johnson*).

5. **Includes both a ‘sale’ and ‘an agreement to sell’**: The term ‘contract of sale’ is a generic term and includes both a ‘sale’ and an ‘agreement to sell’ [as is clear from the definition of the term as per Section 4(1) discussed earlier].

6. **No formalities to be observed (Sec. 5)**: The Sale 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.

   It may be noted that mere payment of price by instalments under an agreement does not necessarily make it a hire-purchase, but it may be a sale. For example, in the case of the ‘Instalment Purchase Method,’ there is a ‘sale,’ because in this case the buyer is bound to buy with no option to return and the property in goods passes to the buyer at once.

**Kinds of Goods**

‘Goods’ form the subject matter of a contract of sale. Goods may be classified into the following types:

1. **Existing goods**: Goods, which are physically in existence and which are in the seller’s ownership and/or possession at the time of entering the contract of sale, are called ‘existing goods’. Where the seller is the owner, he has the general property in them. Where seller is in possession, say, as an agent or a pledgee, he has a right to sell them.

   Unascertained existing goods may again be either ‘specific’ or ‘unascertained’.

   The distinction between ‘specific’ or ‘ascertained’ and ‘unascertained’ goods is important in connection with the rules regarding ‘transfer of property’ from the seller to the buyer.

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)].

3. **Contingent goods**: Goods, the acquisition of which by the seller depends upon an uncertain contingency are called ‘contingent goods’ [Sec. 6(2)].

**The Price**

The money consideration for a sale of goods is known as ‘price’ [Sec. 2(10)]. You have already seen that the price is an essential element in every contract of
sale of goods, that is, no valid sale can take place without a price. The price should be paid or promised to be paid in legal tender money, unless otherwise agreed. It may be paid in the form of a cheque, hundi, bank deposit, etc. For it is not the mode of payment of a price but the agreement to pay a price in money that is requisite to constitute a valid contract of sale.

**Modes of Fixing the Price**

According to Section 9, the price may be fixed by one or the other of the following modes:

1. *It may be expressly fixed by the contract itself*
2. *It may be fixed in accordance with an agreed manner provided by the contract:*
3. *It may be determined by the course of dealings between the parties*
4. *If the price is not capable of being determined in accordance with any of the above modes, the buyer is bound to pay to the seller a ‘reasonable price’*

**Document of Title to Goods**

Any document, which is used in the ordinary course of business as proof of the possession or control of goods, or authorizing or purporting to authorize, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented, is a document of title to goods [Sec. 2(4)]. Thus, a document of title is a proof of the ownership of the goods. It authorizes its holder to receive goods mentioned therein or to further transfer such right to another person by proper endorsement or delivery.

A document of title to goods contains an undertaking on the part of the issuing authority to deliver the goods to the holder thereof unconditionally. Although such a document can be transferred by mere delivery or by endorsement, yet it is regarded as ‘quasi-negotiable instrument’ because the title of the transferee (even if bona fide) will not be superior to that of the transferor in the case of transfer of such document.

Examples of common documents of title to goods include bill of lading, wharfinger’s certificate, delivery order, railway receipt, dock warrant, warehouse keeper’s certificate, etc.

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**Check Your Progress**

1. What is a contract of sale of goods?
2. List the types of goods.
3. What is known as price?
5.3 CONDITIONS AND WARRANTIES

A ‘condition’ is a stipulation essential to the main purpose of the contract, the breach of which gives the aggrieved party a right to repudiate the contract itself [12(2)]. In addition, he may maintain an action for damages for loss suffered, if any, on the footing that the whole contract is broken and the seller is guilty of non-delivery (Miller’s Machinery Co. Ltd. vs David Way & Son).

A ‘warranty’ is a stipulation collateral to the main purpose of the contract, the breach of which gives the aggrieved party a right to sue for damages only, and not to avoid the contract itself [Sec. 12(3)].

It will be seen that the above definitions explain both the meaning and the legal effect of a ‘condition’ and a ‘warranty’. Accordingly, a ‘condition’ forms the very basis of a contract of sale, the breach of which causes irreparable damage to the aggrieved party so as to entitle him even to repudiate the contract, whereas a ‘warranty’ is only of secondary importance, the breach of which causes only such damage as can be compensated for by damages. In fact, a breach of ‘condition’ is followed by the same consequence as the breach of a ‘condition precedent’ in other contracts; namely, the innocent party has a right to rescind the contract, and claim damages.

There is no hard and fast rule as to which stipulation is a condition and which one is a warranty. Section 12(4) lays down to the same effect thus: ‘Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition though called a warranty in the contract’. Thus, the court is not to be guided by the terminology of the parties but has to look to the intention of the parties by referring to the terms of the contract, its construction and the surrounding circumstances to judge whether a stipulation was a condition or a warranty.

Difference between Condition and Warranty

The points of distinction between a condition and a warranty may be summed up as under:

1. **As to value:** A condition is a stipulation which is essential to the main purpose of the contract, whereas a warranty is a stipulation which is collateral to the main purpose of the contract [Sec. 12(2)(3)].

2. **As to breach:** The breach of a condition gives the aggrieved party the right to repudiate the contract and also to claim damages, whereas the breach of warranty gives the aggrieved party a right to claim damages only.

3. **As to treatment:** A breach of condition may be treated as a breach of warranty. But a breach of warranty cannot be treated as a breach of condition.
Breach of Condition and Warranty

Section 13 deals with cases where a breach of condition is to be treated as a breach of warranty, as a consequence of which the buyer loses his right to rescind the contract and has to be content with a claim for damages only. These cases are as follows:

1. Voluntary waiver by buyer
2. Acceptance of goods by buyer.
3. Acceptance of only part of the goods

Express and Implied Conditions and Warranties

Conditions and warranties may be either express or implied. They are said to be express when at the will of the parties they are inserted in the contract, and they are said to be implied when the law presumes their existence in the contract automatically, though they have not been put in express words. Implied conditions and warranties may, however, be negatived or varied by express agreement, or by course of dealing between the parties, or by usage of trade (Sec. 62). This provision is merely an application of the general maxim of law, "what is expressly done puts an end to what is tacit or implied," and "custom and agreement overrule implied conditions and warranties".

A. Implied Conditions

Unless otherwise agreed, the law incorporates the following implied conditions into a contract of sale of goods:

1. Condition as to title [Sec. 14 (a)]
2. Condition in a sale by description [Sec. 15]
3. Condition in a sale by sample (Sec. 17)
4. Condition in a sale by sample as well as by description (Sec. 15)
5. Condition as to fitness or quality [Sec. 16 (1)]
6. Condition as to merchantability [Sec. 16(2)]
7. Condition as to wholesomeness

B. Implied Warranties

Unless otherwise agreed, the law also incorporates into a contract of sale of goods the following implied warranties:

1. Warranty of quiet possession [Sec. 14(b)]
2. Warranty of freedom from encumbrances [Sec. 14(c)]
3. Warranty of disclosing the dangerous nature of goods to the ignorant buyer
5.4 TRANSFER OF TITLE AND PROPERTY

The precise moment of time at which property in goods passes from the seller to the buyer is of great importance from various points of view. Of these, the following require special notice:

1. **Risk 'prima facie' passes with property**: As a general rule, the risk of the loss of goods is *prima facie* in the person in whom property vests. Section 26 provides to the same effect, thus, ‘unless otherwise agreed, the goods remain at the seller’s risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer’s risk whether delivery has been made or not.’ Thus, if after the contract the goods are destroyed or damaged, the bearer of the loss is to be decided not on the basis of possession of the goods but on the basis of ownership of goods. Whosoever is the owner of the goods at the time of loss must bear the loss.

2. **Action against third parties**: If after the contract of sale, the goods have been damaged by a third party, it is only the person in whom the property vests who can take action against the wrongdoer.

3. **Suit for price**: Generally speaking, the seller can only sue for the price if the property in goods has passed to the buyer.

4. **Insolvency of the seller or the buyer**: In the event of insolvency of either the seller or the buyer, the answer to the question whether the official receiver or assignee can take over the goods or not, shall depend upon whether the property in goods was with the party who has become insolvent. For example, if the seller becomes insolvent before giving delivery of the goods but the property in goods has already passed to the buyer who has paid the price, the official receiver can have no claim against the goods.

5.4.1 Rules Regarding Transfer of Property

The rules regarding transfer of property have been discussed under the following two heads (i) Transfer of property in specific or ascertained goods, and (ii) Transfer of property in unascertained and future goods.
A. Transfer of property in specific or ascertained goods

Where there is a contract for the sale of specific or ascertained goods, the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred. For the purpose of ascertaining the intention of the parties regard ‘Shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case [Sec. 19(1) (2)]. Thus, in the case of specific goods, the transfer of property takes place when the parties intend to pass it. The parties may intend to pass the property at once at the time of making of the contract or when the goods are delivered or when the goods are paid for.

It is only when the intention of the parties cannot be judged from their contract or conduct or other circumstances that the rules laid down in Sections 20, 21, 22 and 24 apply [Sec. 19(3)]. These rules are as follows:

1. **When goods are in a deliverable state (Sec. 20):** Where there is an unconditional (i.e., not subject to any condition precedent to be fulfilled by the parties) contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer as soon as the contract is made, and it is immaterial whether the time of payment of the price or the time of delivery of the goods, or both are postponed.

   **Illustrations:**
   - (a) $A$ buys a bicycle for ₹ 300 on a month’s credit and asks the shopkeeper to send it to his house. The shopkeeper agrees to do so. The bicycle immediately becomes the property of $A$.
   - (b) $P$ buys a table for ₹ 100 on a week’s credit and arranges to take delivery of the table the next day. A fire breaks out in the furniture mart the same evening and the table is destroyed. The property in the table has passed to $P$ and he is bound to pay the price.

2. **When goods have to be put into a deliverable state (Sec. 21):** Where there is a contract for the sale of specific goods and the seller is bound to do ‘something’ to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof. The word ‘something’ here means an Act like packing the goods, or loading them on rail or ship, or filling them in containers or polishing them in order to give a finished shape, etc.

3. **When the goods have to be measured, etc., to ascertain price (Sec. 22):** Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof.
Formation of Contract
Under Sale of Goods Act, 1930

4. When goods are delivered on approval (Sec. 24): When goods are delivered to the buyer on approval or 'on sale or return', or on other similar terms, the property therein passes to the buyer:

   (i) When he signifies his approval or acceptance to the seller or does any other act adopting the transaction, e.g., uses the goods, pledges the goods or resells them;

   (ii) If he does not signify his approval or acceptance to the seller but retains the goods, without giving notice of rejection, beyond the time fixed for the return of goods, or if no time has been fixed, beyond a reasonable time.

B. Transfer of Property in Unascertained and Future Goods

The rule relating to transfer of property in unascertained and future goods is contained in Sections 18 and 23. These Sections provide that where goods contracted to be sold are not ascertained or where they are future goods, the property in goods does not pass to the buyer unless and until the goods are ascertained or unconditionally appropriated to the contract so as to bring them in a deliverable state, either by the seller or the buyer with the other’s assent. An assent of this kind can be either implied or expressed. It may even be given before or after the appropriation has been made.

The process of ascertainment or appropriation consists in earmarking or setting apart goods as subject-matter of the contract. It involves separating, weighing, measuring, counting or similar acts done in relation to goods with an intention to identify and determine the specific goods to be delivered under the contract.

Check Your Progress

7. When a seller can use the suit for price?
8. List the rules regarding transfer of property.

5.5 Rights of an Unpaid Seller

The seller of goods is deemed to be an ‘unpaid seller’ (a) when the whole of the price has not been paid or tendered; or (b) where a bill of exchange or other negotiable instrument has been received as a conditional payment, i.e., subject to the realization thereof, and the same has been dishonoured.

The term ‘seller’ here includes any person who is in the position of a seller, as, for instance, an agent of the seller to whom the bill of lading had been endorsed, or a consignor or agent who has himself paid, or is directly responsible for, the price. (Sec. 45)

This definition emphasises the following characteristics of an unpaid seller:
1. He must sell goods on cash terms and not on credit, and he must be 
unpaid.

2. He must be unpaid either wholly or partly. Even if only a portion of the 
price, however small, remains unpaid, he is deemed to be an unpaid 
seller. Where the price is paid through a bill of exchange or other 
negotiable instrument, the same must be dishonoured.

3. He must not refuse to accept payment when tendered. If the price has 
been tendered by the buyer but the seller wrongfully refuses to take the 
same, he ceases to be an unpaid seller.

Rights of an Unpaid Seller

An unpaid seller has two-fold rights, which are as follows:

I. Rights of unpaid seller against the goods.

II. Rights of unpaid seller against the buyer personally.

We shall now examine these rights in detail.

I. Rights of unpaid seller against the goods

Regardless of the fact that the property in the goods has passed to the buyer, an 
unpaid seller has the following rights against the seller:

1. Right of lien (Sec. 47)

2. Right of stoppage of goods in transit

3. Right of resale [Sec. 46(1)]

1. Right of lien (Sec. 47): ‘Lien’ is the right to retain possession of goods 
and refuse to deliver them to the buyer until the price due in respect of them 
is paid or tendered. An unpaid seller in possession of goods sold is entitled 
to exercise his lien on the goods in the following cases:

(a) Where the goods have been sold without any stipulation as to credit;
(b) Where the goods have been sold on credit, but the term of credit has 
expired;
(c) Where the buyer becomes insolvent, even though the period of credit 
may not have yet expired.

2. Right of stoppage of goods in transit: The right of stoppage in transit 
means the right of stopping further transit of the goods while they are 
with a carrier for the purpose of transmission to the buyer, resuming 
possession of them and retaining possession until payment or tender of the 
price. Thus, in a sense this right is an extension of the right of lien because it 
etitles the seller to regain possession even when the seller has parted with 
the possession of the goods.

i. When can this right be exercised (Sec. 50): An unpaid seller can
exercise this right only when:
(a) The buyer becomes insolvent
(b) The property has passed to the buyer
(c) The goods are in the course of transit

ii. Duration of transit (Sec. 51): Since the right of stoppage in transit can be exercised only so long as the goods are in the course of transit, it becomes necessary to know as to when the transit begins and when it comes to an end. When the transit comes to an end the right of stoppage cannot be exercised.

According to Section 51, goods are deemed to be in course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer, until the buyer or his agent takes delivery of them. Thus, the transit continues so long as the goods are not delivered to the buyer or his agent, no matter whether they are lying at the destination with the carrier awaiting transmission or are in actual transit. The goods are still deemed to be in transit if they are rejected by the buyer and the carrier or other bailee continues in possession of them, even if the seller has refused to receive them back.

iii. How is right of stoppage exercised (Sec. 52). The unpaid seller may exercise his right of stoppage in transit either:
(a) By taking actual possession of the goods,
(b) By giving notice of his claim to the carrier or other bailee in whose possession the goods are.

3. Right of resale [Sec. 46(1)]: The right of resale is a very valuable right given to an unpaid seller. In the absence of this right, the unpaid seller’s other rights against the goods, namely, ‘lien’ and ‘stoppage in transit,’ would not have been of much use because these rights only entitle the unpaid seller to retain the goods until paid by the buyer. If the buyer continues to remain in default, then should the seller be expected to retain the goods indefinitely, especially when the goods are perishable? Obviously, this cannot be the intention of the law. Section 54, therefore, gives to the unpaid seller a limited right to resell the goods in the following cases:
(a) Where the goods are of a perishable nature,
(b) Where such a right is expressly reserved in the contract in case the buyer should make a default,
(c) Where the seller has given a notice to the buyer of his intention to resell and the buyer does not pay or tender the price within a reasonable time.

If on a resale there is a loss to the seller, he can recover it from the defaulting buyer. But if there is a surplus on the resale, the seller can keep it with him.
because the buyer cannot be allowed to take advantage of his own wrong. If, however, no notice of resale [as required in case (c) above] is given to the buyer, the right of the seller to claim loss and retain surplus, if any, is reversed. In other words, if the unpaid seller fails to give notice of resale to the buyer, where neither the goods are of perishable nature nor such a right was expressly reserved, he cannot recover the loss from the buyer and is under an obligation to hand over the surplus, if any, to the buyer, arising from the resale. Thus, it will be seen that giving of notice to the buyer, when so required, is very necessary to make him liable for the breach of contract. It is so because such a notice gives an opportunity to the buyer either to pay the price and have the goods, or, if he cannot pay, to supervise the sale to see that the same is properly made.

II. Rights of unpaid seller against the buyer personally

In addition to the rights against the goods as discussed above, the unpaid seller has three rights mentioned below:

1. **Suit for price (Sec. 55):** Where property in goods has passed to the buyer; or where the sale price is payable ‘on a day certain’, although the property in goods has not passed; and the buyer wrongfully neglects or refuses to pay the price according to the terms of the contract, the seller is entitled to sue the buyer for price, irrespective of the delivery of goods. Where the goods have not been delivered, the seller would file a suit for price normally when the goods have been manufactured to some special order and, thus, are unsaleable otherwise.

2. **Suit for damages for non-acceptance (Sec. 56):** Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance. The seller’s remedy in this case is a suit for damages rather than an action for the full price of the goods.

3. **Suit for special damages and interest (Sec. 61):** This Section entitles the seller to sue the buyer for ‘special damages’ also for such loss ‘which the parties knew, when they made the contract, to be likely to result from the breach of it’. In fact, the Section 61 is only declaratory of the principle regarding ‘special damages’ laid down in Section 73 of the Indian Contract Act. The Section also recognizes unpaid seller’s right to get interest at a reasonable rate on the total unpaid price of the goods sold, from the time it was due until it is actually paid (Telu Ram Jam vs Agganval & Sons).

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**Check Your Progress**

9. Who is deemed to be an ‘unpaid seller’?
10. What are the rights of unpaid seller against the goods?
5.6 PERFORMANCE OF CONTRACT OF SALE

“It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them, in accordance with the terms of the contract of sale” (Sec. 31). Thus, the performance of a contract of sale implies delivery of goods by the seller and acceptance of the delivery of goods and payment for them by the buyer, in accordance with the contract. The parties are free to provide any terms they like in their contract about the time, place and manner of delivery of goods, acceptance thereof and payment of the price. But if the parties are silent and do not provide any thing regarding these matters in the contract then the rules contained in the Sale of Goods Act are applicable.

Delivery

Delivery of goods means voluntary transfer of possession of goods from one person to another [Sec. 2(2)]. If transfer of possession of goods is not voluntary, i.e., possession is obtained under pistol point or by theft, there is no delivery.

Modes of Delivery

Delivery of goods may be made in any of the following ways:

1. **Actual delivery**: Where the goods are physically handed over by the seller (or his authorised agent) to the buyer (or his authorised agent), the delivery is said to be actual. For example, the seller of a car hands over the car to the buyer, there is actual delivery of the goods.

2. **Symbolic delivery**: Here the goods remain where they are (probably because they are bulky), but the means of obtaining possession of goods is delivered. For example, the seller hands over to the buyer the key of the godown where the goods are stored, or transfers a document of title (i.e., bill of lading or railway receipt) to the buyer which will entitle him to obtain the goods.

3. **Constructive delivery or delivery by attornment**: Such a delivery takes place when the person in possession of the goods of the seller acknowledges, in accordance with the seller’s order that he holds the goods on behalf of the buyer and the buyer has assented to it. Note that in such a delivery all the three parties, namely, the seller, the person holding the seller’s goods and the buyer, must concur. For example, where the seller hands over the “delivery order” to the buyer and the warehouseman, who was holding the goods as a bailee of the seller, agrees and acknowledges to hold them on behalf of the buyer, there is a constructive delivery. Similarly, where the seller after selling the goods agrees to hold them on behalf of the buyer as his bailee there is deemed to be delivery of the goods to the buyer.
A. Rules as to Delivery of Goods

The rules regarding delivery of goods are as follows:

1. **Delivery may be either actual or symbolic or constructive** (Sec. 33): Delivery of goods sold may be made by doing anything which the parties agree shall be treated as delivery or which has the effect of putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf. Thus, the delivery of the goods may be either actual, or symbolic or constructive. (These terms have already been explained under the preceding heading.)

2. **Delivery and payment are concurrent conditions** (Sec. 32): Unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions, that is, the seller should be ready and willing to deliver the goods to the buyer in exchange for the price and the buyer should be ready and willing to pay the price in exchange for possession of the goods simultaneously, just like in a cash sale over a shop counter.

3. **Effect of part delivery, when property in goods is to pass on delivery** (Sec. 34). A delivery of part of the goods, in progress of the delivery of the whole, has the same effect, for the purpose of passing the property in such goods, as a delivery of the whole. In other words, when a delivery of part of the goods has been made with the intention of delivering the rest also, the property in the whole of the goods is deemed to pass to the buyer as soon as some portion is delivered.

4. **Buyer to apply for delivery** (Sec. 35): Although it is the duty of the seller to deliver the goods according to the contract, yet he is not bound to deliver them until the buyer applies for delivery. It is the duty of the buyer to demand delivery, and if he fails to do so, he cannot blame the seller for the non-delivery. The parties may, however, agree otherwise.

5. **Time of delivery** [Sec. 36(2) & (4)]: Where under the contract of sale the seller is bound to send the goods to the buyer, but no time for sending them is fixed, the seller is bound to send them within a reasonable time. Further, demand of delivery by the buyer or the tender of delivery by the seller should be made at a reasonable hour. What is a reasonable hour is a question of fact.

6. **Place of delivery** [Sec. 36(1)]: The place of delivery may be stated in the contract of sale, and where it is so stated, the goods must be delivered at the named place during business hours on a working day. But where no place is mentioned in the contract, the following rules must be followed:

   (i) In the case of ‘sale,’ the goods are to be delivered at the place at which they are at the time of the sale.
In “an agreement to sell,” the goods are to be delivered at the place where they are at the time of the agreement to sell.

In the case of future goods, the goods are to be delivered at the place at which they are manufactured or produced.

Where the seller of goods agrees to deliver them at his own risk at a place other than that where they are when sold, the buyer must, nevertheless, unless otherwise agreed, take any risk of deterioration in the goods necessarily incidental to the course of transit (Sec. 40).

7. **Delivery of goods where they are in possession of a third party** [Sec. 36(3)]: Where the goods at the time of sale are in the possession of a third person, there is no delivery by the seller to the buyer unless and until such third person acknowledges to the buyer that he holds the goods on his behalf. Such a delivery is known as “constructive delivery” or “delivery by attornment” and requires the consent of all the three parties, the seller, the buyer and the person having possession of the goods. Where the seller hands over the ‘delivery order’ to the buyer, there is no delivery unless the seller’s agent holding the goods has assented thereto.

But where the goods have been sold by the transfer of the document of title to goods, e.g., railway receipt or bill of lading, the buyer is deemed to be in possession of the goods represented by such document, and the assent of the third party is not required.

8. **Expenses of delivery** [Sec. 36(5)]: Unless otherwise agreed, the expenses of and incidental to putting the goods into a deliverable state must be borne by the seller.

9. **Delivery of wrong quantity or different quality** (Sec. 37): As already observed, a seller is duty bound to deliver the goods to the buyer strictly in accordance with the terms of the contract. A defective delivery, i.e., delivery of a quantity less or more than that contracted for or delivery of goods mixed with the goods of a different description not included in the contract, entitles the buyer:

   (i) To reject the whole, or
   (ii) To accept the whole, or
   (iii) To accept the quantity and quality he ordered and reject the rest of the goods so delivered.

Remember that in case of rejection of goods because of defective delivery the buyer is not bound to return them to the seller, but it is sufficient if he intimates to the seller that he refuses to accept them (Sec. 43). Further, the right to reject the goods is not equivalent to right to cancel the contract. If the buyer rejects the goods, the seller has a right to tender again goods of contract quality and quantity subject to the terms and conditions of the contract and the buyer is bound to accept the same (*Vilas Udyog Ltd. vs Prag Janaspatri*).
Where the buyer accepts the goods, he must pay for what he has actually accepted, at the contract rate. In case the buyer has accepted short delivery he is entitled to claim damages for the same from the seller. If, however, the deficiency or excess is so small as to be negligible, the court does not take account of that, and the buyer must accept the goods. This is based on the maxim that “the law does not take trivial deviations into account.” The above provisions are subject to any usage of trade, special agreement or course of dealing between the parties [Sec. 37(4)].

10. **Instalment deliveries** (Sec. 38): Unless otherwise agreed, the buyer of goods is not bound to accept delivery thereof by instalments. If the parties so agree then only the delivery of the goods may be made by instalments. When the parties agree that the delivery is to be made by instalments and each instalment is to be separately paid for, and either buyer or seller commits a breach of contract in respect of one or more instalments, there arises a question as to whether such a breach amounts to a breach of the whole of the contract or a breach of only a part of it? The answer to this question depends upon the terms of the contract and the circumstances of the case. Unless otherwise agreed the following two factors must be borne in mind in deciding the whole matter:

(a) The quantitative proportion which the breach bears to the contract as a whole, and

(b) the degree of probability of the repetition of the breach (Maple Flock Co. Ltd. vs Universal Furniture Products Ltd A).

Generally, failure to deliver or pay for one instalment does not amount to a breach of the whole contract, unless from the special circumstances of the case (e.g., the factory is closed because of a labour strike or the buyer becomes insolvent) it can be inferred that similar breaches will be repeated.

11. **Delivery to carrier or wharfinger** (Sec. 39): Where the seller is authorised or required to send the goods to the buyer, delivery of the goods to a carrier, whether named by the buyer or not, for the purpose of transmission to the buyer, or delivery of the goods to a wharfinger for safe custody, is prima facie deemed to be a delivery of the goods to the buyer.

i. **Seller’s duty**: Unless the buyer requires to despatch the goods at owner’s risk, it is the duty of the seller, when he delivers the goods to the carrier or wharfinger, to enter into a reasonable contract on behalf of the buyer for the safety of the goods, and if he fails to do so, and the goods are lost or damaged, the buyer may decline to treat the delivery to the carrier or wharfinger as a delivery to himself, or may hold the seller responsible in damages.

ii. **Sea transit**: Unless otherwise agreed, where goods are sent by the seller to the buyer by a route involving sea transit, where it is usual to insure, the seller must inform the buyer in time to get the goods insured during their sea transit.
transit, and if the seller fails to do so, the goods shall be deemed to be at his risk during such sea transit.

12. **Liability of buyer for neglecting or refusing to take delivery of goods.**
   (Sec. 44): When the seller is ready and willing to deliver the goods and requests the buyer to take delivery, and the buyer does not within a reasonable time after such request take delivery of the goods, he becomes liable to the seller for any loss occasioned by his neglect or refusal to take delivery, and also for a reasonable charge for the care and custody of the goods.

**B. Acceptance of Delivery by Buyer**

The mere fact that the buyer has taken the delivery of the goods does not amount to acceptance of them. According to Section 42, the buyer is deemed to have accepted the goods in either of the following circumstances, namely:

1. When he intimates to the seller that he has accepted the goods.  
   Before intimating about acceptance, the buyer has a right, under Section 41, to examine and test the goods in order to be sure as to whether they are in conformity with the contract regarding quality etc. He may even use the goods, if it is necessary for the purpose of testing, e.g., in the case of a horse sale conditioned to run at 25 kilometers per hour it is necessary to use the horse for ascertaining, whether the horse is in conformity with the contract. But if he is not satisfied, he must act promptly to inform the seller about rejection.

2. When he does any act in relation to the goods which is inconsistent with the ownership of the seller, e.g., consumes, uses, pledges or resells the goods or puts his mark on them.

**Check Your Progress**

11. What does the performance of a contract of sale imply?
12. List some modes of delivery of goods.

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5.7 **ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

1. Section 4(1) of the Sale of Goods Act defines a contract of sale of goods as 'a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price'.

2. Goods may be classified into the following types:
   i. Existing goods
   ii. Future goods
   iii. Contingent goods
3. The money consideration for a sale of goods is known as 'price'. The price should be paid or promised to be paid in legal tender money, unless otherwise agreed. It may be paid in the form of a cheque, hundi, bank deposit, etc.

4. A 'warranty' is a stipulation collateral to the main purpose of the contract, the breach of which gives the aggrieved party a right to sue for damages only, and not to avoid the contract itself.

5. Section 13 deals with cases where a breach of condition is to be treated as a breach of warranty, as a consequence of which the buyer loses his right to rescind the contract and has to be content with a claim for damages only. These cases are as follows:
   1. Voluntary waiver by buyer
   2. Acceptance of goods by buyer

6. Conditions and warranties may be either express or implied. They are said to be express when at the will of the parties they are inserted in the contract, and they are said to be implied when the law presumes their existence in the contract automatically, though they have not been put in express words.

7. Generally speaking, the seller can only sue for the price if the property in goods has passed to the buyer.

8. Transfer of property is done under the following two conditions: (i) Transfer of property in specific or ascertained goods, and (ii) Transfer of property in unascertained and future goods.

9. The seller of goods is deemed to be an 'unpaid seller' (a) when the whole of the price has not been paid or tendered; or (b) where a bill of exchange or other negotiable instrument has been received as a conditional payment, i.e., subject to the realization thereof, and the same has been dishonoured.

10. Regardless of the fact that the property in the goods has passed to the buyer, an unpaid seller has the following rights against the seller:
   i. Right of lien
   ii. Right of stoppage of goods in transit
   iii. Right of resale

11. The performance of a contract of sale implies delivery of goods by the seller and acceptance of the delivery of goods and payment for them by the buyer, in accordance with the contract.

12. Delivery of goods may be made in any of the following ways:
   i. Actual delivery
   ii. Symbolic delivery
   iii. Constructive delivery or delivery by attornment:
5.8 SUMMARY

- Section 4(1) of the Sale of Goods Act defines a contract of sale of goods as 'a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price'.

- A ‘condition’ is a stipulation essential to the main purpose of the contract, the breach of which gives the aggrieved party a right to repudiate the contract itself. In addition, he may maintain an action for damages for loss suffered, if any, on the footing that the whole contract is broken and the seller is guilty of non-delivery.

- It may be noted that the implied condition as to title makes it obligatory upon the seller that he must not only be the owner but must also be able to uphold the validity of the contract.

- 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 after the contract the goods are destroyed or damaged, the bearer of the loss is to be decided not on the basis of possession of the goods but on the basis of ownership of goods.

- The rules regarding transfer of property have been discussed under the following two heads (i) Transfer of property in specific or ascertained goods, and (ii) Transfer of property in unascertained and future goods.

- The seller of goods is deemed to be an ‘unpaid seller’ (a) when the whole of the price has not been paid or tendered; or (b) where a bill of exchange or other negotiable instrument has been received as a conditional payment, i.e., subject to the realization thereof, and the same has been dishonoured.

- Lien is available only when the goods are in actual possession of the seller, while right of stoppage is available when the seller has parted with possession and the goods are in the custody of an independent carrier.

- If on a resale there is a loss to the seller, he can recover it from the defaulting buyer. But if there is a surplus on the resale, the seller can keep it with him because the buyer cannot be allowed to take advantage of his own wrong.

- The performance of a contract of sale implies delivery of goods by the seller and acceptance of the delivery of goods and payment for them by the buyer, in accordance with the contract.

- Where the goods are physically handed over by the seller (or his authorised agent) to the buyer (or his authorised agent), the delivery is said to be actual. For example, the seller of a car hands over the car to the buyer, there is actual delivery of the goods.

- Although it is the duty of the seller to deliver the goods according to the contract, yet he is not bound to deliver them until the buyer applies for delivery.
• When the parties agree that the delivery is to be made by instalments and each instalment is to be separately paid for, and either buyer or seller commits a breach of contract in respect of one or more instalments, there arises a question as to whether such a breach amounts to a breach of the whole of the contract or a breach of only a part of it?

• Before intimating about acceptance, the buyer has a right, under Section 41, to examine and test the goods in order to be sure as to whether they are in conformity with the contract regarding quality etc.

5.9 KEY WORDS

• **Condition**: A ‘condition’ is a stipulation essential to the main purpose of the contract, the breach of which gives the aggrieved party a right to repudiate the contract itself.

• **Warranty**: A ‘warranty’ is a stipulation collateral to the main purpose of the contract, the breach of which gives the aggrieved party a right to sue for damages only, and not to avoid the contract itself.

• **Suit for price**: Under a contract of sale, the seller may sue him for the price although the property in the goods has not passed and the goods have not been appropriated to the contract.

• **Attornment**: Constructive delivery is also called attornment.

• **Wharfinger**: This is an archaic term for a person who is the keeper or owner of a wharf. The wharfinger takes custody of and is responsible for goods delivered to the wharf.

5.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write in brief about the significance of document of title to goods.
2. Write a short note on difference between condition and warranty.
3. Write in brief about implied conditions into a contract of sale of goods.
4. Write a brief note on transfer of property in specific or ascertained goods.
5. Write a short note on rights of unpaid seller against the buyer.
6. Write a brief note on constructive delivery or delivery by attornment.

**Long-Answer Questions**

1. Discuss the process of formation of contract under Sale of Goods Act, 1930.

3. Analyse various rules regarding delivery of goods.

5.11 FURTHER READINGS

UNIT 6 LAWS ON CARRIAGE OF GOODS

Structure
6.0 Introduction
6.1 Objectives
6.2 The Carriers Act, 1865
6.3 The Railways Act, 1890
   6.3.1 Duties of Railway Administration
   6.3.2 Liabilities of Railway Administration
   6.3.3 Notification of Claims (Sec. 78b)
6.4 The Carriage of Goods by Sea Act, 1925
   6.4.1 Contract of Affreightment
   6.4.2 Duties of a Carrier by Sea
   6.4.3 Liabilities of Carrier by Sea
   6.4.4 Ship-Owner's Lien and Maritime Lien
6.5 The Carriage by Air Act, 1972
   6.5.1 Right of the Consignor and the Consignee
   6.5.2 Liability of the Carrier
6.6 The Carriage by Road Act, 2007
6.7 Answers to Check Your Progress Questions
6.8 Summary
6.9 Key Words
6.10 Self Assessment Questions and Exercises
6.11 Further Reading

6.0 INTRODUCTION

Transport plays a vital role in the economic development of a country. It facilitates the movement of goods and labour. Modern commerce being based pre-eminently on a system of exchange, the role of transport is very important in the development of commerce. Hence, the study of law relating to “Contract of Carriage of Goods” is a must. Carriers are classified into two categories, namely: (i) common carriers, and (ii) private carriers. A common carrier may be an individual, a firm, an association of persons or a body corporate, but the Government is not a common carrier. Railways (owned and run by the Government) are not governed by the Carriers Act, 1865, although they carry goods. A private carrier is not governed by the Carriers Act, 1865. His position is that of a bailee. Hence, he is governed by the Indian Contract Act, 1872. A common carrier is bound to carry goods of the class which he holds himself out as being ready to carry, along his usual route, for any person offering to pay hire, unless his vehicle is already full or the goods are inadequately packed.

The carriage of goods may take place either by land or by sea or by air. We shall, thus, be studying the Law of Carriage of Goods under three distinct heads: (1) Carriage by Land, (2) Carriage by Sea, and (3) Carriage by Air.
The law relating to *carriage of goods by land* (including inland navigation) is contained in (a) The Carriers Act, 1865, and (b) The Indian Railways Act, 1890. Both these Acts have been amended several times by now.

This unit aims at analysing various acts related to carriage of goods by land, sea and air. It also explains rights and liabilities of common carriers.

### 6.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the categories of carriers
- Analyse the rights and liabilities of common carriers
- Learn the carriage of goods by land
- Explain the carriage of goods by sea
- Know the carriage of goods by air
- Analyse the carriage by Road Act, 2007

### 6.2 THE CARRIERS ACT, 1865

‘A contract whereby a person or company agrees to carry goods or people from one place to another in return for a payment is known as a ‘contract of carriage’.

The party who undertakes to carry the goods or people for payment (e.g., a railway, steamship or aircraft company) is called the *carrier*.

#### Classification of Carriers

Carriers are classified into two categories, namely; (1) common carriers, and (2) private carriers.

1. **Common carrier**

The Carriers Act, 1865, defines a common carrier as a person including any association or body of persons, whether incorporated or not (other than the Government) engaged in the business of transporting for hire property from place to place, by land or inland navigation, for all persons indiscriminately.

2. **Private carrier**

A private carrier is one who makes no general offer, but carries goods as a casual occupation and not as a business, and for particular persons on special terms mutually agreed upon. Thus, unlike a common carrier, he is not bound to carry the goods of all and sundry. He enjoys the discretion of accepting or rejecting any proposal for carriage of goods.

A private carrier is not governed by the Carriers Act, 1865. His position is that of a bailee. Hence, he is governed by the Indian Contract Act, 1872.
Duties of Common Carrier

The Carriers Act, 1865, imposes the following duties on a common carrier:

1. A common carrier is bound to carry goods of the class which he holds himself out as being ready to carry, along his usual route, for any person offering to pay hire, unless his vehicle is already full or the goods are inadequately packed.

2. A common carrier must follow the customary or agreed route. He must not deviate from it unless rendered necessary.

3. He must carry the goods with reasonable care.

4. The carrier must deliver the goods at the place of destination at the agreed time or (if no time had been agreed upon) within a reasonable time.

5. When goods are in transit, the carrier is bound to obey the instructions of the consignor as to alterations of delivery.

Rights of Common Carrier

1. A common carrier is entitled to the agreed remuneration or (if nothing had been agreed upon) to a reasonable remuneration for his services. He can demand payment in advance as well.

2. He has a right to retain the goods and refuse delivery thereof until his charges for the carriage are paid. In other words, he can exercise particular lien over the goods.

3. On refusal to accept delivery of the goods by the consignee, the carrier is entitled to take such steps as are reasonable in the circumstances. He can sell the goods if they are of a perishable nature or store them in a warehouse. He can recover warehousing expenses etc., from the consignor. In the absence of privity of contract, the consignee cannot be made liable for such expenses.

4. He can recover damages from the consignor for loss suffered by him because of dangerous nature of goods not being explained to him by the consignor (Bamfield vs Goole and Sheffield Transport Co. Ltd.).

Liabilities of Common Carrier

Under the English Common Law, a common carrier is an insurer of goods handed over to him. He is therefore liable for all loss or damage to the goods even though not negligent (i.e., even if the goods were stolen or damaged in an accident in spite of his best care), except when the loss is caused:

(i) By an act of God, e.g., lightning, earthquake, storm, floods.

(ii) By country’s enemies, e.g., during war.

(iii) By an inherent or latent vice in the goods themselves, e.g., evaporation of liquids, perishing of fruits, disease in animals.
(iv) By the negligence of the consignor, e.g., defective packing.

In India the Carriers Act, 1865, has classified the goods for the purpose of carrier’s liability into two categories; (a) scheduled goods, and (b) non-scheduled goods. Scheduled goods include valuable goods such as gold, silver, precious stones, pearls, jewellery, bills and hundis, currency notes, coins, maps, title deeds, opium, government securities, etc. A list of such goods has been given in the Act. Goods which have not been included in the list are termed as Non-scheduled goods. Regarding the liabilities of a common carrier in respect of the two classes of goods, the provisions of the Carriers Act can be summed up as follows:

1. As regards non-scheduled goods: A common carrier’s liability is that of an insurer of goods carried by him and he is liable for all loss or damage to the goods while they are in the course of transit, except when the loss is caused under the exceptional circumstances as mentioned above under the English Common Law. But he may limit his liability by entering into a special contract with the consignor. For example, it may be agreed between the parties (e.g., by stating in the forwarding note) that the carrier will not be responsible for any loss or damage to goods arising from unexpected and unavoidable emergencies, robbers, thieves, dacoits, fire, rain, leakage, and accident.

2. As regards scheduled goods: Where the value of such goods exceeds ₹ 100, the carrier cannot be held liable, in spite of negligence on his part; if the value and description of the goods have not been so declared expressly by the consignor at the time of their delivery. Of course, where the value and description of the goods are disclosed by the consignor, the carrier will be liable like an insurer for all loss or damage to the goods while they are in transit, except when the loss is caused under the exceptional circumstances as mentioned above under the English Common Law. Further, the carrier cannot limit his liability by any special contract with the consignor (in the case of scheduled goods). He is, however, entitled to charge extra freight for carrying scheduled goods.

3. The carrier is always liable (whether the goods are scheduled or non-scheduled) for loss or damage to the goods caused by gross negligence or any criminal act (e.g., deliberate wrong like theft) of the carrier himself, his servant or agent and for unlawful acts or misfeasance (e.g., converting the goods to his own use or knowingly delivering them to a wrong person). It may be noted that this liability cannot be avoided by a special contract with the consignor and any clause in the contract to that effect shall be null and void and inoperative.

Section 10 of the Carriers Act provides that in case of loss or damage the claimant must notify in writing his claim to the carriers within six months of the date when he first knew of such loss or injury.
Check Your Progress
1. What do you mean by ‘contract of carriage’?
2. What are the common carrier’s liabilities?

6.3 THE RAILWAYS ACT, 1890

Rail transport is regarded as one of the chief means of land transport in the modern world. As observed earlier, railways, as carriers of goods, are not governed by the Carriers Act, 1865, because they are owned and operated by the Government. The carriage of goods by railways is governed by the Indian Railways Act, 1890, as amended from time to time. The ‘railway administration’ looks after the administration and working of railways.

Goods may be transported by railways either in ‘goods trains’ or in ‘passenger trains’. Perishable goods and small packages are mainly transported by passenger trains. This ensures quicker delivery but involves higher freight charges.

- **Forwarding note (Sec. 72):** Every consignor of goods or animals has to execute a note in the form prescribed by the railway administration and approved by the Central Government. This note is referred as the ‘forwarding note’ or ‘consignment note.’ There are different types of forms available for different types of goods. The forwarding note contains the description of goods, number of packages, weight, the names and addresses of the consignor and consignee, the extent of the liability of the railway administration for loss or damage and is marked either ‘Freight Paid’ or ‘Freight to pay’ accordingly as consignor pays the freight or consignee is to pay the freight. The terms and conditions on which goods are carried by the railway are printed on the back of the note.

- **Railway receipt (R/R):** On submission of the forwarding note to the railway ‘parcel office’, the consignor is given a receipt acknowledging the goods and giving an undertaking to carry them in accordance with the instructions and subject to the terms and conditions printed on the back of the forwarding note. This receipt is referred as the ‘railway receipt’ (R/R) and serves as a document of title to the goods. The consignor must send the railway receipt to the consignee because it must be presented to the railway office at the destination to take delivery of the goods.

6.3.1 Duties of Railway Administration

Under the Indian Railways Act, 1890, the duties of railway administration are as follows:
1. Duty to afford all reasonable facilities for the receiving, forwarding and delivering of traffic without unreasonable delay (Sec. 27).

2. Duty not to give any undue or unreasonable preference or advantage to, or in favour of, any particular person, or any particular description of traffic, in any respect whatsoever, or subject any particular person or any particular description of traffic to any undue or unreasonable prejudice or disadvantage in any respect whatsoever (Sec. 28).

3. Duty to comply with any directions given by the Central Government in regard to transport of goods (Sec. 27 A).

By virtue of Section 27 A, the Central Government is empowered to direct by order any railway administration (i.e., manager of the railway):

(a) To give special facilities for, or preference to, the transport of any such goods or class of goods consigned to the Central Government or any State Government or of such other goods or class of goods, as may be specified in the order;

(b) To carry any goods or class of goods by such route or routes and at such rates as may be specified in the order.

The Section further states that any action taken by a railway administration in pursuance of any such direction shall not be deemed to be a contravention of Section 28 (see point 2 above). Again, any order so made shall cease to have effect after the expiry of six months from the date thereof, but it may be renewed from time to time.

Thus, the railway administration is bound to carry goods of every person who is prepared to pay the necessary freight and observes the regulations regarding packing, etc., without unreasonable delay and without partiality, and to comply with any direction given by the Central Government in public interest in that regard.

6.3.2 Liabilities of Railway Administration

1. Liability during transit: The liability of the railway administration for the loss, destruction, damage or deterioration, in transit of animals or goods delivered to it for carriage by railway will depend upon the consignor’s instructions in the ‘forwarding note’ as to whether the goods are to be carried at ‘railway’s risk’ or ‘owner’s risk’.

If the goods are carried at Railway’s Risk, the railway administration is responsible for any loss or destruction, etc., in transit, in respect of the goods arising from any cause except the following:

(a) Act of God;
(b) Act of war;
(c) Act of public enemies;
(d) Arrest, restraint or seizure under legal process;
(e) Order or restrictions imposed by the Central or a State Government or by any officer or authority subordinate to the Central or a State Government authorised in this behalf;

(f) Act or omission or negligence of the consignor or the consignee or the agent or servant of either;

(g) Natural deterioration or wastage in the bulk or weight due to inherent defect, quality or vice of the goods;

(h) Latent defects;

(i) Fire, explosion or any unforeseen risk.

Even where the loss or destruction etc., is proved to have arisen from any one or more of the exceptional cases noted above, the railway administration shall not be relieved of its responsibility for the loss or damage unless the administration further proves that it has used reasonable foresight and care in the carriage of the animals or goods (Sec. 73). In effect, Section 73 makes the liability of the railway administration the same as that of an insurer of goods, in case the goods are sent at Railway’s Risk. Thus, the railway administration will be liable if the goods are stolen while in its custody, even without negligence on its part.

Where the goods are carried at Owner’s Risk, the railway administration cannot be made liable for any loss, destruction or damage, in transit, of such goods from whatever cause arising, except upon the proof that such loss or damage was due to negligence or misconduct on the part of the railway administration or of any of its servants (Sec. 74). In other words, when goods are sent at Owner’s Risk, the railway administration is liable for loss or damage to goods as a ‘bailee’.

The ‘Railway Risk Rate’ is higher than the ‘Owner’s Risk Rate’. The animals or goods shall be deemed to have been tendered to be carried at owner’s risk rate, unless the sender or his agent elects in writing to pay the railway risk rate. In the latter case, the railway administration will issue a certificate to the consignor to that effect (Sec. 74.).

2. Liabilities for delay or detention in transit (Sec. 76): The railway administration is responsible for loss, destruction, damage or deterioration of animals or goods caused by delay or detention in their carriage unless it proves that the delay or detention arose without negligence or misconduct on its part or of any of its servants.

3. Liability for wrong delivery (Sec. 76B): Where the railway administration delivers the goods or animals in good faith to a person who produces the original railway receipt, it shall not be responsible on the ground that such person is not legally entitled thereto or that the endorsement on the railway receipt is forged or otherwise defective.
4. **Liability after termination of transit (Sec. 77):** Transit terminates on the expiry of the free time allowed (after the arrival of consignment at destination) for its unloading from railway wagon without payment of *de-murrage*, and where such unloading has been completed within the free time so allowed, transit terminates on the expiry of the free time allowed for the removal of the animals or goods from railway premises without payment of *wharfage*.

The liability of railway administration *during seven days* after the termination of transit is the same as that of a ‘bailee’ under Sections 151, 152 and 161 of the Indian Contract Act (1872), for the loss, destruction etc., of goods, whether the goods are carried at ‘owner’s risk rate’ or ‘railway risk rate’. Thus, even where goods are carried at ‘railway risk rate’, the liability of railway administration *during seven days* after the termination of transit is reduced to that of a bailee. The railway administration shall be liable only if the loss or damage occurs because of negligence or misconduct on its part of any of its servants.

Regarding the articles of special value like gold, silver, etc., (mentioned in the Second Schedule to the Railways Act), animals and explosives and other dangerous goods carried by railway, the railway administration is not liable for the loss, destruction etc., in spite of negligence on its part, after the termination of transit.

After the expiry of *seven days* after the termination of transit, the railway administration is not liable at all in any case for the loss, destruction, etc., of goods carried by railway.

It may be noted that the exoneration from liability of the railway administration does not relieve the owner of animals or goods from liability to any *demurrage* or *wharfage* for as long as the animals or goods are not unloaded from the railway wagons or removed from the railway premises.

5. **Liability as a carrier of animals (Sec. 77A):** In the case of animals, the liability of railway administration for loss or damage etc., shall not exceed the amount specified in the First Schedule to the Act. The limits of liability as laid down in the First Schedule are as follows: elephants — ₹ 1,500 per head; horse — ₹ 750 per head; mules, horned cattle or camels — ₹ 200 per head; dogs, donkeys, goats, pigs, sheep or other animals not mentioned above or birds — ₹ 30 per head. The railway may, however, accept a higher liability if the consignor declares a higher value in the ‘forwarding note’ and pays a higher freight. The railway is in no case responsible where the loss occurs due to freight or restiveness of the animal or overloading of wagon by the consignor or his agent.

6. **Liability in case of articles of special value (Sec. 77B):** Notwithstanding anything stated earlier, when any articles mentioned in the Second Schedule to the Act (i.e., valuable goods like gold, silver, coins, and jewellery, etc.) are contained in any parcel or package delivered for carriage and the value
of such articles in the parcel or package exceeds five hundred rupees, the railway administration shall not be responsible for the loss, destruction, etc., of the parcel or package unless the consignor declared the value and contents thereof in the 'forwarding note,' and if so required by the administration, paid a higher freight by way of compensation for the increased risk. If the requisite declaration is not made, the railway is not responsible at all.

7. **Exoneration from responsibility in certain cases (Sec. 78):** Notwithstanding anything stated earlier (under the side-heading: ‘Liabilities of Railway Administration’), the railway administration shall not be responsible for the loss, destruction, damage, deterioration or non-delivery of any goods or animals in the following cases:

   (a) Where the goods have been despatched with a false description and the loss or damage is, in any way, brought about by the false description.

   (b) Where a fraud has been practised by the consignor or the consignee or an agent of either.

   (c) Where it is proved by the railway administration that the loss or damage etc., is caused by — (i) improper loading or unloading by the consignor or the consignee or an agent of either, or (ii) riot, civil commotion, strike, lock-out, stoppage or restraint of labour from whatever cause, whether partial or general.

   Further, the railway administration shall also not be responsible for any indirect or consequential damages or for loss of particular market.

**6.3.3 Notification of Claims (Sec. 78b)**

A person shall not be entitled to a refund of an overcharge in respect of animals or goods carried by railway or to compensation for the loss, destruction, damage, deterioration or non-delivery of animals or goods delivered to be so carried, unless his claim to the refund or compensation has been forwarded in writing by him or on his behalf:

   (a) To the railway administration to which the animals or goods were delivered for carriage; or

   (b) To the railway administration on whose railway the destination station lies, or the loss, destruction, damage or deterioration occurs.

   The claim must be made within six months from the date of the delivery of the animals or goods for carriage by railway. The notice of claim may be given to the chief commercial superintendent or the manager of the Railway.

**Check Your Progress**

3. Why is Railways not governed by the Carriers Act, 1865?

4. How can a person claim a refund from the Railways?
6.4 THE CARRIAGE OF GOODS BY SEA ACT, 1925

The law relating to carriage of goods by sea is contained mainly in (i) The Indian Bills of Lading Act, 1856, and (ii) The Carriage of Goods by Sea Act, 1925. The other related Acts governing this subject are — (a) The Merchant Shipping Act, 1958, and (b) The Marine Insurance Act, 1963. These Acts have been modified several times by now.

6.4.1 Contract of Affreightment

A contract for the carriage of goods by sea is called a ‘contract of affreightment’. The word ‘affreightment’ literally means ‘the hiring of a vessel or ship’. It may, thus, be defined as a contract between the consignor or shipper and the shipping company whereby the former agrees to hire, at a price called ‘freight’, space in a ship for transportation of goods. A contract of affreightment may be embodied either in a Charter Party or a Bill of Lading.

A. Charter party

A ‘charter party’ is a contract of affreightment entered into for hiring the whole ship or a principal part thereof to carry goods from one port to another. It also refers to the formal written document in which the contract of hiring of the whole or part of the ship for the conveyance of goods is expressed. The person hiring the ship or a part of it is called the ‘charterer’.

A charter party may be either (i) a voyage charter, i.e., when the vessel is chartered for a particular voyage, or (ii) a time charter i.e., when the vessel is hired for a specified period of time, irrespective of the number of voyages performed.

In the case of hiring the whole ship, the terms of the charter party may sometimes amount to a lease or demise of the ship, whereby the possession of the ship comes under the absolute control of the charterer who becomes temporarily the owner of the ship and the captain and the crew become his servants. This is called a ‘charter by demise’. Generally, a charter party is without a demise or lease of the ship where, like a simple contract of carriage, the charterer only gets the right to have his goods conveyed by the ship and the captain and the crew do not become his servants and the possession and control of the ship remain with the shipowner. In such a case it is called a ‘charter without demise’.

In the case of a ‘charter without demise’ or where only a part of the ship is hired, that is, where the owner of the ship retains himself the possession and control of the ship and the crew, upon delivering the goods on board the ship, a bill of lading signed by the owner or captain of the ship is given to the charterer as an acknowledgement of the receipt of the goods. It is important to note that a bill of lading issued under a charter party is only a receipt of the goods (the evidence of
contract being ‘charter party’), and is quite different from the bill of lading issued in the case of a ‘general ship’ where it is the evidence of the contract of carriage.

i. **Clauses of a charter party**: A charter party contains all the essential terms and conditions of the contract between the charterer and the ship-owner.

ii. **Implied Warranties**

iii. **Effects of breach**

**B. Bill of Lading**

A ‘bill of lading’ is a document issued by the ship-owner or by the master or captain of the ship or other agent in exchange of Mate’s Receipt after the goods have been placed on board the ship for being carried to a specific destination. It is used when the goods shipped form only a part of the cargo of a ‘general ship’. In the case of hiring an entire ship, a charter party is drawn up.

A bill of lading must be stamped and signed by the ship-owner or his agent, *i.e.*, the master or captain of the ship. Under the Carriage of Goods by Sea Act, 1925, a bill of lading, apart from the main terms of contract, must contain the following particulars:

- (a) The leading marks necessary for identification of the goods, provided such marks are stamped on the cases or coverings in which such goods are contained in such a manner as should ordinarily remain legible until the end of the voyage.
- (b) The number of packages or pieces, or the quantity, or weight, as the case may be, as furnished in writing by the shipper.
- (c) The apparent order and condition of the goods.

When it is stated in a bill of lading that the goods are in good order and condition, the bill is said to be a *‘Clean Bill of Lading’*. When it is stated that goods received are in a bad condition, the bill of loading in that case is called a *‘Qualified Bill of Lading’*. When the cargo covered by a bill of lading is to be carried partly by sea and partly by land and a composite freight has been charged for sea and land transportation, the bill of lading is called a *‘Through Bill of Lading’*.

i. **Right of stoppage in transit**

The Indian Bills of Lading Act, 1856, does not affect the provisions regarding unpaid seller’s right of stoppage of goods in transit as given under the Sale of Goods Act. Accordingly, the shipping company is not required to deliver the goods to the holder of Bill of Lading if the consignor, in exercise of the right of stoppage in transit, gives instructions not to deliver the goods.

**6.4.2 Duties of a Carrier by Sea**

The Carriage of Goods by Sea Act, 1925, lays down that under every contract of carriage of goods by sea the carrier shall be subject to the following responsibilities:
1. The carrier, i.e., the ship-owner shall be bound, before and at the beginning of the voyage, to exercise due diligence to:
   (a) Make the ship seaworthy;
   (b) Properly man, equip and supply the ship;
   (c) Make the holds, refrigerating and cool chambers, and all other parts of the ship in which goods are carried, fit and safe for their reception, carriage and preservation.

2. The carrier must properly and carefully load, handle, stow, carry, keep, care for and discharge the goods carried.

3. After receiving the goods into his charge, the carrier or the master or agent of the carrier must, on demand of the shipper, issue to the shipper a bill of lading containing the prescribed particulars.

6.4.3 Liabilities of Carrier by Sea

The Carriage of Goods by Sea Act, 1925, lays down the following rules regarding the liabilities of a carrier of goods by sea:

1. A carrier of goods by sea, i.e., a ship-owner is liable only for loss or damage arising or resulting from his negligence, fault or failure in the duties and obligations provided in the Act, and not otherwise. He is not liable even for the loss caused by the neglect or default of the master, mariner, pilot, or the crew in the navigation or in the management of the ship. He is not an insurer of goods carried by the ship. For insurance against sea perils, separate "Marine Insurance Policy" is to be taken.

2. A ship-owner cannot limit or lessen his liability arising from his negligence or failure in the duties and any clause in the contract to that effect shall be null and void and inoperative.

3. The carrier shall not be liable in any event for any loss or damage to the goods in an amount exceeding £100 per package or unit, unless the nature and value of such goods have been declared by the shipper before shipment and inserted in the bill of lading. But the carrier and the shipper may, by agreement, fix another maximum amount than that mentioned in this paragraph, provided that such maximum shall not be less than the figure above named.

4. The carrier shall not be liable in any event for loss or damage to the goods if the nature or value thereof has been knowingly misstated by the shipper in the bill of lading.

5. Goods of an inflammable, explosive or dangerous nature to the shipment whereof the carrier, master or agent of the carrier, has not consented, with knowledge of their nature and character, may, at any time before discharge, be landed at any place or destroyed or rendered innocuous by the carrier without compensation, and the shipper of such goods shall be liable for all
damages and expenses directly or indirectly arising out of or resulting from such shipment. Further, if any such goods shipped with such, knowledge and consent shall become a danger to the ship or cargo, they may in like manner be landed at any place or destroyed or rendered innocuous by the carrier without liability on the part of the carrier except to general average, if any.

6. The carrier shall be discharged from all liability for loss or damage unless suit is brought within one year after delivery of the goods or the date when the goods should have been delivered.

6.4.4 Ship-Owner’s Lien and Maritime Lien

A ‘ship-owner’s lien’ is the right of a ship-owner to retain possession of the goods (cargo) carried by him until freight and other charges due to him under the contract of carriage have been paid. It is a possessory lien.

A ‘maritime lien’ is a claim on a ship, cargo and the freight in respect of services rendered to them. This right is given by law to all persons who have rendered some service to save the ship or cargo in time of danger. By virtue of this right, they can recover their charges from the ship owner or cargo-owner. Until their charges are paid, the ship is not allowed to leave harbour and the Court may order for sale of the ship or cargo in favour of the holders of maritime lien.

Check Your Progress

5. What do you mean by ‘contract of affreightment’?
6. What is the function of a ‘charter party’?

6.5 THE CARRIAGE BY AIR ACT, 1972

The law relating to carriage by air is contained in the Carriage by Air Act, 1972. This Act repeals the Indian Carriage by Air Act, 1934. The new Act was passed to give effect to the Convention for the unification of certain rules relating to international carriage by air signed at Warsaw in 1929 and to the said Convention as amended by the Hague Protocol in 1955 and to make provision for applying the rules contained in the said Convention in its original form and in the amended form (subject to exceptions, adaptations and modifications) to non-international carriage by air and for matters connected therewith.

The Carriage by Air Act, 1972, contains two schedules. Schedule I contains the Warsaw Convention rules which are applicable to international carriage by air of countries which have not yet signed the Hague Protocol. Schedule II contains the amended rules (as amended by the Hague Protocol in 1955) applicable to international carriage by air of countries which have signed the Hague Protocol. Fifty-seven countries have already ratified the Hague Protocol. The Central Government is empowered to make the rules contained in the aforesaid Schedules
I and II applicable to the internal carriage by air by a notification in the Official Gazette subject, however, to such exceptions, adaptations and modifications, if any, as may be specified (Sec. 8).

It may be pointed out that the rates of air freight being very high, air transport is not a popular mode of transport of goods. Generally, this mode of transport is suitable for the transportation of light and costly goods and carriage of passengers.

The amended rules relating to international carriage of persons, baggage or cargo, as contained in the Second Schedule to the Carriage by Air Act, 1972, are summarized here. These are as follows:

- **High contracting party**: The term “High Contracting Party” means all the governments of countries originally signatories to the Warsaw Convention Rules as amended by the Hague Protocol (i.e., to the amended Convention), together with those who adhere thereto subsequently. India is a signatory to the amended Convention, and is, therefore, a High Contracting Party [Rule 1(2)].

- **International carriage**: The expression ‘international carriage’ means any carriage in which, according to the agreement between the parties, the place of departure and the place of destination, whether or not there be a break in the carriage or a trans-shipment, are situated either within the territories of two High Contracting Parties or within the territory of a single High Contracting Party if there is an agreed stopping place within the territory of another State, even if that State is not a High Contracting Party. Carriage between two points within the territory of a single High Contracting Party without an agreed stopping place within the territory of another State is not international carriage [Rule 1(3)].

### 6.5.1 Right of the Consignor and the Consignee

It is important to note that the Act permits the issue of a negotiable air waybill (Rule 15(3)). Here we need to mention rules regarding right of the consignor and the consignee. These are:

- **Right of disposition of the consignor (Rule 12)**: The consignor has the right to dispose of the cargo by withdrawing it at the aerodrome of departure or destination, or by stopping it in the course of the journey on any landing, or by calling for it to be delivered at the place of destination or in the course of the journey to a person other than the consignee named in the air waybill, or by requiring it to be returned to the aerodrome of departure. He must not exercise this right of disposition in such a way as to prejudice the carrier or other consignors and he must repay any expenses occasioned by the exercise of this right.

   If it is impossible to carry out the order of the consignor the carrier must so inform him forthwith.
If the carrier obeys the orders of the consignor for the disposition of the cargo without requiring the production of the part of the air waybill delivered to the latter, he will be liable, without prejudice to his right of recovery from the consignor, for any damage which may be caused thereby to any person who is lawfully in possession of that part of the air waybill.

The right conferred on the consignor ceases at the moment when that of the consignee begins in accordance with Rule 13 (discussed under next subheading). Nevertheless, if the consignee declines to accept the waybill or the cargo, or if he cannot be communicated with, the consignor resumes his right of disposition.

- **Rights of the consignee (Rule 13)**
  1. Unless it is otherwise agreed the consignee has the right to receive notice from the carrier as soon as the cargo arrives at the place of destination.
  2. The consignee is entitled on arrival of the cargo at the place of destination to require the carrier to hand over to him the air waybill and to deliver the cargo to him, on payment of the charges due and on complying with the conditions of carriage set out in the air waybill.
  3. If the carrier admits the loss of the cargo, or if the cargo has not arrived at the expiration of seven days after the date on which it ought to have arrived, the consignee is entitled to put into force against the carrier the rights which flow from the contract of carriage.

### 6.5.2 Liability of the Carrier

The carrier by air is liable to pay damages in the following cases:

1. The carrier is liable for damage sustained in the event of the death or wounding of a passenger or any other bodily injury suffered by a passenger, if the accident which caused the damage so sustained took place on board the aircraft or in the course of any of the operations of embarking or disembarking (Rule 17).

2. The carrier is liable for damage sustained in the event of the destruction or loss of, or of damage to, any registered baggage or any cargo, if the occurrence which caused the damage so sustained took place during the 'carriage by air'. The term *carriage by air* here comprises the period during which the baggage or cargo is in charge of the carrier, whether in an aerodrome or on board an aircraft, or, in the case of a landing outside an aerodrome, in any place whatsoever (Rule 18).

3. The carrier is also liable for damage occasioned by delay in the carriage by air of passengers, baggage or cargo (Rule 19).

- **Limitations of the carrier's liability:** Under the following circumstances, the carrier is not liable for damages:
If he proves that he and his servants or agents have taken all necessary measures to avoid the damage or that it was impossible for him or them to take such measures (Rule 20).

(ii) If he proves that the damage was caused by or contributed to by the negligence of the injured person. In this case, the Court may, in accordance with the provisions of its own law, exonerate the carrier wholly or partly from his liability (Rule 21).

- **Maximum liability**: The liability of the carrier is limited to the following sums, under Rule 22 of the Second Schedule to the Act:

  (a) **In the carriage of persons**, the liability for each passenger in case of death or injury is limited to the sum of 2,50,000 francs. In case of countries who have not yet signed the Hague Protocol, and therefore are governed by Warsaw Convention Rules, as contained in the First Schedule to the Carriage by Air Act, 1972, the liability for each passenger is limited to the sum of 1,25,000 francs. But by special contract, the carrier and the passenger may agree to a higher limit of liability.

  (b) **In the carriage of registered baggage and of cargo**, the liability in case of its loss, damage or delay is limited to a sum of 250 francs per kilogram, unless the passenger or consignor has made, at the time when the package was handed over to the carrier, a special declaration showing the value of package and has paid additional freight if the case so requires. In that case the carrier will be liable to pay a sum not exceeding the declared sum, unless he proves that the declared value is greater than the real value at the time and place of delivery.

  In the case of loss, damage or delay of part of registered baggage or cargo, the weight to be taken into consideration in determining the amount to which the carrier’s liability is limited shall be only the total weight of the package or packages concerned. But, when the loss, damage or delay of a part of the registered baggage or cargo affects the value of other packages covered by the same ‘baggage check’ or the same ‘air waybill’, the total weight of such package or packages shall also be taken into consideration in determining the limit of liability.

  (c) **As regards objects of which the passenger takes charge himself**, the liability is limited to 5,000 francs per passenger.

  Any sum in “francs” mentioned in the limits of liability stated above shall, for the purpose of any action against a carrier, be converted into rupees at the rate of exchange prevailing on the date on which the amount of damages to be paid by the carrier is ascertained by the Court (Sec. 6 of the Carriage by Air Act, 1972).

  Any provision tending to relieve the carrier of liability or to fix a lower limit than that which is laid down under Rule 22 stated above shall be
null and void except where the liability is excluded for loss or damage resulting from the inherent defect, quality or vice of the cargo carried (Rule 23).

It may further be noted that the limits of liability specified above shall not apply if it is proved that the damage resulted from an act or omission of the carrier, his servants or agents, done with intent to cause damage or recklessly and with knowledge that damage would probably result; provided that, in the case of such act or omission of a servant or agent, it is also proved that he was acting within the scope of his employment (Rule 25).

- **Procedure for realizing damages:** In the case of damage, the person entitled to delivery must complain to the carrier forthwith after the discovery of the damage, and, at the latest, within seven days from the date of receipt in the case of baggage and fourteen days from the date of receipt in the case of cargo (Rule 27(2)).

  In the case of delay, the complaint must be made at the latest within twenty-one days from the date on which the baggage or cargo have been placed at the disposal of the carrier (Rule 27(2)).

  Every complaint must be made in writing upon the document of carriage or by separate notice in writing despatched within the times aforesaid. Failing complaint within the times aforesaid, no action shall lie against the carrier, save in the case of fraud on his part (Rule 27(3)(4)).

  The suit for damages must be filed, at the option of the plaintiff, in the territory of one of the High Contracting Parties, either before the Court having jurisdiction where the carrier is ordinarily resident, or has his principal place of the business or has an establishment by which the contract has been made, or before the Court having jurisdiction at the place of destination (Rule 29). Further the suit must be filed within two years of the date of arrival of the aircraft at the destination or the date on which the aircraft ought to have arrived or the date on which the carriage stopped, otherwise the right to damages shall be extinguished (Rule 30).

  In the case of carriage to be performed various successive carriers and regarded as one undivided carriage as per Rule 1(4), each carrier is deemed to be one of the contracting parties to the contract of carriage insofar as the contract deals with that part of the carriage which is performed under his supervision. In the case of carriage of this nature:

  (a) Suits for damages for death or injury to the passengers are to be filed against the carrier who performed the carriage during which the accident occurred, except in the case where, by express agreement, the first carrier has assumed liability for the whole journey; and

  (b) Suits for damages for loss or damage to baggage or cargo are to be filed by (i) the passenger or consignor against the first carrier, (ii) the passenger or consignee against the last carrier, and further, each may...
take action against the carrier who performed the carriage during which the destruction, loss, damage or delay took place. These carriers will be jointly and severally liable to the consignor or consignee or to the passenger (Rule 31).

### 6.6 THE CARRIAGE BY ROAD ACT, 2007

The Carriage by Road Act, 2007 provides for the regulation of common carriers, limiting liability and declaration of value of goods delivered to them in order to determine their liability for loss of, or damage to, such goods occasioned by the negligence or criminal acts of themselves, their servants or agents and for matters connected therewith or incidental thereto. This Act extends to the whole of India, except the State of Jammu and Kashmir.

As per this Act, no person will engage in the business of common carrier unless that person has been granted a certificate of registration. Also, a person engaged in such activity will be required to register within ninety days of commencement. The person is also expected not to engage in such business on the expiry of 180 days from the date of such commencement unless applied for registration with the registering authority.

The registration can also be cancelled by the registering authority if they feel that the certificate holder has failed to comply with any provisions laid down by the Act or is in violation of the Act. The registering authority also sends a notice either by registered post or electronic media or by any other verifiable means to the holder to rectify within a period of 30 days. In case a holder fails to do so, the registering authority may revoke certificate of registration. A holder may also lose his certificate if a complaint is received against him.

A holder of the certificate of registration has the right to file an appeal against the registering authority within sixty days to the State Transport Appellate Tribunal as stated under the Motor Vehicle Act of 1988.

The Carriage by Road Act of 2007 also mentions that the State Transport Authority in each state or union territory shall submit annually to the ministry or the department of Central Government dealing with road transport and highway a consolidated annual return giving details of the goods carried by the common carriers in the state or union territory.

The Act also makes provisions of carriage of goods of dangerous or hazardous nature to human life. According to which no goods of dangerous or hazardous nature to human life shall be carried by a common carrier except in accordance with such procedure and after complying with such safeguards as may be prescribed. A contract of insurance with respect to such goods needs to be fulfilled in case of any injury, death or damage to property or the consignment.

The Carriage by Road Act of 2007 also specifies that no suit or legal action shall be taken against a common carrier for any loss, damage to the consignment...
unless notice in writing of the loss or damage to the consignment has been served on the common carrier before the institution of the suit or legal action. This has to be initiated within 180 days from the date of booking the consignment.

The common carrier is responsible for the loss, destruction, damage or deterioration in transit or non-delivery of any consignment undertaken by him for carriage, arising from any cause except the act of god, act of war or public enemy, riots and civil commotions, arrests or restraint under legal process and order or restriction imposed by Central Government or state government.

The Carriage by Road Act of 2007 also gives the Central Government thought to make rules in order to carry out the provisions of this act. Also, if any difficulty arises in giving effect to the provisions of this Act, the Central Government has the power to make changes in order to remove these difficulties.

It is to be noted that the mention of particular matters in this section shall not be held to prejudice or affect the general application of Section 6 of the General Clauses Act, 1897, with regard to the effect of repeals.

Check Your Progress
7. What is the regulatory authority of the Carriage by Air Act, 1972?
8. Define ‘high contracting party’.
9. What is the regulatory authority of the Carriage by Road Act, 2007?

6.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. ‘A contract whereby a person or company agrees to carry goods or people from one place to another in return for a payment is known as a ‘contract of carriage’

2. In India the Carriers Act, 1865, has classified the goods for the purpose of carrier’s liability into two categories; (a) scheduled goods, and (b) non-scheduled goods.

3. Railways, as carriers of goods, are not governed by the Carriers Act, 1865, because they are owned and operated by the Government. The carriage of goods by railways is governed by the Indian Railways Act, 1890, as amended from time to time. The ‘railway administration’ looks after the administration and working of railways.

4. The claim must be made within six months from the date of the delivery of the animals or goods for carriage by railway. The notice of claim may be given to the chief commercial superintendent or the manager of the Railway.

5. A contract for the carriage of goods by sea is called a ‘contract of affreightment’. The word ‘affreightment’ literally means ‘the hiring of a vessel
or ship'. It may, thus, be defined as a contract between the consignor or shipper and the shipping company whereby the former agrees to hire, at a price called 'freight', space in a ship for transportation of goods. A contract of affreightment may be embodied either in a Charter Party or a Bill of Lading.

6. A ‘charter party’ is a contract of affreightment entered into for hiring the whole ship or a principal part thereof to carry goods from one port to another. It also refers to the formal written document in which the contract of hiring of the whole or part of the ship for the conveyance of goods is expressed. The person hiring the ship or a part of it is called the ‘charterer’.

7. The law relating to carriage by air is contained in the Carriage by Air Act, 1972. This Act repeals the Indian Carriage by Air Act, 1934. The amended rules relating to international carriage of persons, baggage or cargo, as contained in the Second Schedule to the Act.

8. High contracting party: The term “High Contracting Party” means all the governments of countries originally signatories to the Warsaw Convention Rules as amended by the Hague Protocol (i.e., to the amended Convention), together with those who adhere thereto subsequently. India is a signatory to the amended Convention, and is, therefore, a High Contracting Party [Rule 1(2)].

9. The Carriage by Road Act, 2007 provides for the regulation of common carriers, limiting liability and declaration of value of goods delivered to them in order to determine their liability for loss of, or damage to, such goods occasioned by the negligence or criminal acts of themselves, their servants or agents and for matters connected therewith or incidental thereto. This Act extends to the whole of India, except the State of Jammu and Kashmir.

6.8 SUMMARY

- The Carriers Act, 1865, defines a common carrier as a person including any association or body of persons, whether incorporated or not (other than the Government) engaged in the business of transporting for hire property from place to place, by land or inland navigation, for all persons
- A contract in which a person or company agrees to carry goods or people from one place to another in exchange for a price is called a ‘contract of carriage’.
- The law relating to carriage of goods by sea is contained mainly in (i) The Indian Bills of Lading Act, 1856, and (ii) The Carriage of Goods by Sea Act, 1925. The other related Acts governing this subject are — (a) The Merchant Shipping Act, 1958, and (b) The Marine Insurance Act, 1963.
The carriage of goods by railways is governed by the Indian Railways Act, 1890, as amended from time to time. The ‘railway administration’ looks after the administration and working of railways.

A ‘charter party’ is a contract of affreightment entered into for hiring the whole ship or a principal part thereof to carry goods from one port to another. It also refers to the formal written document in which the contract of hiring of the whole or part of the ship for the conveyance of goods is expressed.

The Indian Bills of Lading Act, 1856, does not affect the provisions regarding unpaid seller’s right of stoppage of goods in transit as given under the Sale of Goods Act. Accordingly, the shipping company is not required to deliver the goods to the holder of Bill of Lading if the consignor, in exercise of the right of stoppage in transit, gives instructions not to deliver the goods.

A ‘ship owner’s lien’ is the right of a ship-owner to retain possession of the goods (cargo) carried by him until freight and other charges due to him under the contract of carriage have been paid. It is a possessory lien.

The law relating to carriage by air is contained in the Carriage by Air Act, 1972. This Act repeals the Indian Carriage by Air Act, 1934.

The Carriage by Air Act, 1972, contains two schedules. Schedule I contains the Warsaw Convention rules which are applicable to international carriage by air of countries which have not yet signed the Hague Protocol.

The Carriage by Road Act of 2007 provides for the regulation of common carriers, limiting liability and declaration of value of goods delivered to them in order to determine their liability for loss of, or damage to, such goods occasioned by the negligence or criminal acts of themselves, their servants or agents and for matters connected therewith or incidental thereto.

6.9 KEY WORDS

- **Maritime lien:** A ‘maritime lien’ is a claim on a ship, cargo and the freight in respect of services rendered to them. This right is given by law to all persons who have rendered some service to save the ship or cargo in time of danger.

- **Air waybill:** An air waybill or air consignment note is a receipt issued by an international airline for goods and an evidence of the contract of carriage, but it is not a document of title to the goods. Hence, the air waybill is non-negotiable.

- **Octroi:** This is a local tax collected on various articles brought into a district for consumption.
6.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

102 Short-Answer Questions

1. Write a short note on rights and duties of common carriers.
2. Write in brief about the liability of the railway administration.
3. Write a short note on ‘contract of affreightment’.
4. Write in brief about Bill of Lading.
5. Write a brief note on a ship-owner’s lien.
6. Write a short note on limitations of the carrier’s liability.
7. Write a brief note on rights of disposition of the consignor.

Long-Answer Questions

1. Discuss the various laws which govern the passage of goods through carriers.
2. Enumerate the role of the Carriers Act, 1865 in the passage of goods in India.
3. Analyse the liabilities of Railways during transit.
4. Discuss in detail the numerous laws relating to the carriage of goods by sea.
5. Analyse various provisions in the Carriage by Road Act, 2007.

6.11 FURTHER READING

UNIT 7  NEGOTIABLE INSTRUMENTS ACT, 1881

Structure
7.0 Introduction
7.1 Objectives
7.2 Negotiable Instruments: Definition, Features, Types and Parties
   7.2.1 Features of a Negotiable Instrument
   7.2.2 Promissory Note
   7.2.3 Bill of Exchange
   7.2.4 Cheque
   7.2.5 Bank Draft
   7.2.6 Maturity of Negotiable Instruments
   7.2.7 Payment in Due Course
   7.2.8 Payment of Interest
   7.2.9 Holder
7.3 Presentation of Negotiable Instrument
7.4 Dishonour and Discharge of Negotiable Instruments and Material Alteration
   7.4.1 Discharge of the Instrument and the Parties
7.5 Answers to Check Your Progress Questions
7.6 Summary
7.7 Key Words
7.8 Self Assessment Questions and Exercises
7.9 Further Readings

7.0 INTRODUCTION

The ‘negotiable instrument’ literally means ‘a written document transferable by delivery’. The Negotiable Instruments Act mentions three kinds of negotiable instruments, namely promissory note, bill of exchange and cheque. These instruments work under the provisions of Section 31 of the Reserve Bank of India Act, 1934, which as amended by the Amendment Act of 1946. They are transferable from one person to another without any formality. In other words, the property (right of ownership) in these instruments passes by either endorsement (in case it is payable to order) or by delivery merely (in case it is payable to bearer), and no further evidence of transfer is needed.

This unit aims at analysing negotiable instruments as mentioned in the Negotiable Instruments Act which functions under the provisions of Reserve Bank of India or the Central government.
7.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the term ‘negotiable instrument’.
- Analyse the characteristics of a negotiable instrument
- Learn the presentation of negotiable instrument.
- Explain the parties to negotiable instruments
- Know the essentials of a promissory note
- Analyse the bill of exchange

7.2 NEGOTIABLE INSTRUMENTS: DEFINITION, FEATURES, TYPES AND PARTIES

The word **negotiable** means ‘transferable by delivery’, and the word **instrument** means ‘a written document by which a right is created in favour of some person’. Thus, the term ‘negotiable instrument’ literally means ‘a written document transferable by delivery’.

According to Section 13 of the Negotiable Instruments Act, ‘a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer’. A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one or two, or one or some of several payees’ [Section 13(2)].

The Act, thus, mentions three kinds of negotiable instruments, namely notes, bills and cheques, and declares that to be negotiable they must be made payable in any of the following forms:

1. **Payable to order**: A note, bill or cheque is payable to order which is expressed to be ‘payable to a particular person or his order’. For example, (i) Pay A, (ii) Pay A or order, (iii) Pay to the order of A, (iv) Pay A and B, and (v) Pay A or B are various forms in which an instrument may be made payable to order. But it should not contain any word prohibiting transfer, e.g., ‘Pay to A only’ or ‘Pay to A and none else’ is not treated as ‘payable to order’ and therefore such a document shall not be treated as negotiable instrument because its negotiability has been restricted. It may be noted that documents containing express words prohibiting negotiability remain valid as a document (i.e., as an agreement) but they are not negotiable instruments as they cannot be negotiated further. There is, however, an exception in favour of a cheque. A cheque crossed ‘Account Payee only’ can still be negotiated further, of course, the banker is to take extra care like a bloodhound in that case.
2. **Payable to bearer**: ‘Payable to bearer’ means ‘payable to any person whosoever bears it’. A note, bill or cheque is payable to bearer which is expressed to be so payable or on which the only or last endorsement is an endorsement in blank. Thus, a note, bill or cheque in the form ‘Pay to A or bearer’, or ‘Pay A, B or bearer’, or ‘Pay bearer’ is payable to bearer. Also, where an instrument is originally ‘payable to order’, it may become ‘payable to bearer’ if endorsed in blank by the payee. For example, a cheque is payable to A. A endorses it merely by putting his signature on the back and delivers it to B with the intention of negotiating it (without making it payable to B or B’s order). In the hands of B, the cheque is a bearer instrument.

The definition given in Section 13 of the Negotiable Instruments Act does not set out the essential characteristics of a negotiable instrument. Possibly, the most expressive and all-encompassing definition of negotiable instrument had been suggested by Thomas which is as follows:

‘A negotiable instrument is one which is, by a legally recognised custom of trade or by law, transferable by delivery or by endorsement and delivery in such circumstances that (a) the holder of it for the time being may sue on it in his own name and (b) the property in it passes, free from equities, to a bona fide transferee for value, notwithstanding any defect in the title of the transferor’.

**7.2.1 Features of a Negotiable Instrument**

An examination of the given definition of negotiable instrument reveals the following essential characteristics of negotiable instruments which make them different from an ordinary chattel:

1. **Easy negotiability**: They are transferable from one person to another without any formality. In other words, the property (right of ownership) in these instruments passes by either endorsement (in case it is payable to order) or by delivery merely (in case it is payable to bearer), and no further evidence of transfer is needed.

2. **Transferee can sue in his own name without giving notice to the debtor**: A bill, note or a cheque represents a debt, i.e., an ‘actionable claim’ and implies the right of the creditor to recover something from his debtor. The creditor can either recover this amount himself or can transfer his right to another person. In case he transfers his right, the transferee of a negotiable instrument is entitled to sue on the instrument in his own name in case of dishonour, without giving notice to the debtor of the fact that he has become the holder. In case of transfer or assignment of an ordinary ‘actionable claim’ (i.e., a book debt evidenced by an entry by the creditor in his account book or hawi), under the Transfer of Property Act, notice to the debtor is necessary in order to make the transferee entitled to sue in his own name,
3. **Better title to a bona fide transferee for value:** A *bona fide* transferee of a negotiable instrument for value (technically called a *holder in due course*) gets the instrument ‘free from all defects’. He is not affected by any defect of title of the transferor or any prior party. Thus, the general rule of the law of transfer of title applicable in the case of ordinary chattels that ‘nobody can transfer a better title than that of his own’ does not apply to negotiable instruments. A man may sell to another a stolen radio set but the true owner may claim back the radio set from the buyer even though he may have got it in good faith for consideration.

4. **Presumptions:** Certain presumptions apply to all negotiable instruments. These presumptions shall be discussed later in this unit.

Examples of negotiable, non-negotiable, quasi-negotiable and presumptions are given below. These are:

**a. Examples of negotiable instruments**

The following instruments have been recognized as negotiable instruments by statute or by usage or custom: (i) bills of exchange; (ii) promissory notes; (iii) cheques; (iv) government promissory notes; (v) treasury bills; (vi) dividend warrants; (vii) share warrants; (viii) bearer debentures; (ix) port trust or improvement trust debentures; (x) hundis; (xi) railway bonds payable to bearer, etc.

**b. Examples of non-negotiable instruments**

These are: (i) money orders; (ii) postal orders; (iii) fixed deposit receipts; (iv) share certificates; (v) letters of credit.

**c. Examples of quasi-negotiable instruments**

There are some instruments called ‘documents of title’, e.g., (i) bills of lading; (ii) dock warrants; (iii) railway receipts and (iv) wharfinger’s certificates, which, like a negotiable instrument, are capable of being transferred by endorsement and/or delivery, but the transferor of such documents cannot give to the holder any better title to the goods than he himself possesses. Such instruments are termed as ‘quasi-negotiable instruments’, and the provisions of the Negotiable Instruments Act do not apply to them.

**d. Presumptions as to negotiable instruments**

Sections 118 and 119 lay down the following presumptions in respect of negotiable instruments, unless the contrary is proved:

1. That every negotiable instrument was made, drawn, accepted, indorsed or transferred for consideration;
2. That every negotiable instrument bearing a date was made or drawn on such date;
3. That every bill of exchange was accepted within a reasonable time after its date and before its maturity;

4. That every transfer of a negotiable instrument was made before its maturity;

5. That the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon;

6. That a lost negotiable instrument was duly stamped;

7. That the holder of a negotiable instrument is a holder in due course; but this presumption would not arise where it is proved that the holder has obtained the instrument from its lawful owner, or from any person in lawful custody thereof, by means of an offence, fraud or for unlawful consideration and in such a case the holder has to prove that he is a holder in due course;

8. That the instrument was dishonoured, in case a suit upon a dishonoured instrument is filed with the court and the fact of ‘protest’ is proved.

The above presumptions are rebuttable by the defendant.

7.2.2 Promissory Note

According to Section 4, a promissory note is ‘an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument’.

From the definition given in the Act, it follows that to be a valid promissory note, an instrument must fulfil the following essential requirements:

1. It must be in writing: A promissory note has to be in writing. An oral promise to pay does not become a promissory note. The writing may be on any paper, on any bahi or book. It may be in pencil or in ink and includes printing or typing. No particular form of words is necessary, even a promise contained in a letter will suffice, provided the other requirements of Section 4 are complied with. Of course the words used must import a clear undertaking to pay, but it is not necessary that the word ‘promise’ should be used (Balmukund vs Munnalal).

2. It must contain a promise or undertaking to pay: There must be a promise or an undertaking to pay. The undertaking to pay may be gathered either from express words or by necessary implication. A mere acknowledgement of indebtedness is not a promissory note, although it is valid as an agreement and may be sued upon as such.

Where, however, the acknowledgement of indebtedness contained in the document is in a defined sum of money payable on demand, there is a valid promissory note even though the words ‘promise to pay’ may not have been used. It is so because the phrase ‘payable on demand’ necessarily implies ‘a promise to pay at once or immediately’.
3. **The promise to pay must be unconditional**: Certainty is very necessary in the commercial world. As such, a promissory note must contain an unconditional promise to pay. The promise to pay must not depend upon the happening of some uncertain event, i.e., a contingency or the fulfilment of a condition. It must be payable absolutely. If an instrument contains a conditional promise to pay, it is not a valid promissory note and will not become valid and negotiable even after the happening of the condition (*Hill vs Halford*).

But a promise to pay is not conditional if the amount is made payable at a particular place or after a specified time or on the happening of an event which must happen, although the time of its happening may be uncertain (Sec. 5, para 2). Thus, if A signs an instrument stating: 'I promise to pay B ₹500 seven days after C’s death’, the promissory note is valid because it is not considered to be conditional, for it is certain that C will die, though the exact time of his death is uncertain.

4. **It must be signed by the maker**: It is imperative that the promissory note should be duly authenticated by the ‘signature’ of the maker. ‘Signature’ means the writing or otherwise affixing a person’s name or a mark to represent his name, by himself or by his authority with the intention of authenticating a document. The signature may be in any part of the instrument and need not necessarily be at the bottom. The intention to sign, however, must in all cases be proved. It may be in pencil or in ink. When the maker of promate is illiterate, his thumb mark is sufficient. But facsimile impressions, whether affixed in printing or by perforation or in some other form, and impressions by a rubber stamp are not recognized as signatures unless the parties specifically agree to treat them as such.

5. **The maker must be a certain person**: The instrument itself must indicate with certainty who is the person or are the persons engaging himself or themselves to pay. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. Where there are two or more makers, they may bind themselves jointly, or jointly and severally. But alternative promisors are not permitted in law because of the general rule that ‘where liability lies no ambiguity must lie’. Thus, a note in the form ‘I, Alok Kumar promise to pay’ and signed by Alok Kumar or also Satish Chandra is a good note as against Alok Kumar only.

6. **The payee must be certain**: Like the maker the payee of a promate must also be certain on the face of the instrument. A note is valid even if the payee is misnamed or indicated by his official designation only (Sec. 5, para 4), provided he can be ascertained by evidence. It may be made payable to two or more payees jointly or it may be made payable in the alternative to one of two, or one or some of several payees [Sec. 13(2)]. Thus alternative payees are permissible in law. But it must be made payable to order originally. A note originally made payable to bearer is illegal and void as per Reserve
Bank of India Act, 1934. Also, a note in favour of fictitious person is illegal and void, for it is treated as payable to bearer. A promissory note made payable to the maker himself is a nullity, the reason being the same person is both the promisor and the promisee.

7. The sum payable must be certain: For a valid promissory note, it is also essential that the sum of money promised to be payable must be certain and definite. The amount payable must not be capable of contingent additions or subtractions.

But, according to Section 5, para 3, the sum does not become indefinite merely because:

(i) There is a promise to pay the amount with interest, provided the rate of interest is stated;
(ii) The amount is to be paid at an indicated rate of exchange or according to the course of exchange; or
(iii) The amount is payable by instalments, even with a provision that on default being made in payment of an instalment, the balance unpaid shall become due.

8. The amount payable must be in legal tender money of India: A document containing a promise to pay a certain amount of foreign money or to deliver a certain quantity of goods is not a promissory note. Similarly, a promise to deliver paddy either in the alternative or in addition to money does not constitute a promissory note. Thus, an instrument signed by A, saying, ‘I promise to pay B ₹ 500 and to deliver to him my black horse on 1st January next’ is not a valid promissory note.

9. Other formalities: Though it is usual and proper to state in a note the place where it is made and the date on which it is made but their omission will not render the instrument invalid. Even where the amount is made payable at a certain time after the date, omission of the date does not invalidate the instrument and the date of execution can be independently ascertained or proved. The words ‘value received’ are also not an essential part of the form of a promissary note, because, as per Section 118, consideration is presumed until the contrary is proved. But a promissory note must be properly stamped as required by the Indian Stamp Act and each stamp must also be duly cancelled. The maker’s signature with the date across the stamp cancels the stamp effectively. Although an unstamped or inadequately stamped promissory note is invalid, but the amount of loan can be recovered if proved otherwise.

7.2.3 Bill of Exchange

Section 5 of the Negotiable Instruments Act defines a bill of exchange as follows:

‘A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument’.
At the very outset the following two facts must be noted:

(i) Although a bill of exchange directing to pay ‘only to a particular person’ is valid if it satisfies the requirements of the definition but it shall not be a negotiable instrument within the meaning of the Negotiable Instruments Act as its transferability is restricted.

(ii) Although a bill of exchange may be originally drawn ‘payable to bearer’ but in such a case it must be payable otherwise than on demand (say, three months after date). In other words, a bill cannot be drawn ‘payable to the bearer on demand’. If it is ‘payable on demand’, then it must be made ‘payable to order’ (Sec. 31 of the Reserve Bank of India Act).

Essentials of a Bill of Exchange

To be a valid bill of exchange, this instrument must comply with these requirements, which are as follows:

1. It must be in writing.
2. It must contain an order to pay. A mere request to pay on account will not amount to an order. But an order may be expressed in polite language.
3. The order to pay must be unconditional.
4. It must be signed by the drawer.
5. The drawer, drawee and payee must be certain. A bill cannot be drawn on two or more drawees in the alternative because of the rule of law that ‘where liability lies, no ambiguity must lie’. But a bill may be made payable in the alternative to one of two or more payees (Sec. 13).
6. The sum payable must be certain.
7. The bill must contain an order to pay money only.
8. It must comply with the formalities as regards date, consideration, stamps, etc.

It will be seen that the fundamental essentials of a bill enumerated above are more or less similar to that of a promissory note. As such the rules that apply to promissory notes are in generally applicable to bills of exchange as well. (For details of these essentials, see notes to promissory note.)

7.2.4 Cheque

Section 6, as substituted by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002 defines a cheque as follows:

‘A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form’.

Explanation I: For the purposes of this Section, the expression:

(a) ‘a cheque in the electronic form’ means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and
signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system;

(b) ‘a truncated cheque’ means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.

Explanation II: For the purposes of this Section, the expression ‘clearing house’ means the clearing house managed by the Reserve Bank of India or a clearing house recognised as such by the Reserve Bank of India.

Thus, a cheque is a bill of exchange with two distinctive features, namely:

(i) It is always drawn on a bank, and
(ii) It is always payable on demand.

Specimen of a cheque

Distinction Between a Cheque and a Bill of Exchange

A cheque, being, a part of a bill of exchange, must satisfy almost all the essentials of a bill, e.g., signed by the drawer, containing an unconditional order to pay a certain sum of money, to the order of a person or the bearer, etc. Yet there are few points of difference between the two, namely:

<table>
<thead>
<tr>
<th>CHEQUE</th>
<th>BILL OF EXCHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cheque is always supposed to be drawn by a bank</td>
<td>Bill of exchange may be drawn on any person, including a banker</td>
</tr>
<tr>
<td>Cheque can only be drawn payable on demand</td>
<td>Bill of exchange can be drawn payable to demand or on the expiry of a certain period after date or site</td>
</tr>
<tr>
<td>A cheque drawn ‘payable to bearer on demand’ is valid</td>
<td>Bill of exchange drawn ‘payable to bearer on demand’ is absolutely void and illegal</td>
</tr>
<tr>
<td>Cheque does not require acceptance by the drawee before payment can be demanded</td>
<td>Bill of exchange requires acceptance by the drawee before he can be made liable upon it</td>
</tr>
<tr>
<td>Cheque does not require any stamp</td>
<td>Bill of exchange needs to be properly stamped</td>
</tr>
<tr>
<td>Number days of grace are allowed in the case of cheque as it is always payable on demand</td>
<td>Three days of grace are allowed while calculating the maturity date in the case of time bills</td>
</tr>
<tr>
<td>Cheques can be crossed</td>
<td>Bills of exchange cannot be crossed</td>
</tr>
<tr>
<td>There is no system of noting or protest in cheques</td>
<td>There is a system of noting and protest in bills of exchange</td>
</tr>
<tr>
<td>Payment of cheque can be countermanded by drawer</td>
<td>Payment of bills of exchange cannot be countermanded by the drawer</td>
</tr>
<tr>
<td>Drawing of cheque will not be discharged from liability in case of delay of the holder in presenting it for payment</td>
<td>The drawer of bills of exchange is discharged from liability</td>
</tr>
</tbody>
</table>
7.2.5 Bank Draft

A bank draft is an order issued by one bank on another bank or on its own branch (usually drawn on its own branch) instructing the latter to pay a specified sum of money to a specified person or his order. It is a negotiable instrument and is very much like a cheque, with the following distinctions:

(a) It can be drawn only by a bank on another bank or on its other branch and not by an individual as in the case of a cheque.
(b) It cannot so easily be countermanded as a cheque.
(c) It cannot be made payable to bearer.

7.2.6 Maturity of Negotiable Instruments

‘Maturity’ means the date on which the payment of an instrument falls due. An instrument payable on demand or at sight such as a cheque becomes payable immediately on the date of its execution and there is no question of its maturity. Its payment falls due at once on the date of its issue. The question of maturity, therefore, arises only in the case of a promissory note or a bill of exchange which is expressed to be payable otherwise than on demand.

Every promissory note or bill of exchange expressed to be payable on a specified day, or at a certain period after date or after sight, or at a certain period after the happening of an event which is certain to happen is at maturity on the third day after the day on which it is expressed to be payable (Sec. 22). A time bill or note is as such entitled to three days of grace and matures or falls due on the last day of grace (and not on the date on which it is expressed to be payable). For example, a bill of exchange drawn on 1 January, if expressed payable three months after date, is at maturity on 4 April. Such a bill or note must be presented for payment only on the last day of grace, and if dishonoured, the suit can be filed on the next day after maturity. Any presentment for payment earlier to the third day of grace is invalid, even if the word ‘punctually’ is added to a fixed date.

Rules for calculating maturity: Sections 23 to 25 lay down the following rules for calculating the maturity of a time bill or note:

1. If it is made payable a stated number of months after date or after sight, or after a certain event, it matures (or becomes payable) three days after the corresponding date of the month after the stated number of months.
2. If the month in which the period would terminate has no corresponding date, the period shall be held to terminate on the last day of such month.
3. If it is made payable a certain number of days after date or after sight, or after a certain event, the maturity is calculated by excluding the day on which the instrument is drawn or presented for acceptance or sight or on which the event happens. Note that only one day is to be excluded.
4. If the date on which a bill or note is at maturity is a public holiday, the instrument shall be deemed to be due on the next preceding business day.
The expression ‘public holiday’ includes Sundays and any other day declared by the Central Government, by notification in the Official Gazette, to be a public holiday. Thus, if the maturity of an instrument falls on Sunday, it shall be deemed to be due on Saturday. If the maturity falls on an emergency holiday, the instrument shall be deemed to be due on the next succeeding business day.

5. If an instrument is payable by instalments, three days of grace are to be allowed on each instalment (Sec. 67).

7.2.7 Payment in Due Course

The payment of the amount due under a negotiable instrument must amount to ‘payment in due course’ in order to operate as a valid discharge of the instrument against the holder. Section 10 provides that in order to constitute a payment of a negotiable instrument as a ‘payment in due course’, the following conditions must be fulfilled:

1. The payment must be in accordance with the apparent tenor of the instrument: It should be made at or after maturity. A payment before maturity is not a payment in due course so as to discharge the instrument. Thus, if a bill of exchange is paid before the last day of grace and is subsequently indorsed over, it is valid in the hands of a holder in due course and the acceptor will be liable to pay again on the instrument. Similarly, if the banker makes payment of a post-dated cheque before the date mentioned therein, he acts against the apparent tenor of the instrument i.e., against the true intentions of the drawer and hence the payment will not be treated as payment in due course.

2. The payment must be made in good faith and without negligence: It must be honestly made in the bona fide belief that the person demanding payment is legally entitled to it. The payer must not be guilty of any negligence in making the payment. If there are suspicious circumstances and the payer fails to make necessary inquiry which may reveal the defects, the payment is not a payment in due course. Thus, if a specially endorsed bill of exchange is paid without inquiry as to the payee or if a cheque with forged signature of the drawer is paid, it will amount to negligence on the part of the payer and the payment will not be treated as payment in due course.

3. The payment must be made to a person in possession of the instrument under circumstances which do not arouse suspicion about his title to possess the instrument and to receive payment of the amount therein mentioned. A payment cannot be a payment in due course if it is made without requiring production of the instrument and, therefore, the payer must insist on seeing the instrument before making the payment and must obtain the instrument on payment.
4. The payment must be made in money only, unless the holder agrees to accept payment in any other medium or by cheque or draft.

To sum up, ‘payment in due course’ implies payment (i) according to the apparent tenor of the instrument at or after maturity (ii) in good faith and without negligence (iii) in money (or by cheque if acceptable to the holder) (iv) to a person who is legally entitled to the instrument and is in possession of the same.

7.2.8 Payment of Interest

The Negotiable Instruments Act lays down the following provisions regarding the payment of interest:

1. **When rate specified:** When interest at a specified rate is expressly made payable on a promissory note or bill of exchange, interest shall be calculated at the rate specified, on the amount of the principal money due thereon, from the date of the instrument, until tender or realization of such amount, or until such date after the institution of a suit to recover such amount as the Court directs (Sec. 79).

2. **When no rate specified:** When no rate of interest is specified in the instrument, or when no mention is made of interest at all, interest on the amount due thereon shall, notwithstanding any oral agreement relating to interest between any parties to the instrument, be calculated at the rate of 18 per cent per annum, from the date at which the same ought to have been paid by the party charged, until tender or realization of the amount due thereon, or until such date after the institution of a suit to recover such amount as the Court directs (Sec. 80).

3. When the party charged is the endorser of an instrument dishonoured by non-payment, he is liable to pay interest only from the time that he receives notice of the dishonour (Explanation to Section 80).

7.2.9 Holder

The ‘holder’ of a negotiable instrument means any person entitled to possess the instrument in his own name and to receive or recover the amount due thereon from the parties liable thereto (Sec. 8). Thus, in order to be called a ‘holder’, a person must satisfy the following two conditions:

1. **He must be entitled to the possession of the instrument in his own name:** Actual possession of the instrument is not essential. What is required is a right to possession under some legal or valid title. He should be a ‘de jure holder’ and not necessarily a ’de facto holder’. It means that the person must be named in the instrument as the payee or the indorsee, or he must be the bearer thereof, if it is a bearer instrument. However, the heir of a deceased holder or any other person becoming entitled by operation of law is a holder although he is not the payee or indorsee or bearer thereof.
If a person is in possession of a negotiable instrument without having a right to possess the same, he cannot be called the holder. Thus, although a thief, or a finder on the road, or an indorsee under a forged indorsement, may be having the possession of the instrument, he cannot be called its holder because he does not acquire legal title thereto and hence is not entitled in his own name to the possession thereof. Similarly, a beneficial owner claiming through a benamidar in whose favour the instrument had been made or drawn is not a holder because he is not entitled to the possession in his own name and cannot by himself maintain an action on the instrument (Subba Narayana vs Ramaswami).

2. He must be entitled to receive or recover the amount due thereon from the parties liable thereto. In order to be called a holder, besides being entitled to the possession of the instrument in his own name, the person must also have the right to receive or recover the amount of the instrument and give a valid discharge to the payer. Thus, one may be the bearer or the payee or indorsee of an instrument but he may not be called a holder if he is prohibited by a court order from receiving the amount due on the instrument.

It may, thus, be concluded that both the above conditions must be satisfied by a person to be called a holder. For instance, where an instrument payable to order is, without endorsement, entrusted by the payee to his agent, the agent does not become the holder of it, although he may receive its payment, because he has no right to sue on the instrument in his own name.

The holder of a negotiable instrument is a very important party to the instrument as such. It is he alone who can sue upon a negotiable instrument, can negotiate it (with certain exceptions) and can give a valid discharge for it.

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Check Your Progress

1. What do you mean by ‘negotiable instrument’?
2. List the provision of negotiable instrument in Reserve Bank of India Act.
3. List some examples of non-negotiable instruments.
4. List a few of special benefits of bills of exchange.
5. What is ambiguous instrument?
6. What do you mean by escrow?

7.3 PRESENTATION OF NEGOTIABLE INSTRUMENT

Exhibiting, presenting or placing of a negotiable instrument for acceptance, sight or payment before the acceptor, maker, drawee or other party liable thereon by or on behalf of the holder is called ‘presentment.’ Thus presentment may be made for any of the following three purposes:
NOTES

1. Presentment for acceptance.
2. Presentment for sight.
3. Presentment for payment.

1. Presentment for acceptance

'Presentment for acceptance' is necessary in case of bills of exchange only. But it is not every bill which has to be presented for acceptance. A bill of exchange 'payable on demand', or 'payable on the expiry of certain period after date' (say, payable three months after date), or 'payable on the date of happening of an event which is certain to happen' (say, on the death of Mr X) need not be presented for acceptance and it becomes due for payment even otherwise. The following bills, however, must be presented for acceptance in order to charge the parties with liability:

(a) A bill payable at a specified period after sight. Such a bill must be presented to the drawee for sight or acceptance in order to fix the maturity of the bill.

(Sec. 61)

(b) A bill in which there is an express stipulation that it shall be presented for acceptance before it is presented for payment.

Even where presentation is optional, it is advisable to present the bill to the drawee for his acceptance in order to get (i) the additional security of the acceptor's name on the bill, or (ii) an immediate right of recourse against the drawer and the endorsers, if any, in case the bill is dishonoured by non-acceptance. From the drawer's point of view also presentment for acceptance is desirable, for if acceptance is refused, he may, on receiving early notice of dishonour, be able to get his effects out of the hands of the drawee.

i. Acceptance

When the drawee of the bill signifies his consent in writing to the drawer's order in the bill, by signing across the face of the bill with or without the word 'accepted' and delivers back the bill to the holder or gives notice of acceptance to the holder, the bill is said to have been accepted. The drawee is not liable on a bill until he gives his acceptance and thereby becomes the acceptor thereof. A bill may be accepted even before the drawer has signed it or after notice of the drawer's death.

ii. Types of acceptance. An acceptance on the bill may be either (i) general acceptance, or (ii) qualified acceptance.

(i) General acceptance: If the drawee accepts the order of the drawer to pay the sum specified in the bill in full, without any condition or qualification, the acceptance is said to be general, absolute or unqualified. The acceptor may mention the bank where payment shall be made and this does not amount to putting a condition. As a rule, in order to be valid, an acceptance must be 'general' or unconditional.
(ii) **Qualified acceptance (Sec. 86):** When the drawee accepts the bill subject to some condition or qualification, thereby varying the terms as expressed in the bill, it is said to be a qualified acceptance. For example, acceptance for an amount less than that mentioned in the bill or for a period longer than that specified in the bill or acceptance dependent upon the happening of an event or acceptance to pay only at a specified place and not elsewhere or to pay at a place different from the place mentioned in the bill is a qualified acceptance. When the bill is drawn on two or more drawees, not being partners, and only one or some of them accept, it is also a qualified acceptance. In case of partners, acceptance by one of the partners is a general acceptance.

The holder may refuse to take a qualified acceptance and regard the bill dishonoured by non-acceptance. The holder may, at his option, accept qualified acceptance. If he accepts such qualified acceptance, without the consent of the prior parties, the latter are discharged from their liability. A qualified acceptance makes the bill an invalid negotiable instrument and thereafter the bill will be treated as an ordinary contract of acknowledging debt.

**ii. Presentment by Whom?**

Only a ‘holder’ of the bill or his agent can present a bill for acceptance. It means that the drawer himself or the endorsee, if the bill has been negotiated before acceptance, or his agent can present the bill for acceptance.

**iii. Presentment to Whom?**

A bill can be presented for acceptance to any one of the following:

1. *The drawee* of the bill or his duly authorised agent (Secs. 61 and 27).
2. *All the drawees* where there are several drawees. But if some of the drawees have the authority from others to accept, as in case of partnership firm, presentment to a person having such an authority or to a partner is enough. A bill accepted by some of the several drawees, who are not partners, binds only those who accept it and not the others who do not accept it and the acceptance is a qualified acceptance (Sec. 34).
3. *The legal representative* in case the drawee is dead (Sec. 75). The legal representative would be personally liable by such an acceptance unless accepted ‘sans recourse’ (Sec. 29).
4. *The Official Receiver* in case the drawee has become insolvent (Sec. 75).
5. *The drawee in case of need, i.e.,* the person whose name is mentioned in the bill as one to whom the bill is to be presented in case of its dishonour by the original drawee (Secs. 33 and 115).
6. *An acceptor for honour.* In certain circumstances a stranger to the bill may also accept it for the honour of any party—drawee or endorser liable on the bill. This is known as ‘acceptance for honour’ or ‘acceptance supraprotest.’
Section 108 lays down that “when a bill of exchange has been noted or protested for non-acceptance or for better security, any person not being a party already liable thereon may with the consent of the holder, by writing on the bill, accept the same for the honour of any party thereto.” Thus, for a valid acceptance for honour it must be made: (i) after the bill has been noted or protested; (ii) by a stranger to the bill; (iii) in writing on the bill; (iv) with the consent of the holder.

The acceptor for honour must by writing on the bill declare that he accepts under protest the protested bill for the honour of the drawer or of a particular endorser whom he names, or generally for honour (Sec. 109). Where the acceptance does not express for whose honour it is made, it shall be deemed to be made for the honour of the drawer (Sec. 110).

Rights and liabilities of acceptor for honour: On acceptance the acceptor for honour takes exactly the same position as the party for whose honour he accepts. His rights and liabilities are the same with the only difference that his liability is conditional and arises only after:

(i) The bill has been again presented to the original drawee for payment at its maturity and has been dishonoured by him, and
(ii) Noting and protesting has been done for such dishonour by non-payment.

If the acceptor for honour makes payment without the fulfilment of the above conditions, none will be liable to him, not even the original drawer. (Secs. 111 and 112)

Payment for honour: The essentials of a valid payment for honour are:

(a) The bill must have been noted and protested for non-payment.
(b) The acceptor for honour making payment must declare before a Notary Public the party for whose honour he is paying which must be duly recorded by the Notary Public. (Sec. 113)

An acceptor for honour, on making a valid payment of the bill, is entitled to recover from the party for whose honour he has paid and from all parties prior to such party, all sums paid by him with interest thereon and with all expenses properly incurred in making such payment. All parties subsequent to the party for whose honour the payment has been made are discharged from liability. (Sec. 114) It will be seen that this Section, by allowing an acceptor for honour to recover the amount paid by him from the party for whose honour he has paid or from other parties prior to such party, makes an exception to the general rule of law that ‘no person by voluntarily paying the debt of another, can make himself his creditor.’

iv. Time for Presentment

The rules with regard to time of presentment for acceptance are as follows:

1. The presentation for acceptance must be made on a business day within business hours, whether the parties are traders or non-traders (Sec. 61).
2. Where presentation for acceptance is obligatory, i.e., where the bill is expressed payable at a specified period after sight, the bill must, if no time is specified therein for presentation, be presented within a reasonable time after it is drawn (Sec. 61).

3. Where period of presentment is specified in the bill, it must be presented within that period.

v. Place of Presentment

If a particular place has been specified in the bill for presentment for acceptance, it must be presented at that place. If at such a place the drawee cannot be found on the due date for presentment, after reasonable search, the bill is dishonoured. (Sec. 61) If no place is mentioned in the bill, it may be presented at the usual place of business of the drawee or his residence.

v. Proof of Presentment

There must be a definite proof of presentment for acceptance and the drawee’s refusal for the same. In order to declare ‘dishonour by non-acceptance’ the holder must prove before the Notary Public with the help of witnesses that the bill was in fact presented to the drawee for his acceptance or that the drawee could not be found after reasonable search, and such proof must be duly recorded by the Notary Public.

Where authorised by agreement or usage, a presentment through the post office by means of a registered letter is sufficient (Sec. 61).

vi. Drawee’s Time for Deliberation

The holder must, if so required by the drawee of a bill of exchange presented to him for acceptance, allow the drawee forty-eight hours (exclusive of public holidays) to consider whether he will accept it (Sec. 63). Thus, if the drawee wants time for deliberation before taking up liability, the holder is bound to allow him forty-eight hours’ time at the most. If the holder allows the drawee more than forty-eight hours, exclusive of public holidays, for deliberation, all previous parties not consenting to such extension of time are thereby discharged from liability to such holder (Sec. 83). If the drawee does not return the accepted bill within forty-eight hours the holder should treat the bill as dishonoured. If the drawee gives acceptance, it has retrospective effect and dates back to the date of the presentation.

vii. Presentment for Acceptance when Excused?

In the following cases presentment for acceptance is excused and the bill is deemed to be dishonoured for non-acceptance even without presentment for acceptance:

1. When the drawee is incompetent to contract or he is a fictitious person (Sec. 91).

2. When the drawee, even after a reasonable search, cannot be found (Sec. 61).
viii. Effect of Non-presentment

Where presentation for acceptance is obligatory, i.e., where the bill is payable at a specified period after sight, and the holder fails to present the bill for acceptance, all parties thereto, i.e., the drawer and the endorsers, if any, are discharged from their liability to such a holder (Sec. 61).

2. Presentment for sight

“Presentment for sight” is necessary only in the case of a promissory note which is made payable at a certain period after sight, so that the maturity of the note may be ascertained. According to Section 62, “a promissory note, payable at a certain period after sight, must be presented to the maker thereof for sight (if he can after reasonable search be found) by a person entitled to demand payment, within a reasonable time after it is made and in business hours on a business day. In default of such presentment, no party thereto is liable thereon to the person making such default.”

3. Presentment for payment

Promissory note, bill of exchange and cheques must be presented for payment on the due dates. On default of such presentment, the parties thereto, other than the maker, acceptor or drawee, are not liable thereon to the holder of the instrument. [Sec. 64(1)]

i. The presentment for payment is to be made by the person who can give valid discharge to the debtor, i.e., either by the holder or by his authorised agent, or in case of his death or insolvency, by his legal representative or Official Assignee, as the case may be. Where authorised by agreement or trade usage, a presentment through the post office by means of a registered letter is sufficient. [Sec. 64(1)]

ii. The presentment for payment of promissory notes, bills of exchange and cheques must be made to the maker, acceptor or drawee thereof respectively [Sec. 64(1)]. It may also be made to the duly authorised agent of the maker, acceptor or drawee, as the case may be, or, where the maker, acceptor or drawee has died, to his legal representative, or, where he has been declared an insolvent, to his Official Assignee (Sec. 75).

Where an electronic image of a truncated cheque is presented for payment, the drawee bank is entitled to demand any further information regarding the truncated cheque from the bank holding the truncated cheque in case of any reasonable suspicion about the genuineness of the apparent tenor of instrument, and if the suspicion is that of any fraud, forgery, tampering or destruction of the instrument, it is entitled to further demand the presentment of the truncated cheque itself for verification and retain the truncated cheque so demanded if the payment is made accordingly [Sub-section (2) inserted in Section 64 by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002 (w.e.f. 6-2-2003)].
A. Time of Presentment for Payment

The rules with regard to time of presentment for payment as laid down in the Act are as follows:

1. Presentment for payment must be made during the usual hours of business and if payable at a bank, during the usual banking hours (Sec. 65).

2. A negotiable instrument payable otherwise than on demand, i.e., payable at a specified period after date or sight thereof, must be presented for payment at maturity (Sec. 66). Earlier presentment is premature and ineffective, and even a day’s delay would discharge the parties thereto except one which is primarily liable.

3. A negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder, otherwise the parties thereto except one which is primarily liable will be discharged from their liability (Secs. 74 and 73).

4. A cheque, which is always payable on demand, should be presented for payment not only within a reasonable time after delivery thereof but also before the relation between the drawer and his banker has been altered to the prejudice of the drawer (i.e., before the bank has failed), otherwise even the party primarily liable, namely, the drawer will also be discharged from his liability to the extent of loss suffered by him on account of the delay (Secs. 72 and 84).

When delay in presentment is excused (Sec. 75A): Delay in presentment (for acceptance or payment) is excused if the same is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct or negligence. Thus, delay on account of impracticability of transmitting the instrument to the place of payment because of postal strike is excusable. But when the cause of delay ceases to operate, presentment must be made within a reasonable time.

Reasonable time (Sec. 105). In determining what is a reasonable time for presentment for acceptance or payment regard shall be had to the nature of the instrument and the usual course of dealing with respect to similar instruments; and, in calculating such time, public holidays shall be excluded.

B. Place of Presentment for Payment

The Act lays down the following rules regarding the place of presentment for payment:

1. Where in an instrument the precise address of the place of payment has been indicated by the maker, drawer or acceptor, it must be presented at that place for payment (Secs. 68 and 69). For example, if a bill has been accepted ‘payable at his bankers’, the bill must be presented at the acceptor’s bank and a presentment to the acceptor personally will be insufficient. However, if alternative places of payment have been mentioned then the instrument may be presented for payment at either of the places.
Negotiable Instruments
Act, 1881

NOTES

2. Where no place of payment has been indicated, the note or the bill must be presented at the place of business (if any), or at the usual residence of the maker, drawee or acceptor, as the case may be (Sec. 70).

3. If the maker, drawee or acceptor of a negotiable instrument has no known place of business or fixed residence, and no place is specified in the instrument for presentment for acceptance or payment such presentment may be made to him in person wherever he can be found (Sec. 71).

If there is a default in making the presentment in accordance with the above rules, the parties to the instrument, other than the maker, acceptor or drawee thereof, are not liable thereon to the holder. Non-presentment for payment discharges only the drawer and the endorsers in the case of a bill of exchange, and the endorsers, if any, in the case of a promissory note (Sections 68-69 read with Section 64).

When Presentment for Payment Unnecessary (Sec. 76)

No presentment for payment is necessary, and the instrument may be taken to be dishonoured on the due date for presentment, in any of the following cases:

1. When presentment is intentionally prevented: Where the maker, acceptor or drawee intentionally does something which prevents the holder from presenting the instrument, e.g., where a promissory note is lost and the maker refuses to give a duplicate.

2. Place of business closed: If the instrument is payable at the payer’s place of business and he closes such place on a business day during the usual business hours.

3. Payer absent from place of payment: If the instrument is payable at some other specified place, neither the payer nor any person authorised to make payment attends at such place during the usual business hours.

4. When the payer cannot be found: If the instrument is not payable at any specified place and the payer cannot after due search be found.

5. Waiver of presentment: If the person entitled to the presentment, namely, the payer waives the presentment and promises to pay even though no presentment is made. Such waiver may be made either expressly or impliedly. An express waiver may be made before maturity by expressly adding in the instrument such words as ‘presentment waived’. An implied waiver will be inferred from the conduct of the maker, acceptor or drawee, when after maturity he makes a part payment on account of the amount due on the instrument or promises to pay the amount due thereon in whole or in part.

6. Where the drawer could not suffer damage: Where the drawer is not likely to suffer damage by non-presentment for payment e.g., where drawee is a fictitious person or one incompetent to contract or where the drawer and the drawee are the same person, the presentment is excused as against the drawer and a holder can make the drawer liable without presentation.
Check Your Progress

7. Why is ‘presentment for acceptance’ necessary?
8. When is “presentment for sight” necessary?

7.4 DISHONOUR AND DISCHARGE OF NEGOTIABLE INSTRUMENTS AND MATERIAL ALTERATION

A negotiable instrument may be dishonoured by (i) non-acceptance or (ii) non-payment. As presentment for acceptance is required only in case of bills of exchange, it is only the bills of exchange which may be dishonoured by non-acceptance. Of course any type of negotiable instrument—promissory note, bill of exchange or cheque—may be dishonoured by non-payment.

Dishonour by Non-Acceptance

A bill of exchange is said to be dishonoured by non-acceptance in the following cases:

1. When the drawee or one of several drawees (not being partners) makes default in acceptance upon being duly required to accept the bill. It may be recalled that the drawee may require 48 hours’ time (exclusive of public holidays) to consider whether he will accept or not (Sec. 63).
2. Where the presentment for acceptance is excused and the bill is not accepted, i.e., remains unaccepted.
3. Where the drawee is incompetent to contract.
4. Where the drawee makes the acceptance qualified.
5. If the drawee is a fictitious person or after reasonable search cannot be found (Sec. 61).

It is important to note that where a ‘drawee in case of need’ is named in a bill of exchange, the bill is not dishonoured until it has been dishonoured by such drawee (Sec. 115).

Dishonour by Non-Payment

A promissory note, bill of exchange or cheque is said to be dishonoured by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same (Sec. 92). Also, a promissory note or bill of exchange is dishonoured by non-payment when presentment for payment is excused expressly by the maker of the note or acceptor of the bill and the note or bill remains unpaid at or after maturity (Sec. 76). There are some other aspects associated with dishonour.
NOTES

Noting

‘Noting’ is the authentic and official proof of presentment and dishonour of a negotiable instrument. The question of noting does not arise in the case of dishonour of a cheque because in such a case the bank, while refusing payment, returns the cheque giving reasons in writing for the dishonour of the same, and that itself acts as an authentic evidence of the fact of dishonour. Even in the case of inland bills or notes, noting is not compulsory (Sec. 104).

According to Section 99, when a promissory note or a bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may cause such dishonour to be noted by a Notary Public upon the instrument, or upon a paper attached thereto, or partly upon each. For this the holder takes the bill or note to the notary public who makes a demand for acceptance or payment upon the drawer or acceptor or maker formally and on his refusal to do so notes the same on the bill or note. Thus ‘noting’ means recording the fact of dishonour on the dishonoured instrument or on a paper attached thereto for the purpose. Noting must be made within a reasonable time after dishonour and must specify: (i) the date of dishonour; (ii) the reason assigned for such dishonour; and (iii) the notary’s charges.

Protest

‘Protest’ is a formal certificate of dishonour issued by the notary public to the holder of the bill or note, on his demand (noting is merely a record of dishonour on the instrument itself) (Sec. 100).

7.4.1 Discharge of the Instrument and The Parties

The term ‘discharge’ in relation to negotiable instruments has two connotations: (i) discharge of the instrument, and (ii) discharge of one or more parties from liability on the instrument.

(i) Discharge of the instrument

A negotiable instrument is said to be discharged when it becomes completely useless i.e., it cannot be negotiated further. After a negotiable instrument is discharged the rights against all the parties thereto come to an end, and no party, even a holder in due course, can claim the amount of the instrument from any party thereto.

Discharge of the party primarily and ultimately liable on the instrument results in the discharge of the instrument itself.

(ii) Discharge of One or More Parties

A party is said to be discharged from his liability when his liability on the instrument comes to an end. When only some of the parties to a negotiable instrument are discharged, the instrument continues to be negotiable and the undischarged parties
remain liable on it. Thus, the discharge of one or more parties to an instrument does not discharge the instrument and the rights under it can still be enforced against those parties who continue to be liable thereon.

One or more parties to a negotiable instrument is/are discharged from liability in the following ways. We will discuss material alteration in detail.

1. By cancellation [Sec. 82(a)]
2. By release [Sec. 82 (b)]
3. By payment [Sections S2(c) and 78]
4. By allowing drawee more than 48 hours to accept (Sec. 83)
5. By taking qualified acceptance (Sec. 86)
6. By not giving notice of dishonour
7. By non-presentment for acceptance of a bill (Sec. 61)
8. By delay in presenting cheque (Sec. 84)
9. **By material alteration:** Any material alteration of a negotiable instrument renders the same void, i.e., discharges the instrument itself, and all parties thereto at the time of making such alteration and not consenting to the change are discharged from liability thereon (Sec. 87). But persons who become parties to the instrument after the alteration are liable under the instrument as altered. In other words, those who take an altered instrument cannot complain (Sec. 88).

It is worth noting that the material alteration of the instrument discharges all the parties’ liability at the time of making such alteration, and it makes no difference whether the alteration is for the benefit or detriment to any party to the instrument or whether it is made by the holder of the instrument or by a stranger while the instrument was in the custody of the holder, because the party in custody of the instrument is bound to preserve it in its integrity (*Davidson vs Cooper*). But alteration made by a stranger without any negligence on the part of the holder does not affect the liability of the parties there to (*Guorochandra vs Krushna Charana*).

**What constitutes a material alteration?** It is not every alteration that necessarily would affect the validity of an instrument or the rights of parties thereto. Only when the alteration is “material”, the validity of the instrument or the rights of parties would come in for question. The Negotiable Instruments Act is silent on the question—what constitutes a material alteration? Courts in India have, therefore, followed the English Common Law and held that anything which has the effect of altering the legal relations between the parties or the character of the instrument or the sum payable amounts to a material alteration.

The following are the examples of material alteration:
(i) Any alteration of the date, the sum payable, the time of payment and the place of payment.

(ii) Alteration by the addition of a new party to the instrument (Gardener vs Walsh).

(iii) Alteration of the rate of interest (Verco Pvt. Ltd. vs Newandram).

(iv) Tearing off the material part of the instrument.

*Alterations not vitiating the instrument.* There is no material alteration so as to vitiate the instrument in the following cases, as they do not prejudice the rights and liabilities of the parties thereto:

(i) Alteration made for the purpose of correcting a mistake or a clerical error.

(ii) Alteration made to carry out the common intention of the original parties (Sec. 87).

(iii) Alteration made before the instrument is issued.

(iv) Alteration made with the consent of the parties liable on the instrument.

(v) Conversion of bearer cheque into an order cheque.

(vi) Filling blanks in the case of inchoate or incomplete instruments (Sec. 20). Thus, putting a date on the undated cheque by the payee does not amount to material alteration rendering the instrument void (Bhaskaran Chandrasekharan vs Radhakrishnan).

(vii) Conversion of blank indorsement into an indorsement in full (Sec. 49).

(viii) Making qualified acceptance (Sec. 86).

(ix) Crossing of an uncrossed cheque (Sec. 125).

(x) Alteration which is the result of an accident, e.g., mutilation by washing, ravages by white ants or rats, document torn by a child, document burnt in part by the hot end of a cigarette (Hongkong and Shanghai Banking Corporation vs Lo Lee Shi).

*Payment of instrument on which alteration is not apparent:* Sometimes, a negotiable instrument is materially altered but does not appear to have been so altered, for example, a cheque is drawn for ‘500 with space left before the amount in both words and figures and the payee fraudulently alters the amount of ‘3,500 which is not apparent. In such cases, if the person or banker liable to pay makes the payment according to the apparent tenor and otherwise is due course, then he will be discharged from liability and such payment cannot be questioned by reasons of the instrument having been altered [Sec. 89(1)].
Where the cheque is an electronic image of a truncated cheque, any difference in apparent tenor of such electronic image and the truncated cheque shall be a material alteration and it shall be the duty of the bank or the clearing house, as the case may be, to ensure the exactness of the apparent tenor of electronic image of the truncated cheque while truncating and transmitting the image [Sec. 89(2). Any bank or a clearing house which receives a transmitted electronic image of a truncated cheque, shall verify from the party who transmitted the image to it, that the image so transmitted to it and received by it, is exactly the same [Sec. 89(3)].

10. **By ‘negotiation back’ of a bill.** When a bill of exchange comes back to the acceptor by process of negotiation and he becomes its holder, it is called ‘negotiation back’. If a bill of exchange which has been negotiated is, at or after maturity, held by the acceptor in his own right, all rights of action thereon are extinguished (Sec. 90).

### Check Your Progress

9. List the cases wherein a bill of exchange is said to be dishonoured by non-acceptance.

10. When is a negotiable instrument said to be discharged?

### 7.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The term ‘negotiable instrument’ literally means ‘a written document transferable by delivery’. According to Section 13 of the Negotiable Instruments Act, ‘a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer’. ‘A negotiable instrument may be made payable to two or more payees jointly, or it may be made payable in the alternative to one or two, or one or some of several payees’ [Section 13(2)].

2. It is important to note that negotiable instrument is subject to the provisions of Section 31 of the Reserve Bank of India Act, 1934, which as amended by the Amendment Act of 1946. It states:
   - i. No person in India other than the Reserve Bank or the Central Government can make or issue a promissory note ‘payable to bearer’.
   - ii. No person in India other than the Reserve Bank or the Central Government can draw or accept a bill of exchange ‘payable to bearer on demand’.
   - iii. A cheque ‘payable to bearer on demand’ can be drawn on a person’s account with a banker.
3. These are: (i) money orders; (ii) postal orders; (iii) fixed deposit receipts; (iv) share certificates; (v) letters of credit.

4. The special benefits of using bills of exchange in the world of commerce are as follows:
   i. A bill of exchange is a double secured instrument. If the bill is dishonoured by the acceptor, the holder or the payee may look to the drawer of the bill for payment.
   ii. In case of immediate need of money, a bill can be discounted with a bank by the payee.
   iii. Two separate trade debts can be discharged by a bill of exchange.
       Hence, where A buys goods on credit from B for ₹1,000 to be paid three months after date and B buys goods on credit from C on similar terms for similar amount, an order by B to A to pay the sum of ₹1,000 to C will discharge two separate trade debts.

5. An instrument, which may either be treated as a bill of exchange or as a promissory note, is an ambiguous instrument. In such a case, the holder may either treat it as a bill of exchange or a promissory note, but once he has made his choice, the instrument shall henceforth be treated accordingly (Sec. 17).

6. When a negotiable instrument is endorsed and delivered conditionally or for a special purpose only, e.g., as collateral security or for safe custody, and not for the purpose of absolutely transferring property therein, it is called an escrow.

7. ‘Presentment for acceptance’ is necessary in case of bills of exchange only.
   But it is not every bill which has to be presented for acceptance. A bill of exchange ‘payable on demand’, or ‘payable on the expiry of certain period after date’ (say, payable three months after date), or ‘payable on the date of happening of an event which is certain to happen’ (say, on the death of Mr. X) need not be presented for acceptance and it becomes due for payment even otherwise.

8. “Presentment for sight” is necessary only in the case of a promissory note which is made payable at a certain period after sight, so that the maturity of the note may be ascertained. According to Section 62, “a promissory note, payable at a certain period after sight, must be presented to the maker thereof for sight (if he can after reasonable search be found) by a person entitled to demand payment, within a reasonable time after it is made and in business hours on a business day. In default of such presentment, no party thereto is liable thereon to the person making such default.”

9. A bill of exchange is said to be dishonoured by non-acceptance in the following cases:
i. When the drawee or one of several drawees (not being partners) makes default in acceptance upon being duly required to accept the bill. It may be recalled that the drawee may require 48 hours’ time (exclusive of public holidays) to consider whether he will accept or not (Sec. 63).

ii. Where the presentment for acceptance is excused and the bill is not accepted, i.e., remains unaccepted.

iii. Where the drawee is incompetent to contract.

iv. Where the drawee makes the acceptance qualified.

v. If the drawee is a fictitious person or after reasonable search cannot be found (Sec. 61).

10. A negotiable instrument is said to be discharged when it becomes completely useless i.e., it cannot be negotiated further. After a negotiable instrument is discharged the rights against all the parties thereto come to an end, and no party, even a holder in due course, can claim the amount of the instrument from any party thereto.

7.6 SUMMARY

- The word negotiable means ‘transferable by delivery’, and the word instrument means ‘a written document by which a right is created in favour of some person’. Thus, the term ‘negotiable instrument’ literally means ‘a written document transferable by delivery’.

- ‘Payable to bearer’ means ‘payable to any person whosoever bears it’. A note, bill or cheque is payable to bearer which is expressed to be so payable or on which the only or last endorsement is an endorsement in blank.

- A promissory note has to be in writing. An oral promise to pay does not become a promissory note. The writing may be on any paper, on any bahi or book. It may be in pencil or in ink and includes printing or typing.

- Although a bill of exchange directing to pay ‘only to a particular person’ is valid if it satisfies the requirements of the definition but it shall not be a negotiable instrument within the meaning of the Negotiable Instruments Act as its transferability is restricted.

- A cheque, being, a part of a bill of exchange, must satisfy almost all the essentials of a bill, e.g., signed by the drawer, containing an unconditional order to pay a certain sum of money, to the order of a person or the bearer, etc.

- An incomplete or blank negotiable instrument properly stamped and signed is termed as an ‘inchoate instrument’.
’Maturity’ means the date on which the payment of an instrument falls due. An instrument payable on demand or at sight such as a cheque becomes payable immediately on the date of its execution and there is no question of its maturity.

The holder of a negotiable instrument is a very important party to the instrument as such. It is he alone who can sue upon a negotiable instrument, can negotiate it (with certain exceptions) and can give a valid discharge for it.

’Presentment for acceptance’ is necessary in case of bills of exchange only. But it is not every bill which has to be presented for acceptance.

“Presentment for sight” is necessary only in the case of a promissory note which is made payable at a certain period after sight, so that the maturity of the note may be ascertained.

A negotiable instrument may be dishonoured by (i) non-acceptance or (ii) non-payment. As presentment for acceptance is required only in case of bills of exchange, it is only the bills of exchange which may be dishonoured by non-acceptance.

A promissory note, bill of exchange or cheque is said to be dishonoured by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same.

Notice of dishonour can also be given by the duly authorized agent of the person who is bound to give notice. When an instrument is deposited with an agent for presentment and is dishonoured, the agent can himself give notice to prior parties on behalf of the holder.

According to Section 94 the notice of dishonour may be oral or written. If it is written it may be sent by post. A notice duly addressed and posted is good even though it may be miscarried.

’Noting’ is the authentic and official proof of presentment and dishonour of a negotiable instrument. The question of noting does not arise in the case of dishonour of a cheque because in such a case the bank, while refusing payment, returns the cheque giving reasons in writing for the dishonour of the same.

The term ‘discharge’ in relation to negotiable instruments has two connotations: (i) discharge of the instrument, and (ii) discharge of one or more parties from liability on the instrument.

The discharge of one or more parties to an instrument does not discharge the instrument and the rights under it can still be enforced against those parties who continue to be liable thereon.
It is worth noting that the material alteration of the instrument discharges all the parties’ liability at the time of making such alteration, and it makes no difference whether the alteration is for the benefit or detriment to any party to the instrument.

### 7.7 KEY WORDS

- **Documentary Bill**: When documents relating to the goods represented by the bill, e.g., bill of lading or railway receipt, invoice, marine insurance policy, are attached to a bill, the bill is called a documentary bill.
- **Maturity**: The term means the date on which the payment of an instrument falls due.
- **Official Receiver**: The designated person acts as a provisional liquidator after an order of a winding up has been made.
- **Official Assignee**: An officer in the law court who distributes a bankrupt’s assets to the creditors. He also assists the bankrupt to relieve of his obligations to the creditors.
- **Discharge of a Negotiable Instruments**: When the liability of the party, primarily and ultimately liable on the instrument, comes to an end, the instrument is said to be discharged.
- **The Indian Limitation Act**: Section 5 of the Indian Limitation Act, 1963 is an enabling provision to assist the litigants who failed to do an act within the prescribed time period as originally fixed under various enactments.

### 7.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on various forms wherein negotiable instruments become payable.
2. Write in brief about the characteristics of negotiable instruments.
3. Write a short note on the essentials of a promissory note.
4. Write a brief note on presentment for payment.
5. Write a short note on discharge of one or more parties.

**Long-Answer Questions**

1. “Negotiability is not essential to the validity of a promissory note as an instrument.” Justify this statement.
2. Enumerate the essential requirements for a bill to become a negotiable instrument.

3. Analyse the presentation of negotiable instrument.

4. Discuss in detail the numerous factors for the dishonour of negotiable instruments.

5. Analyse in details the concept and nature of material alteration of the instrument.

7.9 FURTHER READINGS


UNIT 8  INSURANCE

8.0  INTRODUCTION

The Insurance Act, 1938, a law originally passed in 1938 in British India to regulate the insurance sector, provides the broad legal framework within which the industry operates. This Act covered all sorts of insurance. The Act also contains provisions relating to the constitution, management and winding up of insurance companies. The provisions of the Insurance Act, 1938, are applicable to both Life and General Insurance business so far as these are not inconsistent with those contained in the special Acts governing them.

In 1963, a new Marine Insurance Act for independent India was passed. The Insurance Act had resulted in the formation of Controller of Insurance, a regulatory. But following the nationalization of major insurance companies in India, under Life Insurance of India Corporation Act, 1956 and General Insurance Business (Nationalization) Act, 1972, its importance diminished. However, as the India’s insurance sector was thrown open to private companies, Insurance Regulatory and Development Authority (IRDA) of India was formed in 1999. Under it, an Indian company, as defined and registered under Companies Act, 1956, is allowed to operate in India. With a huge potential of the insurance market and the need to make insurance, particularly life insurance, available on a wider scale, the Government opened the insurance sector to private companies. Its foreign entity-owned equity must have a licence from IRDA of India. One of the main objectives of this IRDA Act is to provide for the establishment of a statutory...
Insurance

Authority to regulate, promote and ensure the orderly growth of the insurance business in India.

This unit aims at analysing the evolution of insurance business in India and explains its various principles and legal framework which govern it.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the term ‘insurance’
- Analyse the sources of law in insurance
- Learn the judicial set-up for insurance business
- Explain the history of insurance legislation
- Know the legal principles that govern insurance
- Analyse insurance as a contract
- Understand fundamental principles of life, fire and marine insurance

8.2 INSURANCE: DEFINITION AND SOURCES OF LAW

The risks which can be insured have increased in number and extent owing to the growing complexity of the present-day economic system. Insurance, thus, occupies an important place in the modern world. It plays a vital role in the life of every citizen and has developed in recent times on an enormous scale leading to the evolution of many different types of insurance. In fact, nowadays almost any risk can be made the subject-matter of contract of insurance. As per the new Clause (7A) in Section 2 of the Insurance Act, 1938, Indian Insurance Company means any insurer being a company:

(a) Which is formed and registered under the Companies Act, 1956;
(b) In which the aggregate holdings of equity shares by a foreign company, either by itself or through its subsidiary companies or its nominees, do not exceed 26 per cent paid up equity capital of such Indian insurance company.
(c) Whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business.

Explanation: For the purposes of this clause, the expression “foreign company” shall have the meaning assigned to it under Clause (23A) of Section 2 of the Income-tax Act, 1961.

8.2.1 Types of Insurance Business

Insurance business is divided into two main branches:
1. Life Insurance business.
2. General Insurance business.

General Insurance business means fire, marine or miscellaneous insurance business. Items like employers’ liability insurance, burglary insurance, fidelity guarantee insurance, livestock insurance, crop insurance, motor vehicles insurance, etc., fall under Miscellaneous Insurance business category. We shall be discussing in detail the three most important types of insurance, namely, Life, Fire, and Marine insurance.

8.2.2 Judicial Set-Up and Legal Principles Governing Insurance

The insurance business in India is governed by the following Acts:

1. The Insurance Act, 1938 (as amended up-to-date).

The Insurance Act, 1938, contains provisions of insurer and insured, commission payable to agents, licensing of agents, appointment of staff, register of policies and claims, powers of the Controller of Insurance, acquisition of surrender value by policy, actuarial report, deposits, investment and loans, valuation of the assets and liabilities, accounts and balance sheet, re-insurance, etc. The Act also contains provisions relating to the constitution, management and winding up of insurance companies. The provisions of the Insurance Act, 1938, are applicable to both Life and General Insurance business insofar as these are not inconsistent with those contained in the special Acts governing them. In addition to this Act, all three types of insurance are also governed by specific acts, namely, (i) life insurance business is also governed by the Life Insurance Corporation Act, 1956, (ii) fire insurance business is also governed by the General Insurance Business (Nationalization) Act, 1972, and (iii) marine insurance business is also governed by the Marine Insurance Act, 1963, and the General Insurance Business (Nationalization) Act, 1972. After the passage of Insurance Regulatory and Development Authority (IRDA) Act, 1999, both Life Insurance and General Insurance businesses are also governed by the IRDA Act, 1999, with effect from 29 December, 1999.

8.2.3 History of Insurance Legislation in India

A. Nationalization of Insurance Business

All types of insurance business in India had been completely in public sector under full ownership and control of the Central Government till 28 December, 1999. From 29 December, 1999, the insurance sector was thrown open to private
Insurance companies also as a consequence of the enactment of Insurance Regulatory and Development Authority Act, 1999. The Life Insurance business was nationalized in 1956. From 1 September, 1956 till 28 December, 1999, life insurance business was carried on exclusively by the Life Insurance Corporation of India (LICI), formed and regulated by the Life Insurance Corporation Act, 1956. The General Insurance business was nationalized through the General Insurance Business (Nationalization) Act, 1972. From 1 January, 1974 till 28 December, 1999, General Insurance Business was transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act. Its four subsidiary companies are: (i) National Insurance Co. Ltd., Kolkata, (ii) The New India Assurance Co. Ltd., Mumbai, (iii) The Oriental Fire and General Insurance Co. Ltd., New Delhi, and (iv) The United India Fire and General Insurance Company Ltd., Chennai.

**Exemptions:** Section 36 of the General Insurance Business (Nationalization) Act, 1972, provides exemptions in favour of (i) Calcutta Hospital and Nursing Home Benefits Association Ltd., (ii) Export Credit and Guarantee Corporation Ltd., and (iii) Deposit Insurance Corporation (established under the Deposit Insurance Corporation Act, 1961) which can also carry on the general insurance business in addition to the General Insurance Corporation of India and its four subsidiaries (mentioned above).

**B. Insurance Regulatory and Development Authority (IRDA) Act, 1999**

Insurance business in India has been under public sector for over five decades. It has not been able to achieve significant penetration in the market. It is proved by the fact that only 22 per cent of the insurable population possesses life insurance.

Recognizing the huge potential of the insurance market and the need to make insurance, particularly life insurance, available on a wider scale, the Government opened the insurance sector to private companies. Accordingly, the Insurance Regulatory and Development Authority Act, 1999, was enacted, which has been made effective from 29 December, 1999.

**Capital requirement:** As per the new substituted Section 6 of the Insurance Act, 1938, requirement as to capital of an insurer has been prescribed. Accordingly, no insurer carrying on the business of life insurance, general insurance or reinsurance in India on or after the commencement of the IRDA Act, 1999 (i.e., 29 December, 1999), shall be registered unless he has:

(i) A minimum paid up equity capital of ₹100 crore, in case of a person carrying on the business of life insurance or general insurance; or

(ii) A minimum paid up equity capital of ₹200 crore, in case of a person carrying on exclusively the business of a re-insurer.

Provided that in determining the paid up equity capital specified in clause (i) or clause (ii), the deposit to be made under Section 7 and any preliminary expenses incurred in the formation and registration of the company shall be excluded.
Provided further that an insurer carrying on business of life insurance, general insurance or re-insurance in India before the commencement of the IRDA Act, 1999, (i.e., 29 December 1999) and who is required to be registered under this Act, shall have a paid-up equity capital in accordance with clause (i) and clause (ii), as the case may be, within six months of the commencement of that Act.

It may thus be observed that a very high requirement of capital has been kept so as to create an entry barrier so that only serious players enter this business.

**Duties, powers and functions of the IRDA**

The important duties, powers and functions of the IRDA may be summed up as under:

(i) To regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

(ii) To issue to the applicant a certificate of registration, to renew, modify, withdraw, suspend or cancel such registration.

(iii) To protect the interests of the policyholders in matters concerning assignment of policy, nomination by policyholders, insurable interest, settlement of insurance claims, surrender value of policy and other terms and conditions of contracts of insurance.

(iv) To regulate investment of funds by insurance companies.

(v) To specify requisite qualifications, code of conduct and practical training for “insurance intermediaries” and agents.  
   (“Insurance intermediaries” include insurance brokers, re-insurance brokers, insurance consultants, surveyors and loss assessors.)

(vi) To specify the code of conduct for surveyors and loss assessors.

(vii) To promote efficiency in the conduct of insurance business.

(viii) To promote and regulate professional organizations connected with the insurance and re-insurance business.

(ix) To adjudicate disputes between insurers and insurance intermediaries.

(x) To specify the percentage of life insurance business and general insurance business to be undertaken by the insurers in the rural or social sector.

**C. Amendments to the Insurance Acts**

i. Amendments to the Insurance Act, 1938 through the First Schedule of the IRDA Act, 1999: Section 30 of IRDA Act, 1999, seeks amendments in certain provisions of the Insurance Act, 1938, in the manner as set out in the First Schedule of the Act. The amendments to the Insurance Act are consequential in nature in order to empower ‘Insurance Regulatory and Development Authority’ (IRDA) to effectively regulate, promote and ensure orderly growth of the insurance industry. However, a few important amendments are discussed below:
ii. Amendments to the Life Insurance Corporation Act, 1956, and General Insurance Business (Nationalization) Act, 1972 through the Second and Third Schedule of IRDA Act, 1999:

Sections 31 and 32 of the IRDA Act, 1999, seek to amend Life Insurance Corporation Act, 1956, and General Insurance Business (Nationalization) Act, 1972, in the manner set out in Second and Third Schedule of the Act, respectively. The amendments provide that the exclusive privilege of Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) and its four subsidiaries to carry on their respective life/non-life insurance business shall cease on the commencement of the IRDA Act, 1999, (i.e., 29 December 1999) to enable other Indian Insurance Companies to do the insurance business. In other words, the amendments provide that the monopoly of LIC and GIC shall come to an end and the insurance sector shall be thrown open to other companies in private sector with effect from 29 December 1999.

There are over a dozen private life insurance companies and about half-a-dozen private non-life insurance companies which have started their operations in India. Most of these insurance companies have signed joint venture agreements with foreign companies. Major international insurers—Prudential and Standard Life of the UK, Sun Life of Canada and AIG, Met Life and New York Life of the USA, to name a few, tied with leading companies in India to reach out the vast unexploited insurance market. Popular private insurance companies are: ICICI Prudential Life Insurance Company Ltd., Tata AIG Life Insurance Company Ltd., Birla Sunlife Life Insurance Co. Ltd., ING Vysya Life Insurance Co. Ltd., ICICI Lombard General Insurance Co. Ltd., Tata AIG General Insurance Co. Ltd., and Bajaj Allianz General Insurance Co. Ltd.

Privatization of insurance sector has changed the mind-set of customers. They are now looking at insurance as complete financial solution offering stable returns coupled with total protection. As a result, the private insurance companies are offering a wide range of products/policies to suit specific customer needs, customer focused service and professional advice to survive in the era of strong competition.

iii. Insurance (Amendment) Act, 2002

The Insurance (Amendment) Act, 2002, seeks to amend the Insurance Act, 1938. It has been made effective from 23 September 2002. The Amendment Act provides for the establishment of ‘Insurance Cooperative Society’. According to the newly inserted Clause (18A) in Section 2, ‘Insurance Cooperative Society’ means any insurer being a cooperative society:

(a) Which is registered as a cooperative society under the Cooperative Societies Act, 1912, or under any other law of the time being in force in any State relating to cooperative societies or under the Multi-State Cooperative Societies Act, 1984;

(b) Having a minimum paid-up capital, (excluding the deposits required to be made under Section 7) of ₹100 crore;
(c) In which no body corporate, whether incorporated or not, formed or registered outside India, either by itself or through its subsidiaries or nominees, at any time, holds more than 26 per cent of the capital of such cooperative society; and

(d) Whose sole purpose is to carry on life insurance business or general insurance business in India.

The Amendment Act further provides that every Insurance Cooperative Society will be deemed to be an ‘insurer’. All the provisions applicable to an ‘insurer’ being an Indian insurance company shall, so far as may be, apply to an Insurance Cooperative Society; provided that the Insurance Regulatory Development Authority (IRDA) may, by notification direct that any of the provisions of the Act, (a) shall not apply to any Insurance Cooperative Society, or (b) shall apply to an Insurance Cooperative Society only with such exceptions, modifications and adaptations as may be specified in the notification.

Check Your Progress
1. What does general insurance mean?
2. List some miscellaneous insurance types.

8.3 INSURANCE AS A CONTRACT

A contract of insurance is a contract whereby one party undertakes, in return of a consideration called premium, to pay to the other party a certain sum of money on the happening of a certain event (death or attainment of a certain age) or to indemnify the other party against a loss arising from the risk insured (in case of property). The party which promises to pay a certain sum of money to, or to indemnify, the other party is called the Insurer [sometimes called assurer (in case of life insurance) or underwriter (in case of marine insurance)], and the party to whom this protection is given in exchange of premium is called the Insured (or assured).

The document containing the terms and conditions of the contract of insurance is called a Policy, and the insured is, therefore, called a Policy-holder. The consideration which the insured has to pay to the insurer for the protection given to him is called Premium. The amount for which a policy is issued is known as the Insured Amount or Policy Amount. The thing or property insured is called the subject-matter of insurance, and the interest of the insured in the subject-matter is called his insurable interest.

8.3.1 Nature of a Contract of Insurance

A contract of insurance is a type of contingent contract and is a per-feetly valid contract. A contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen (Sec. 31 of the Indian
Insurance

Contract Act). Thus where A agrees to pay B ₹50,000, in exchange of B’s paying ₹1,000 as premium, if B’s house is burnt, there is a contingent contract the performance of which depends upon the happening of an uncertain event. Although a contract of insurance resembles to some extent to a wagering or gambling agreement, the insurer betting with the insured that his house will not be burnt and giving him the odds of its value against the premium. But, in reality, it is not a wagering agreement for the following reasons:

1. In an insurance contract, the object is to protect the insured against losses in case of some uncertain future event. In a wagering agreement, the object is to gamble for money and money only. Thus where A contracts with B that if it rains today he will pay ₹100 to B and if it does not rain B will pay ₹100 to him, there is a wagering agreement.

2. In an insurance contract, the insured has an insurable interest in the life or property sought to be insured. In a wagering agreement neither party has any pecuniary or insurable interest in the subject-matter of the agreement except the resulting gain or loss. This is the main distinguishing feature of a valid contingent contract as compared to a wagering agreement. If either party has any insurable interest, i.e., proprietary interest in the contract, it will not be a wager.

3. A contract of insurance (except life, accident and sickness insurances) is based on the principle of indemnity. But in a wagering agreement, there is no question of indemnity as it does not cover any risk.

4. A contract of insurance is based on scientific calculation of risks and the amount of premium is ascertained after taking into account the various factors affecting the risk. In a wager, there is no question of any calculation whatsoever, it being a mere gamble.

Thus, a contract of insurance, being a contingent contract, is an absolutely valid contract. The general principles of the law of contract apply equally to such a contract. As such, to be a valid contract it must fulfil the following requirements: (i) there must be an agreement between the parties, (ii) the agreement must be supported by consideration, (iii) the parties must be capable of contracting, (iv) the consent of the parties to the agreement must be ‘free consent’, and (v) the object must not be illegal or immoral.

8.3.2 Fundamental Principles of Insurance Contract

There are certain fundamental principles (or characteristics) more or less common to all classes of insurance business. These are enumerated below:

1. **Utmost good faith:** The general rule of ‘caveat emptor’ (let the buyer beware), which applies to ordinary trade contracts, does not apply to insurance contracts. Insurance contracts are contracts of utmost good faith or contracts uberrimae fidei. Accordingly, it is the inherent duty of both parties to a contract of insurance to make full and fair disclosure of all
material facts relating to the subject-matter of the proposed insurance. It is so because insurance shifts risk from one party to another. A material fact for this purpose is a fact which would affect the judgment of a prudent insurer in considering whether he would enter into a contract at all or enter into it at one premium rate or another. For example, in life insurance, suffering from a disease like asthma or diabetes is a material fact whereas having occasionally a headache is not a material fact.

**Exceptions**: The following types of facts are not required to be dis-closed by the proposer, i.e., the non-disclosure of them shall not be fatal to the contract:

(i) Any fact which diminishes the risk.
(ii) Any fact which is known or presumed to be known to the insurer.
(iii) Any fact which is of the nature of public knowledge or which relate to the law of the country.
(iv) Any fact as to which information is waived by the insurer.

**Consequences of breach**: If the utmost good faith is not observed by either party, the contract becomes voidable at the option of the party, not at fault, irrespective of whether the non-disclosure was intentional or inno-cent. Of course, in case of innocent misrepresentation, the premium is re-fundable on the avoidance of the contract.

2. **Indemnity**: The second fundamental principle is that all contracts of insurance are contracts of indemnity, except those of life and personal accident insurances where no money payment can indemnify for loss of life or bodily injury. In case of marine and fire insurances, the insurer under-takes to indemnify the insured for loss or damage resulting from specified perils. In case of loss, the insured can recover from the insurer the actual amount of loss, not exceeding the amount of policy. If there is no loss under the policy, the insurer is under no obligation to indemnify the insured. The object of indemnity is to place the insured after a loss in the same position as he occupied immediately before the event. Under no circumstances, the insured is allowed to benefit more than the loss suffered by him. This is because, if that were so, the temptation would always be present to desire the insured event and thus to obtain the policy proceeds. This would obvi-ously be contrary to the public interest.

Even contracts of fire or marine insurance cease to be contracts of indemnity when they provide for the payment of a fixed sum of money in the event of total loss or destruction by the peril insured against, without demanding any further proof of actual loss. This is so in the case of ‘valued policies’. Of course, in such policies as well, if partial loss is there then the insured is only indemnified, because nobody is allowed to make a profit of his loss. It may also be mentioned that indemnity is linked with ‘insurable interest’. If a one-fourth co-owner gets the full property insured, he shall be indemnified
Insurance

NOTES

to the extent of his interest or share only in the case of total destruction of
the property insured.

3. **Insurable interest**: ‘Insurable interest’ is an essential prerequisite in effecting
a contract of insurance. The insured must possess an **insurable interest** in
the subject-matter of the insurance **at the time of contract**, otherwise the
contract of insurance will be a wagering agreement which shall be void and
unenforceable.

In the case of **Life Insurance**, insurable interest must be present only at the
time of contract (i.e., when the insurance is effected). It need not be there at
the time of death or when the claim is made because it is not a contract of
indemnity. Thus a life insurance policy is freely assignable.

In the case of **Fire Insurance**, insurable interest must be present both at the
time when the insurance is effected and at the time of loss. Being a contract
of indemnity, a fire insurance policy can be assigned only to one who has
acquired some interest in the subject-matter as a purchaser, mort-gagee or
pledgee because unless the assignee has interest at the time of loss, he
cannot be indemnified.

In the case of **Marine Insurance**, insurable interest must be present at the
time of the loss of subject-matter and it is not essential for the assured to
have an insurable interest at the time of effecting the insurance.

4. **Causa proxima**: The next principle of insurance is that the insurer is liable
only for those losses which have been proximately caused by the peril insured
against. In other words, in order to make the insurer liable for a loss, the
nearest or immediate or last cause is to be looked into, and if it is the peril
insured against, the insured can recover. This is the rule of **causa proxima**.

Insurers are not liable for remote causes and remote con-sequences even if
they belong to the category of insured perils. “The question, which is the
causa proxima of a loss, can only arise where there has been a succession
of causes. When a result has been brought about by two causes, you must,
in insurance law, look to the nearest cause, although the result would, no
doubt, not have happened without the remote cause.... The law will not
allow the assured to go back in the succession of causes to find out what is
the original cause of loss” (**Pink vs Fleming**).

Thus, in deciding whether the loss has arisen through any of the risks insured
against, the proximate or the last of the causes is to be looked into and
others rejected. If loss is caused by the operation of more than one peril
simultaneously and if one of the perils is an excepted (i.e., uninsured) peril,
the insurer shall be liable to the extent of the effects of insured peril if it can
be separately ascertained. The insurer shall not be liable at all if the effects
of insured peril and excepted peril cannot be separated.

It may be added that although the principle of **causa proxima** applies mostly
in the case of marine and fire insurances, it is applicable in the life insurance as
well because in ‘personal accident policies’ the proximate cause of the death should be accident. In case of natural death the insurer is not liable thereon.

5. Risk must attach: The next principle of insurance is that for a valid contract of insurance the risk must attach. If the subject-matter of insurance ceases to exist (e.g., the goods are burnt) or the insured ship has already arrived safely, at the time the policy is effected, the risk does not attach, and as a consequence, the premium paid can be recovered from the insurers because the consideration for the premium has totally failed. Thus, where the risk is never run, the consideration fails and, therefore, the premium is returnable. It being a general principle of law of insurance that ‘if the insurers have never been on the risk, they cannot be said to have earned the premium’. The risk also does not attach and therefore the premium is returnable where a policy is declared to be void ab-initio on account of some defect, e.g., assured being minor or parties not being ad-idem. But where a policy is void because there is no ‘insurable interest’, premium paid cannot be recovered because in that case it amounts to ‘wager’, except in the case of marine insurance where the assured is not required to have insurable interest at the time of entering into the contract (Harase vs Pearl Life Assurance Co.). Also, the premium cannot be recovered where the policy is avoided by the insurer on grounds of fraud by the insured.

6. Mitigation of loss: When the event insured against occurs, for example, in the case of a fire insurance policy when the fire occurs, it is the duty of the policy-holder to take steps to mitigate or minimise the loss as if he were uninsured and must do his best for safeguarding the remaining property, otherwise the insurer can avoid the payment of loss attributable to his negligence. Of course, the insured is entitled to claim compensation for the loss suffered by him in taking such steps from the insurer.

7. Doctrine of subrogation: The doctrine of subrogation is a corollary to the principle of indemnity and as such applies only to fire and marine insurances. According to the principle of indemnity, the insured can recover only the actual amount of loss caused by the peril insured against and cannot be allowed to benefit more than the loss suffered by him. In case the loss to the property insured has arisen by chance without any fault on anybody’s part, the insurer can make the claim against the insurer only. In case the loss has arisen out of tort or mischief by some third party, the insured becomes entitled to proceed against both the insurer as well as the wrongdoer. But since a contract of insurance is a contract of indemnity, the insured cannot be allowed to recover from both and thereby make a profit from his insurance claim, he can make a claim against either the insurer or the wrongdoer. If the insured elects to be indemnified by the insurer, the doctrine of subrogation comes into play and as a result the insurer shall be subrogated to all the rights and remedies of the insured against third parties in respect of the property destroyed or damaged.
8. **Doctrine of contribution:** Like the doctrine of subrogation, the doctrine of contribution also applies only to contracts of indemnity, *i.e.*, to fire and marine insurances. The doctrine of contribution states: ‘in case of double insurance all insurers must share the burden of payment in proportion to the amount assured by each. If an insurer pays more than his rateable proportion of the loss, he has a right to recover the excess from his co-insurers, who have paid less than their rateable proportion.’

There are certain essential conditions required for the application of the doctrine of contribution.

9. **Terms of policy:** A contract of fire insurance is for a fixed duration, usually for one year, and the liability of the insurer automatically comes to an end on the expiry of the period. A contract of marine insurance may be either for a certain period or for a particular voyage. If it is for a certain period, the liability of the insurer comes to an end after the expiry of that period even if the voyage has not yet ended. And if it is for a particular voyage, then the liability of the insurer continues till the voyage has ended even if it takes longer than a year. A contract of life insurance is not a contract for a year only, but is a continuing contract and covers either a specified number of years or the balance of the insured’s life. As a contract of life insurance covers a continuing risk, advance payment of premium every year during the whole term of policy is a condition precedent for keeping the policy in force and if the premium due is not paid within the due time plus the grace period, the policy lapses.

### 8.3.3 Life Insurance

The Life Insurance business is governed by the Insurance Act, 1938 (as amended up-to-date), the Life Insurance Corporation Act, 1956 and the Insurance Regulatory and Development Authority Act, 1999. The Life Insurance Corporation Act, 1956, was passed to provide for the nationalization of life insurance business in India by transferring all such business to the Life Insurance Corporation of India (LICI) established for the purpose, and to provide for the rules and regulations relating to the working of LICI, *i.e.*, relating to its administration, deposits and investment of funds, finance, accounts and audit, *etc.*

From 1 September, 1956 till 28 December, 1999, life insurance business was carried on exclusively by the Life Insurance Corporation of India, formed and governed by the Life Insurance Corporation Act, 1956. After commencement of the “Insurance Regulatory and Development Authority Act, 1999”, *i.e.*, 29 December, 1999, life insurance business was thrown open to other Indian Insurance Companies as well and the monopoly of the Life Insurance Corporation of India came to an end.

A ‘contract of life insurance’ is a contract whereby the insurer, in consideration of a certain premium, undertakes to pay to the assured, or to the nominee/assignee or the legal successor (as the case may be) of the assured in case of his death, a
stated sum of money or annuity (i.e., payment in monthly, quarterly, half-yearly or yearly instalments), on the death of the insured (the person whose life is insured) or on the expiry of a certain period, whichever is earlier, in case of an Endowment Policy, and on the death of the insured, under a Whole Life Policy.

According to Section 2(11) of the Insurance Act, 1938, ‘life insurance business’ means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include:

(a) The granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance;
(b) The granting of annuities upon human life; and
(c) The granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.

Now we shall discuss the various aspects of Life Insurance. These are as follows:

1. Insurable Interest

‘No insurable interest, no insurance’ is a maxim of the law of insurance. Thus, a contract of life insurance is void unless the assured has an insurable interest in the life insured. Insurable interest arises out of the pecuniary relationship that exists between the assured (i.e., the policy-holder) and the life insured, so that the policy-holder stands to lose by the death of the insured and continue to gain by his remaining alive. In other words, one can have an insurable interest only when he would stand to benefit financially by the continued existence of the person whose life is insured, or when he would be put to a financial loss by the death of the insured person. Insurable interest is thus a financial or pecuniary interest in the preservation of the life to be insured. Mere ties of blood and affection, howsoever strong, do not give rise to insurable interest. Thus, a son has no insurable interest in the life of his father who is a pauper and is supported by the son.

In life insurance, the assured must have insurable interest in the life upon which insurance is effected at the time when the contract of insurance is entered into. It need not be present at the time of the death of the person insured or when the policy falls due. The reason for this rule is that a contract of life insurance is not a contract of indemnity.

i. Presumption of insurable interest: In the following three cases, insur-able interest is presumed to exist and no proof is required:

(a) In own’s life: In this case, interest is presumed because one can protect his estate from that loss of his future gains or savings which might be the result of his premature death.
Insurance

NOTES

(b) Wife in the life of her husband: In this case, interest is presumed because the husband is legally bound to support his wife and hence she has insurable interest in the life of her husband.

c) Husband in the life of her wife: In this case, interest is presumed only if the wife is literate and earning member.

In these cases, there is no limit to the amount of insurable interest (i.e., interest is presumed up to an unlimited extent) and one can insure for any sum whatsoever, and as often as he pleases. However, in practice, the sum assured is restricted by the assured’s financial status and capacity to pay the premium.

ii. No presumption of insurable interest: The cases where insurable interest is not presumed and an evidence of interest is required can be studied under two heads: (i) persons related, and (ii) persons not related.

(i) Persons related: In case of relations other than husband and wife, e.g., father and son, uncle and nephew, sister and brother, insurable interest is to be proved. If one proves that he is supported by another relation then only he can insure that other relation’s life. Thus, a father has no insurable interest in the life of his son unless he proves that he is dependent on the son. Similarly, a son has no insurable interest in the life of the mother who is supported by him. A widow sister has an insurable interest in the life of her brother who supports her.

In such relationships where pecuniary interest is proved there is no limit as regards the amount of insurance. But usually assured’s ability to pay premium decides the amount of insurance policy.

(ii) Persons not related: The following have been held to have an insurable interest due to business or contractual relationship:

(a) A creditor in the life of his debtor “to the extent of the debt”.

(b) A creditor in the life of a surety, and the surety in the life of his principal debtor and of his co-surety, to the extent of his guarantee.

(c) A partner (in a firm) in the life of a co-partner to the extent of the capital invested by the latter, because in case of the death of a co-partner his share of capital will have to be paid to his heirs as a result of which there may be shortage of funds causing great financial loss to the partner(s).

(d) An employee in the life of his employer, up to wages or salary for the term of service contracted for.

(e) An employer in the life of his key employee, e.g., the general manager or the chief engineer, up to the likely loss of profits to the employer because of loss of skill and knowledge of such an employee until a man of equal calibre and experience is found out.

It is to be noted that in the above cases, the assured has a limited interest, in the life of another upon which insurance is effected, to the extent of possible financial

Self-Instructional Material
loss by the demise of such another person, and he can insure only for a sum not exceeding his interest in the life of another. It may further be noted that in these cases, the full amount of insurance is payable irrespective of the fact that the assured has no insurable interest in the life of the insured at the time of making the claim.

It is so because life insurance is not a contract of indemnity. Thus, if the life of a debtor has been insured and the debtor repays the debt in due course, the assured can recover the amount of the policy on the death of the debtor in spite of the fact that he has no insurable interest in the debtor’s life at the time of his death as the debt has been already repaid.

II. Procedure for Effecting a Life Policy

Any person who has attained majority and who can enter into a valid contract can take out a life insurance policy on self and on those in whom he has insurable interest. Policies can be taken out, subject to certain conditions, on the life of one’s spouse or child. Proposals on the lives of women, either with earned income or with unearned income attracting Income-tax or having wealth which attracts Wealth-tax, are treated on par with male lives. In other cases, an extra premium is charged.

A person desiring to take out a policy of life insurance has to fill in a Proposal Form supplied by the insurer (i.e., the Life Insurance Corporation of India). There are different types of proposal forms for each type of policy. The proposal form requires information with regard to the health of the proposer, his family history, his age, habits of life, the amount, kind and term of policy. The proposer should answer all the questions in the good faith. He must disclose all the material facts truly and fully. The proposer is also required to undergo a medical examination. The proposal form is accompanied by the first premium amount and if the insurer accepts the same unconditionally and issues the First Premium Receipt (which acts as the acceptance letter), there comes into existence a binding contract and the risk commences from the date of issuing the Receipt. In due course the insurer issues the Insurance Policy which evidences the contract of insurance which has already been made between the insured and the insurer. In the Policy the contract is completely expressed.

The proposal form is the basis of the contract of insurance. Life insurance being a contract ‘uberrimae fidei’, i.e., of utmost good faith, if any statement in the proposal form is false, or there is concealment of material facts, the insurer can avoid the policy. Of course, in case of innocent misrepresentation, the premium is returnable on the avoidance of the policy.

III. Surrender Value

The ‘surrender value’ denotes that value or consideration which the insurer is prepared to pay at any particular time during the currency of the policy, after it has run for a specified period, in total discharge of the contract, in case the assured wishes to surrender his policy and extinguish his claim upon it. In brief, the surrender
A policy acquires a surrender value only after it has run for a specified period. The Life Insurance Corporation of India provides certain rules in this regard. The surrender value increases with each payment of premium, though it is only a fraction of the total amount paid by way of premia. The actual surrender value calculation chart is appended in the policy itself. Generally the minimum surrender value allowable is equal to 30 per cent of the total amount paid by way of premia, excluding the premium of the first year and all extra premiums paid for accident benefit, etc. Further, if the policy is one with profits, the cash value of any existing vested bonus additions will also be allowed.

IV. Paid-up Value

If, after the policy has acquired a ‘surrender value’, a policy-holder discontinues the payment of premium, the policy does not become wholly void but continues to subsist as a ‘paid-up policy’. In such a case, the policy-holder becomes entitled to the ‘paid-up value’ of the policy. Of course, such a value is payable only at the maturity of the policy; and it is for this reason that this value is always higher than the ‘surrender value’ which is payable immediately on surrendering the policy.

The ‘paid-up value’, is the amount which bears the same proportion to the sum assured as the number of premiums actually paid bears to the number of premiums stipulated for in the policy. In the shape of a formula:

V. Loan Value

In the case of policies issued by the Life Insurance Corporation of India, where the policy has acquired a ‘surrender value’, it also acquires a ‘loan value’. The Loan Value is calculated at 90 per cent of the Surrender Value in the case of policies which are in force for full sum assured and 85 per cent of Surrender Value in case of policies which are in paid-up condition. The amount is then rounded off to the nearest lower multiple of ₹5. Loans for amounts less than ₹150 are not given. In the case of policies issued after 1 January 1976, loans for amounts less than ₹250 are not granted. Loans are granted subject to such further terms and conditions as the Life Insurance Corporation may fix from time to time. The rate of interest charged at present is 9 per cent per annum and it is payable half-yearly. Loans are not granted for a shorter period than six months. This is the best investment that the Corporation can make, as there is never any danger of the money being lost, because in case the loan is not repaid within the agreed time, it along with interest accumulation is deducted from the claim amount when the policy is finally surrendered or falls due.

VI. Assignment of Life Policies

A life insurance policy is more than a proof of contract, it is a property. On the death of the insured, the legal representatives of the insured can collect the sum...
assured which forms part of the insured’s estate in the same way as any other debt due to the insured. The holder of a life policy can deal with it like any other property. He can sell it, assign or transfer it as a security for a loan, or give it away as a gift.

The assignment is the mode of transferring the rights of the transferor in respect of the policy to the assignee. A life policy, being an actionable claim, cannot be transferred by mere delivery like a personal chattel. It needs assignment for transfer. The rules relating to the assignment of life policies have been laid down in Section 38 of the Insurance Act, 1938.

It is important to note that a valid assignment is irrevocable and cannot be cancelled subsequently.

VII. Nomination by the Policy-Holder

The holder of a life policy on his own life has a statutory right to nominate any person to receive the policy money in the event of his death before the maturity of the policy. The person to be nominated is called the ‘nominee’. The insurer is bound to pay the policy money to the nominee in the event of the death of the insured. It is important to note that a nominee cannot be appointed to receive the sum assured when the policy is surrendered or in the event of the insured dying after the maturity of the policy. It is only in the event of death of the policy-holder before the maturity of the policy that the amount secured is payable to the nominee. During the lifetime of the policy-holder, he continues to have interest in the policy notwithstanding the nomination. It does not divest him of the rights in the policy and he retains disposing power over it.

The ‘nomination’ simply provides that the policy money is payable to the nominee and the insurer need not look to the legal representatives of the deceased insured. In D.M. Mudaliar vs Indian Insurance and Banking Corporation (1957), it was held that the nomination does no more than make the nominee a ‘receiver’ to receive the money from the insurer without deciding the question of title. In the absence of nomination, the payment of claim may be delayed due to involvement of legal proceedings. The claimant will have to present ‘succession certificate’ from a competent court of law which involves delay and expense. To avoid this delay and expense, nomination is usually preferred by the policy-holder.

It may be noted that only a holder of a policy of life insurance on his own life may make a nomination. The assignee or transferee of the policy cannot nominate. Further, in the case of a joint life policy, the insured persons cannot nominate because the amount thereunder is payable to the survivor(s) on the death of the first of the assured lives. In such a case, nomination can be made only to receive money in the event of simultaneous death of all the persons insured.

Section 39 of the Insurance Act, 1938, makes certain provisions regarding ‘nomination’ by a policy-holder:
8.3.4 Fire Insurance

The contracts of fire insurance are governed by the Insurance Act, 1938, (as amended up-to-date), the General Insurance Business (Nationalization) Act, 1972, and the Insurance Regulatory and Development Authority Act, 1999, besides the judicial decisions of courts in England and India. The General Insurance Business (Nationalization) Act, 1972, was passed to provide for the nationalization of fire insurance business in India. From 1 January, 1974 till 28 December, 1999, fire insurance business was transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act, and its four subsidiaries, namely, (i) National Insurance Company Ltd., Kolkata, (ii) the New India Assurance Company Ltd., Mumbai, (iii) the Oriental Fire and General Insurance Company Ltd., New Delhi, and (iv) the United India Fire and General Insurance Company Ltd., Chennai.

On and from the commencement of the “Insurance Regulatory and Development Authority Act, 1999”, (i.e., 29 December 1999), fire insurance business was thrown open to other Indian Insurance Companies as well and the monopoly of General Insurance Corporation of India and its four subsidiary Companies (as stated above) to carry on general insurance business came to an end.

The General Insurance Business (Nationalization) Amendment Act, 2002, seeks to delink the General Insurance Corporation of India (GICI) from its four subsidiaries (discussed above). The Amendment Act provides that the delinked four acquiring insurance companies will carry on general insurance business as usual but the GICI will cease to do general insurance business and it will carry on only re-insurance business.

Contract of Fire Insurance: ‘Fire insurance’ means insurance against any loss of or damage to property by fire. A contract of fire insurance is a contract whereby the insurer, in consideration of the premium paid, undertakes to indemnify the insured against financial loss which the latter may sustain by reason of certain defined subject-matter being damaged or destroyed by fire during a specified period, subject to the condition that the actual amount of indemnity will never exceed the amount of the policy.

Let us elaborate important aspects of a contract of fire insurance. These are as follows:

I. Characteristics of a contract of Fire Insurance

The main characteristics of a contract of fire insurance are:

1. It is a contract of indemnity. The insured suffering the loss in fire policy can only recover to the extent of the actual loss, so far as it does not exceed the sum insured.

2. It is a contract of utmost good faith, i.e., ‘uberrimae fidei’. The proposer is under an obligation to supply detailed information regarding the subject-
matter to be insured. He must disclose all material facts correctly and fully, otherwise the contract is voidable at the instance of the insurer.

3. It is a contract from year to year, and therefore, a fire insurance policy can be issued for a period of one year only.

4. The principles of 'subrogation' and 'contribution' apply to a contract of fire insurance.

5. It covers loss caused proximately by fire.

6. Unlike a life insurance policy, a fire policy does not carry any surrender value or paid-up value.

7. The assured must have insurable interest in the subject-matter, i.e., the property insured, both at the time of contract and at the time of loss. Unlike a life insurance contract, in a fire insurance contract insurable interest must also exist at the time of loss because it is a contract of indemnity and unless the assured or the assignee has interest in the property insured at the time of loss, he cannot be indemnified. There are certain cases that have been held to have an insurable interest.

II. Meaning of 'Fire' and 'Loss or Damage by Fire'

'Fire' within the meaning of a Fire Policy means fire which has broken bounds and is fortuitous in its nature. There must be actual ignition or burning, whether accidental or otherwise. Heating unaccompanied by ignition is not fire. So, unless there be actual ignition and the loss be proximately caused by such ignition, the insurers are not liable. Thus, where sugar was spoiled by great heat caused due to a ventilator in the chimney being closed, but there was not actual ignition, it was held that the assured could not recover (Austin vs Drewe). Similarly, the heat of the sun often contracts timber, but that would not be considered as loss by fire. If the heat was caused by actual ignition of premises where the sugar or timber was kept, the damage shall be deemed as 'damage by fire', although the subject-matter, namely the sugar or timber, has not been actually burnt. It is explained under causa proxima.

III. Causa proxima in fire insurance

The principle of causa proxima applies in fire insurance. If the proximate cause of loss or damage is fire, the loss is recoverable. The subject-matter of insurance need not have been burnt. Ignition (i.e., burning) must be of the goods insured or the premises where it is lying. The expression ‘loss or damage occasioned by fire’ means “loss or damage either by ignition of the article consumed, or by ignition of part of the premises where the article is: in the one case there is loss, in the other a damage, occasioned by fire”. Thus, where the ‘stock of medicines’ was insured against fire and there was ignition on the premises of the shop as a result of which most of the medicines were damaged because of excessive heat, it was taken to be a loss or damage caused by fire. Remember that if the medicines are spoiled by high heat of the sun, the damage shall not be deemed as ‘damage by fire’ as there
is no ignition. Hence, in order to cover a particular loss or damage under a Fire Policy, the following three things must be present:

(a) The loss or damage must relate to the subject-matter of policy;

(b) The loss or damage must be caused by ignition or fire; and

(c) The ignition must be either of goods insured or of the premises where it is placed.

It is to be noted that the cause of fire is immaterial for a fire insurance claim to be admitted. If the loss happens by fire, it is recoverable from the insurer, unless it is deliberately brought about by the assured himself or his agents, it matters not how the flame is kindled—whether it be the result of accident or design. Even if it is caused by the negligence of the assured or his servants, the insurer shall continue to be liable (Dudgeon vs Pembrake).

On the basis of judicial decisions the expression ‘loss or damage by fire’ also includes the loss or damage caused by efforts to extinguish fire with a view to mitigating the loss. Thus, the following losses are covered by fire insurance:

(a) Property damaged or goods spoiled by water used to extinguish the fire;

(b) Fire brigade destroying an adjacent house to prevent the progress of flames;

(c) Wages paid to persons engaged for extinguishing fire;

(d) Loss arising from efforts to avert damage by fire, e.g., removal of goods from the building where fire is raging. Even the damage caused by throwing furniture out of window is included.

The following types of losses, however, are not covered by a fire policy:

(i) Loss by theft during or after the occurrence of a fire.

(ii) Loss or damage to property by its own fermentation or spontaneous combustion, e.g., if a bomb is insured, which explodes itself because of inherent defect, the loss is not covered.

(iii) Loss caused by the burning of property by order of any public authority.

(iv) Loss caused by subterranean (underground) fire.

(v) Loss happening by fire which is caused by earthquake, war, invasion, act of foreign enemy, hostilities or warlike operations (whether war be declared or not), civil war, mutiny, riot, military or usurped power, martial law, and military rising.

In the above cases the insurer is not liable, unless specially provided for in the Policy.

Successive losses: In case of a fire policy for a fixed period, as is usual, the insurer is liable for successive losses, even if the total payment exceeds the policy amount. If partial loss is immediately followed by total loss, then only total loss can be recovered.
IV. Procedure for Effecting Fire Insurance

For taking out a fire policy, the proponent has to fill a proposal form, giving necessary description such as location, amount, age, nature of possession, etc., of the property. While filling up the proposal form, the proposer must observe utmost good faith and disclose all the material facts. On receiving the proposal form, the insurer assesses the risk to be insured. The property is fully inquired and examined by the surveyors who determine the degree of risk precisely. If the insurer thinks that the property is insurable, he gives his acceptance of the proposal subject to the payment of premium. The risk will commence only when the premium is paid. After the receipt of the premium, the insurer will issue a ‘cover note’ which is in the nature of an interim protection note and covers the property until the final policy has been issued. If loss occurs before the issue of policy, the ‘cover note’ will be sufficient to make the insurer liable for payment of the loss. Finally, a fire insurance policy duly stamped and containing the terms and conditions of insurance will be issued by the insurer to the assured.

8.3.5 Marine Insurance

The contracts of marine insurance are governed by the Insurance Act, 1938 (as amended up-to-date), the Marine Insurance Act, 1963, the General Insurance Business (Nationalization) Act, 1972, and the Insurance Regulatory and Development Authority Act, 1999. The main Act regulating the marine insurance business is the Marine Insurance Act, 1963, and references in this chapter are to that Act, unless otherwise stated.

The marine insurance business was nationalized through the General Insurance Business (Nationalization) Act, 1972. From 1 January, 1974 till 28 December, 1999, marine insurance business was transacted only by the General Insurance Corporation of India (GICI), formed in accordance with the aforementioned Act, and its four subsidiaries, namely, (i) National Insurance Co. Ltd., Kolkata, (ii) the New India Assurance Co. Ltd., Mumbai, (iii) the Oriental Fire and General Insurance Co. Ltd., New Delhi, and (iv) the United India Fire and General Insurance Co. Ltd., Chennai.

From the commencement of the Insurance Regulatory and Development Authority Act, 1999, marine insurance business was thrown open to other India Insurance Companies as well and the monopoly of General Insurance Corporation of India and its four subsidiary companies (stated above) to carry on General Insurance business came to an end.

The General Insurance Business (Nationalization) Amendment Act, 2002, seeks to delink the General Insurance Corporation of India (GICI) from its four subsidiaries (stated above). This Act provides that the delinked four acquiring insurance companies will continue to carry on general insurance business (including marine insurance) as usual but the GICI will cease to do general insurance business and it will carry on re-insurance business only.
Insurance

NOTES

Contract of Marine Insurance: A 'contract of marine insurance' is a contract whereby the insurer (also called the underwriter) undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against Marine losses, that is to say, the losses incidental to marine adventure (Sec. 3). The contract may also, by its express terms, or by usage of trade, be extended so as to protect the assured against losses on inland waters or on any land risk which may be incidental to any sea voyage [Sec. 4(1)].

Let us discuss some essential aspects of Marine Insurance. These are as follows:

I. Subject-matter of a Contract of Marine Insurance

Every lawful marine adventure may be the subject-matter of a contract of marine insurance (Sec. 5). Thus, marine insurance may be effected in relation to all such interests which are exposed to maritime perils. The more popular types of marine insurance are as follows:

1. Hull insurance: Insurance of vessel and its equipment (i.e., furniture and fittings, machinery, tools, coal and engine stores etc.) are included in hull insurance. The owner of a ship may affect hull insurance.

2. Cargo insurance: The insurance of cargo includes goods and merchandise and not the personal belongings of the crew and passengers.

3. Freight insurance: In many instances, under the terms of contract, the shipping company is unable to earn freight, whether paid in advance or otherwise, if the cargoes are not safely transported. As such, if the cargoes are destroyed or the ship is lost on the way, the shipping company loses the freight. To guard against such an eventuality, the shipping company may affect freight insurance.

4. Liability insurance: Liability insurance includes liability to a third party by reason of hazards like collision, etc.

It is necessary to specify with certainty the subject-matter insured in a contract of marine insurance. The marine policy may cover the ship or the cargoes or the same policy may cover the ship, cargoes, freight and liability.

II. Maritime Perils

As observed earlier, marine insurance policies protect the assured against maritime perils. According to Section 2(e), "maritime perils mean the perils consequent on, or incidental to, the navigation of the sea, that is to say, perils of the seas, fire, war perils, pirates and rovers, thieves, captures, seizures, restraints and detainments of princes and peoples, jettisons, barratry, and any other perils which are either of the like kind or may be specified by the policy."

It is to be noted that the term 'perils of the seas' refers only fortuitous accidents or casualties of the seas. It does not include the ordinary wear and tear, e.g., bursting of boiler or breakage of shaft because of inevitable action of the winds and waves. By the implied warranty of 'seaworthiness', it is understood
that a ship will be in such a condition as to withstand the ordinary waves and winds, and therefore, if the ship is sunk because of unseaworthiness (e.g., defective boiler and machinery) at the commencement of voyage, the peril is not a sea peril and the insurer is not liable for any such loss. On the other hand, the ship owner shall be liable to compensate the insurer, for any moneys payable to cargo owners, whose cargoes might have been damaged. ‘Perils of the seas usually relate to casualties which might occur, and not to those which must occur’.

III. The Marine Policy

The instrument embodying the terms and conditions on which the contract of marine insurance is entered into between the insurer and the assured is called a marine policy. It is a must for a valid contract of marine insurance. It may be executed and issued either at the time when the contract is concluded, or afterwards (Sec. 24). A contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer, whether the policy be then issued or not; and for the purpose of showing when the proposal was accepted, reference may be made to the ‘slip’, ‘covering note’ or other customary memorandum of the contract, although it be unstamped (Sec. 23).

A marine policy must specify the following:

(i) The name of the assured, or of some person who effects the insurance on his behalf;
(ii) The subject-matter insured and the risk insured against;
(iii) The voyage, or period of time, or both, as the case may be, covered by the insurance;
(iv) The sum or sums insured; and
(v) The name or names of the insurer or insurers (Sec. 25).

A marine policy must be signed by or on behalf of the insurer. Where it is subscribed by or on behalf of two or more insurers, each subscription, unless the contrary be expressed, constitutes a distinct contract with the assured (Sec. 26). The subject-matter insured must be specified in the policy with reasonable certainty. However, the nature and extent of the interest of the assured in the subject-matter insured need not be specified in the policy (Sec. 28). The policy must also be duly stamped under the Stamp Act.

IV. Characteristics of Marine Insurance Contracts

The characteristics of a contract of marine insurance are as follows:

1. It is a contract of indemnity (except in the case of a “valued policy”) under which the assured can recover only the amount of actual loss, if any, suffered by him subject to the limit of the insured amount.

2. It is a contract based upon the utmost good faith (i.e., a contract uberrimae fidei), and if the utmost good faith be not observed by either party, the contract may be avoided by the other party (Sec. 19). The assured must
disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known to him. If the assured fails to make such disclosure, the insurer may avoid the contract (Sec. 20).

3. The doctrine of ‘subrogation’ and ‘contribution’ apply to a contract of marine insurance.

4. A marine policy is invariably subject to the ‘average clause’.

5. All marine insurance contracts are subject to certain “express and implied warranties.”

6. In a marine insurance contract, the assured must have insurable interest in the subject-matter insured at the time of the loss, though he may not have insurable interest when the insurance is effected (Sec. 8).

Check Your Progress

3. What do you mean by a contract of insurance?
4. What is doctrine of contribution?
5. What does surrender value denote?
6. Which Acts govern the Fire Insurance business?
7. What is Marine Policy?

8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. General Insurance business means fire, marine or miscellaneous insurance business. Items like employers’ liability insurance, burglary insurance, fidelity guarantee insurance, livestock insurance, crop insurance, motor vehicles insurance, etc., fall under Miscellaneous Insurance business category.

2. Items like employers’ liability insurance, burglary insurance, fidelity guarantee insurance, livestock insurance, crop insurance, motor vehicles insurance, etc., fall under Miscellaneous Insurance business category.

3. A contract of insurance is a contract whereby one party undertakes, in return of a consideration called premium, to pay to the other party a certain sum of money on the happening of a certain event (death or attainment of a certain age) or to indemnify the other party against a loss arising from the risk insured (in case of property).

4. Like the doctrine of subrogation, the doctrine of contribution also applies only to contracts of indemnity, i.e., to fire and marine insurances. The doctrine of contribution states: ‘in case of double insurance all insurers must share
the burden of payment in proportion to the amount assured by each. If an insurer pays more than his rateable proportion of the loss, he has a right to recover the excess from his co-insurers, who have paid less than their rateable proportion.

5. The ‘surrender value’ denotes that value or consideration which the insurer is prepared to pay at any particular time during the currency of the policy, after it has run for a specified period, in total discharge of the contract, in case the assured wishes to surrender his policy and extinguish his claim upon it. In brief, the surrender value is the cash value of the policy which is payable to the policy-holder if he decides to terminate the contract.


7. The instrument embodying the terms and conditions on which the contract of marine insurance is entered into between the insurer and the assured is called a marine policy. It is a must for a valid contract of marine insurance. It may be executed and issued either at the time when the contract is concluded, or afterwards.

8.5 SUMMARY

- Recognizing the huge potential of the insurance market and the need to make insurance, particularly life insurance, available on a wider scale, the Government opened the insurance sector to private companies. Accordingly, the Insurance Regulatory and Development Authority Act, 1999, was enacted, which has been made effective from 29 December, 1999.

- A contract of insurance is a contract whereby one party undertakes, in return of a consideration called premium, to pay to the other party a certain sum of money on the happening of a certain event (death or attainment of a certain age) or to indemnify the other party against a loss arising from the risk insured (in case of property).

- From 1 September, 1956 till 28 December, 1999, life insurance business was carried on exclusively by the Life Insurance Corporation of India, formed and governed by the Life Insurance Corporation Act, 1956. After commencement of the “Insurance Regulatory and Development Authority Act, 1999”, (i.e., 29 December, 1999), life insurance business was thrown open to other Indian Insurance Companies as well and the monopoly of the Life Insurance Corporation of India came to an end.

- The holder of a policy of life insurance on his own life may, when effecting the policy or at any time before the policy matures for payment, nominate a...
person to whom the amount secured by the policy shall be paid in the event of his death.

- ‘Fire insurance’ means insurance against any loss of or damage to property by fire. A contract of fire insurance is a contract whereby the insurer, in consideration of the premium paid, undertakes to indemnify the insured against financial loss.


- The instrument embodying the terms and conditions on which the contract of marine insurance is entered into between the insurer and the assured is called a marine policy. It is a must for a valid contract of marine insurance.

8.6 KEY WORDS

- **Endowment policy**: This is a life insurance contract designed to pay a lump sum after a specific term or on death. Typical maturities are ten, fifteen or twenty years up to a certain age limit. Some policies also pay out in the case of critical illness. Policies are typically traditional with-profits or unit-linked.

- **Seaworthiness**: This is a concept that runs through maritime law in at least four contractual relationships. In a marine insurance voyage policy, the assured warrants that the vessel is seaworthy.

- **Subrogation principle**: Legal principle under which an insured party surrenders its rights against a third party to the insurer after claiming and receiving a compensation for an insured loss.

- **Causa proxima**: The term means ‘the immediate cause,’ ‘the proximate cause’. It is a rule of law that in actions on fire policies, full regard must be had to the causa proxima.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on various types of insurance business.
2. Write in brief about the nature of a contract of insurance.
3. Write a short note on the role of the Life Insurance Corporation of India (LICI).
4. Write a brief note on characteristics of a contract of Fire Insurance.
5. Write a short note on *causa proxima* in fire insurance.
6. Write a brief note on the concept of ‘Maritime Perils’.

**Long-Answer Questions**

1. Discuss the evolution of insurance business in India in recent times.
2. Enumerate the legal principles which govern insurance in India.
3. Analyse the main objectives and purpose of the IRDA Act, 1999.
4. Discuss in detail the fundamental principles of insurance contract.
5. Discuss the types of losses which are not covered by a fire policy.
6. Analyse the significance of the Marine Policy in marine insurance contract.

**8.8 FURTHER READINGS**

BLOCK - III
IIPR AND IT

UNIT 9 INDIAN PARTNERSHIP ACT, 1932

Structure
9.0 Introduction
9.1 Objectives
9.2 Meaning and Test of Partnership
  9.2.1 Essential Elements of Partnership
  9.2.2 Test of Partnership
  9.2.3 Formation and Registration of Firms
9.3 Life Insurance Corporation Act, 1956
  9.3.1 General Insurance Business Nationalization Act, 1973
  9.3.2 Functions of Corporation
  9.3.3 Functions of Acquiring Companies
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions And Exercises
9.8 Further Readings

9.0 INTRODUCTION

Provisions of partnership like partnership deed, formation and registration of firms are incorporated in Indian Partnership Act, 1932. Section 4 of the Act defines ‘partnership’ as ‘relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all’. A contract is the very foundation of partnership; it does not arise from status, operation of law or inheritance. Only persons competent to contract can enter into a contract of partnership. A partnership firm, since it is not recognized as a legal person having a separate entity from that of partners, cannot enter into contract of partnership with another firm or individuals.

The partnership must aim to make profits because then only profits may be divided among the partners. The successful working of a partnership depends upon mutual confidence and utmost good faith among the partners because each partner is an agent of others and binds them to the fullest extent of their fortunes. The document in which the respective rights and obligations of the members of a partnership are set forth is called a ‘partnership deed’.

A firm is merely a collective name of the individuals composing it. Hence, unlike a company which is a separate legal entity distinct from its members, a firm cannot possess property or employ servants. Under the Partnership Act, it is not
compulsory for every partnership firm to get itself registered, but an unregistered firm suffers from a number of disabilities. The Register of Firms maintained at the Registrar of Firms’ office contains complete and up-to-date information about each registered firm regarding all matters likely to affect the interests of those persons who propose to deal with the firm.

This unit aims at analysing the framework for the formation and registration of partnership and firms. It also elaborates the Acts which govern Life Insurance and General Insurance Business Nationalization.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the enactment of Indian Partnership Act, 1932
- Analyse the meaning and test of partnership
- Learn the essential elements of partnership
- Explain the difference between partnership and company
- Know the registration of firms
- Analyse Life Insurance Corporation Act, 1956
- Understand General Insurance Business Nationalization Act, 1973

9.2 MEANING AND TEST OF PARTNERSHIP

The law of partnership is contained in the Indian Partnership Act, which came into force on 1 October, 1932. The Act doesn’t deal with Section 69 (the effect of non-registration of firms, which came into force on 1 October, 1933). Since partnership comes into existence only by a contract between the parties for the purpose, the provisions of the Indian Contract Act, except when they are inconsistent with the express provisions of the Partnership Act, continue to apply to partnership firms (Sec. 3). Section 4 of the Indian Partnership Act, 1932 defines ‘partnership’ in the following terms:

‘Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all’.

9.2.1 Essential Elements of Partnership

There are five elements which constitute a partnership. These are: (1) there must be a contract; (2) between two or more persons; (3) who agree to carry on a business; (4) with the object of sharing profits; and (5) the business must be carried on by all or any of them acting for all (i.e., there must be mutual agency).

All the above elements must coexist in order to constitute a partnership. If any of these is not present, there cannot be a partnership. We now discuss these elements one by one:
1. **Contract**: Partnership is the result of a contract. It does not arise from status, operation of law or inheritance. Thus at the death of father, who was a partner in a firm, the son can claim share in the partnership property but cannot become a partner unless he enters into a contract for the same with other persons concerned. Similarly, the members of Joint Hindu Family carrying on a family business cannot be called partners for their relation arises not from any contract but from status. To emphasize the element of contract, Section 5 expressly provides that 'the relation of partnership arises from contract and not from status'.

Thus a 'contract' is the very foundation of partnership. It may, however, be either express or implied. Again, it may be oral or in writing (*Laxmibai vs Roshan Lap*).

2. **Association of two or more persons**: Since partnership is the result of a contract, at least two persons are necessary to constitute a partnership. The Partnership Act does not mention anything about the maximum number of persons who can be partners in a partnership firm but Section 11 of the Companies Act, 1956, lays down that a partnership consisting of more than 10 persons for banking business and 20 persons for any other business would be illegal. Hence, these should be regarded as the maximum limits to the number of partners in a partnership firm.

Only persons competent to contract can enter into a contract of partnership. Persons may be natural or artificial.

3. **Carrying on of business**: The third essential element of a partnership is that the parties must have agreed to carry on a business. The term 'business' is used in its widest sense and includes every trade, occupation or profession (Sec. 2(A)). If the purpose is to carry on some charitable work, it will not be a partnership. Similarly, if a number of persons agree to share the income of a certain property or to divide the goods purchased in bulk among themselves, there is no partnership and such persons cannot be called partners because in neither case they are carrying on a business.

4. **Sharing of profits**: This essential element provides that the agreement to carry on business must be with the object of sharing profits among all the partners. Impliedly the partnership must aim to make profits because then only profits may be divided among the partners. Thus, there would be no partnership where the business is carried on with a philanthropic motive and not for making a profit or where only one of the partners is entitled to the whole of the profits of the business. The partners may, however, agree to share profits in any ratio they like.

   i. **Sharing of losses not necessary**: To constitute a partnership it is not essential that the partners should agree to share the losses (*Raghunandan vs Harmasjee*). It is open to one or more partners to agree to bear all the losses of the business. The Act, therefore, does not seek to make agreement to share losses a test of the existence of
partnership. Section 13(A), however, provides that the partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm, unless otherwise agreed. Thus sharing of losses may be regarded as consequential upon the sharing of profits and where nothing is said as to the sharing of losses, an agreement to share profits implies an agreement to share losses as well. It must be noted that even though a partner may not share in the losses of the business, yet his liability vis-à-vis outsiders shall be unlimited because there cannot be ‘limited partnerships’ in our country under the Partnership Act.

ii. Sharing of profits not conclusive test: Although sharing of profits is an evidence of partnership, this is not the conclusive test of partnership. There may be persons sharing the profits of a business but who do not by that reason become partners. In this respect, Explanation II to Section 6 clearly states: ‘The receipt by a person of a share of the profits of a business, or of a payment contingent upon the earning of profits or varying with the profits earned by a business, does not of itself make him a partner with the persons carrying on the business; and, in particular, the receipt of such share or payment:

(a) By a lender of money to persons engaged or about to engage in any business,
(b) By a servant or agent as remuneration,
(c) By a widow or child of a deceased partner as annuity, or
(d) By a previous owner or part-owner of the business as consideration for the sale of the goodwill or share thereof, does not of itself make the receiver a partner, with the persons carrying on the business’.

The question whether a person sharing profits of a business is a partner or not depends upon the real relation between the parties, as shown by all relevant facts taken together (Sec. 6).

5. Mutual agency: The fifth element in the definition of a partnership provides that the business must be carried on by all the partners or any (one or more) of them acting for all, that is, there must be mutual agency. Thus every partner is both an agent and principal for himself and other partners, i.e., he can bind by his acts the other partners and can be bound by the acts of other partners in the ordinary course of business. To test whether a person is a partner or not, it should be seen, among other things, whether or not the element of agency exists, i.e., whether the business is conducted on his behalf. It is on the basis of this test that a widow of a deceased partner or a manager having a share in the profits is not a partner, because business is not carried on, on the widow or the deceased behalf. If she or he does something the firm is not legally bound by that.
9.2.2 Test of Partnership

From the above discussion of various elements of partnership, it is clear that there is no single test of partnership. For example, in one case there may be sharing of profits but may not be any business; in the other case, there may be business but there may not be sharing of profits and, in yet another case, there may be both business and sharing of profits but the relationship between persons sharing the profits may not be that of principal and agent. In the above cases, there is no partnership. All the essential elements mentioned before must co-exist in order to constitute a partnership. To emphasize this fact, Section 6 expressly provides that ‘in determining whether a group of persons is or is not a firm or whether a person is or is not a partner in a firm, regard shall be had to the real relation between the parties, as shown by all relevant facts taken together’.

Partners, Firm and Firm Name

Persons who have entered into partnership with one another are called individually ‘partners’ and collectively a ‘firm’ and the name under which their business is carried on is called the ‘firm name’ (Sec. 4).

A ‘firm’ is not a separate legal entity distinct from its members. It is merely a collective name of the individuals composing it. Hence, unlike a company which is a separate legal entity distinct from its members, a firm cannot possess property or employ servants, neither can it be a debtor nor a creditor. It cannot sue or be sued by others. It is only for the sake of convenience that in commercial usage terms like ‘firm’s property’, ‘employee of the firm’, ‘suit against the firm’ and so on are used, but in the eye of law that simply means ‘property of the partners’, ‘employee of the partners’ and ‘a suit against the partners’ of that firm. It is relevant to state that for the purposes of the Income Tax Act, a partnership firm is an entity quite distinct from the partners composing it and is assessable separately.

The partners are free to choose any name for the firm subject to the following rules:

1. The name must not be too identical or similar to the name of another existing firm doing similar business so as to lead to confusion (Havana Cigars Factories Ltd. vs Oddenino). The reason for this rule being that the reputation or goodwill of a firm may be injured, if a new firm could adopt an allied name.

2. The name must not contain words like Crown, Emperor, Empress, Empire, Imperial, King, Queen, Royal, or words expressing or implying the sanction, approval or patronage of Government except when the State Government signifies its consent to the use of such words as part of the firm name by order in writing [Sec. 58(3)].
9.2.3 Formation and Registration of Firms

In this section, we will discuss the formation and registration of a partnership and partnership deed.

1. Formation of Partnership

We know that a partnership may be formed by oral or by written agreement or agreement of partnership can be inferred from the conduct of the parties. The following basic facts must be borne in mind by the persons desirous of entering into an agreement of partnership:

1. The successful working of a partnership depends upon mutual confidence and utmost good faith among the partners.
2. All the essential elements of a valid contract must be present.
3. The mutual rights and obligations of partners must be discussed in detail and should be put in black and white in the shape of a ‘partnership deed’, before the partnership is actually started.
4. The partnership should be registered as soon as it is formed with the Registrar of Firms of the area. In the absence of registration, the firm will not be able to enforce its legal remedies against outsiders, and the partners also cannot enforce the conditions laid down in the ‘partnership deed’ through a court of law.

a. Partnership Deed

The document in which the respective rights and obligations of the members of a partnership are set forth is called a ‘partnership deed’. It should be drafted with care and be signed by all the partners. It must be stamped in accordance with the Indian Stamp Act. Each partner should have a copy of the Deed. The firm should be registered and copy of the Deed should be filed at the time of registration with the Registrar of Firms because in the absence of such registration partners cannot enforce the conditions laid down in the Deed through a court of law.

b. Duration of Partnership

From the duration point of view, the partnerships may be classified into the following two categories:

1. Partnership at will: Where no provision is made by contract between the partners for the duration of their partnership or for the determination of their partnership, the partnership is ‘partnership at will’ (Sec. 7). Thus, the essence of a ‘partnership at will’ is that the partners do not fix any term of partnership and are free to break their relationship at their sweet will. It is a partnership for an indefinite period. Such a partnership may be dissolved by any partner by giving a notice to that effect to all the other partners [Sec. 43(1)]. It may be noted that if this freedom to dissolve the firm at will is curtailed by agreement, say, if the agreement provides that the partnership
can be dissolved by mutual consent of all the partners only, it will not constitute a ‘partnership at will’.

2. **Particular partnership:** When a partnership is formed for a particular period or for a specific venture, e.g., for working a coal mine or producing a film, it is called a ‘particular partnership’ (Sec. 8). In such a case, the partnership is automatically dissolved at the expiry of the fixed term or on the completion of the venture (Sec. 42). Before such time the partnership would not be dissolved unless all the partners agree to it (Sec. 40). If the partners decide to continue such a partnership even after the expiry of the fixed term or the completion of the specific venture then it becomes a ‘partnership at will’.

c. **Kinds of Partners**

There may be various types of partners in a partnership firm. These are as follows:

1. **Active or actual partners:** Partners who take an active part in the conduct of the partnership business are called ‘actual’ or ‘ostensible’ partners. They are full-fledged partners in the real sense of the term. Such a partner must give public notice of his retirement from the firm in order to free himself from liability for acts after retirement.

2. **Sleeping or dormant partners:** Sometimes, however, there are persons who merely put in their capital (or even without capital they may become partners) and do not take active part in the conduct of the partnership business. They are known as ‘sleeping’ or ‘dormant’ partners. They do share profits and losses (usually less than proportionately), have a voice in management, but their relationship with the firm is not disclosed to the general public. They are liable to the third parties for all acts of the firm just like an undisclosed principal. They are, however, not required to give public notice of their retirement from the firm.

3. **Silent partners:** Those who by agreement with other partners have no voice in the management of the partnership business are called ‘silent’ partners. They share profits and losses, are fully liable for the debts of the firm and may take active part in the conduct of the business.

4. **Partner in profits only.** A partner who has stipulated with other partners that he will be entitled to a certain share of profits, without being liable for the losses, is known as a ‘partner in profits only’. As a rule such a partner has no voice in the management of the business. However, his liability vis-a-vis third parties will be unlimited because in India we cannot have ‘limited partnership’.

5. **Sub-partner.** When a partner agrees to share his share of profits in a partnership firm with an outsider, such an outsider is called a ‘sub-partner’. Such a sub-partner has no rights against the firm nor is he liable for the debts of the firm.
6. **Partner by estoppel or holding out (Sec. 28):** If a person represents to the outside world by words spoken or written or by his conduct or by lending his name, that he is a partner in a certain partnership firm, he is then estopped from denying his being a partner, and is liable as a partner in that firm to anyone who has on the faith of such representation granted credit to the firm.

It is to be emphasized that in order to entitle a person to bring an action under the doctrine of holding out, it must be shown that he acted on the faith of the representation while giving credit to the firm. It does not matter whether the person representing himself, or represented to be a partner, does or does not know that the representation has reached the other person so giving credit. But a person who knows nothing about the representation or who knows but does not believe it or who knows about it subsequently cannot take advantage of this doctrine and make the supposed partner liable as a partner (Juggilal Kamalapat vs Shiv Chand Bagree).

d. **Minor Admitted to the Benefits of Partnership**

Partnership is based on mutual contract and, therefore, only those who possess the capacity to contract can be partners in a partnership firm. According to the Indian Contract Act, an agreement by a minor is void *ab initio* as against him but he can derive benefit under it. As such a minor cannot be a full-fledged partner, he can at most be admitted to the benefits of a partnership. Section 30 of the Partnership Act thus provides that though a minor cannot be a partner in a firm, but, with the consent of all the partners for the time being, he may be admitted to the benefits of partnership by an agreement executed through his guardian with the other partners.

II. **Registration of Firms**

Prior to the passing of the Indian Partnership Act, 1932, there was no provision for the registration of partnership firms in India. As a result it was difficult for a third person to prove the existence of partnership and make his claim against all the members of the firm. Whenever the question of partners’ liability arose, they did not hesitate to deny their membership of the partnership in question. As such there was a demand for compulsory registration, as prevalent in England, so that necessary particulars regarding the constitution of the firm could be made available to those who may be dealing with the firm.

In view of the very large number of small partnership firms working in India, where registration may not produce much public benefit, the present Act has made the registration *optional* entirely at the discretion of partners. Under the Partnership Act, it is *not compulsory* for every partnership firm to get itself registered, but an unregistered firm suffers from a number of disabilities. In practice, therefore, few partnerships would deem it advisable to remain unregistered.
i. **Time of registration**: Registration may take place *at any time* during the continuance of the partnership firm. Where the firm intends to institute a suit in a court of law to enforce rights arising from any contract, registration must be effected before the suit is instituted otherwise the court shall not entertain the suit. Registration may also be effected even after a suit has been filed by the firm, but in that case it is necessary to withdraw the suit, get the firm registered and then file a fresh suit. Registration of the firm subsequent to the institution of the suit cannot by itself cure the defect.

ii. **Procedure of registration (Sec. 58)**: The procedure of registration is very simple. An application in the prescribed form along with the prescribed fee has to be submitted to the Registrar of Firms of the State where business of the firm is situated or proposed to be situated. The application or statement must be signed by all the partners, or by their agents especially authorized in this behalf, and must contain the following particulars:
   1. The name of the firm.
   2. The place or principal place of business of the firm.
   3. The names of any other places where the firm carries on business.
   4. The date when each partner joined the firm.
   5. The names in full and permanent addresses of the partners.
   6. The duration of the firm.

When the Registrar is satisfied that the above provisions have been duly complied with, he shall record an entry of the statement in a register called the Register of Firms, and shall file the statement (Sec. 59). This completes the procedure of registration.

(a). **Change of particulars**: With a view to keep the Registrar of Firms posted with up-to-date information regarding the firm, if any change takes place in any of the particulars given above, it should be notified to the Registrar, who shall thereupon incorporate the necessary change in the Register of Firms. Further, the Registrar should also be informed when any partner ceases to be a partner by retirement, expulsion, insolvency or death, or when a new partner is admitted or a minor, having been admitted, elects to become or not to become a partner, or when the firm is dissolved. (Sections 60–63).

(b). **Penalty for false particulars**: If any person knowingly or without belief in its truth signs any statement, amending statement, notice or intimation containing false or incomplete information to be supplied to the Registrar, he shall be punishable with imprisonment which may extend to three months, or with fine, or with both. (Sec. 70).

iii. **Effects of non-registration (Sec. 69)**: An unregistered firm and its partners suffer from the following disabilities:
   1. No suit in a civil court by a partner against the firm or other co-partners:
      If any dispute arises among the partners or between a partner and the
firm or between a partner and ex-partners, and the dispute is based
upon the rights arising from contract (i.e., partnership deed) or upon
the rights conferred by the Partnership Act, then a partner of an
unregistered firm cannot institute a suit to settle such disputes. However,
criminal proceedings can be brought by one partner against the other(s).
Thus, if a partner steals the property of the firm or sets fire to the
buildings of the firm, any partner can prosecute him for the same.

2. No suit in a civil court by firm against third parties: An unregistered
firm cannot file a suit against a third party, if it so becomes necessary,
to enforce any right arising from contract, e.g., for the recovery of the
price of goods supplied. Of course, criminal proceedings can be
brought against the wrong doers. It may be noted that a suit by a third
party against the firm or its partners is not prohibited, it is only a suit
by the firm, and that too arising out of a contract, against a third party
which is prohibited.

3. The firm or its partners cannot make a claim of set-off or other
proceeding based upon a contract: The above two disabilities also
apply to a claim of set-off or other proceeding to enforce a right
arising from a contract. Thus, if a third party sues the firm to recover
a sum of money, the firm cannot claim a set-off, i.e., the firm cannot
say that the third party also owes some money to the firm and the
same should be adjusted against the claim in question. Similarly, if an
unregistered firm institutes a suit for the reduction of rent against its
landlord, such a suit is not maintainable because the suit falls under the
disability relating to ‘other proceeding’ to enforce a right arising from
a contract (Gappulal Gordhandas vs Chunilal Shyamla).

Exceptions: Non-registration of a firm does not, however, affect the
following rights, namely:

1. The right of third parties to sue the firm or any partner.
2. The right of partners to sue for the dissolution of the firm or for the
accounts of a dissolved firm or for the realisation of the property of a
dissolved firm (i.e., for claiming share of the assets of a dissolved firm
or for recovering money from firm’s debtors).
3. The power of an Official Assignee or Receiver or the Court, as the
case may be, to realise the property of an insolvent partner and to
bring an action therefore, if necessary, on behalf of the insolvent.
4. The rights of firm or partners of firm having no place of business in
India.
5. The right to sue or claim a set-off if the value of suit does not exceed
‘ 100 in value.

It may be mentioned that registration of firms from income-tax point of
view is different from the registration of firms discussed above. For the
purpose of assessment of income-tax separate registration with the income-tax department is needed. However, this is also optional.

iv. Registrar of firms: The Register of Firms maintained at the Registrar of Firms’ office contains complete and up-to-date information about each registered firm regarding all matters likely to affect the interests of those persons who propose to deal with the firm. The Registrar is empowered to rectify any mistake in the Register of Firms (Sec. 64). The Registrar is bound to amend the entry in the Register, if so directed by the Court as a consequence of its decision relating to a matter concerning the registered firm (Sec. 65). The Register of Firms shall be open to inspection by any person on payment of the prescribed fee (Sec. 66). The Registrar is bound to supply on demand, on payment of the prescribed fee, a copy of any entry in the Register of Firms (Sec. 67). The Register of Firms is a conclusive proof of the truth of the matters contained therein as against the parties signing the statements on the basis of which the Register is prepared. The third party, however, is allowed to challenge the fact of a statement and prove that it is false (Sec. 68). As such if a person’s name does not appear in the Register of Firms as a partner, the third party may prove that he is a partner in the firm.

v. Property of the firm: Section 14 provides that subject to contract between the partners, the property of the firm includes all property and rights and interest in property originally brought into the stocks of the firm, or acquired by purchase or otherwise, by or for the firm, or for the purpose and in the course of the business of the firm, and includes also the goodwill of the business. If a partner brings in immovable property as his share of capital in the firm, that becomes the property of the firm even without a formal document of transfer in the name of the partnership firm. Similarly, property purchased with the partnership money is deemed to be the property of the firm even if a partner purchases that in his own name, unless a contrary intention appears from the conduct of the partner concerned.

9.3  LIFE INSURANCE CORPORATION ACT, 1956

9.3.1 General Insurance Business Nationalization Act, 1973

We have already learnt about the Act in Unit 8. Let’s recapitulate the gist of the Act here.

Although Life Insurance was nationalized as early as 1956, general insurance business continued to be in the private sector right up to 1969. In that year the Government imposed strict social control on General Insurance Companies. This was a prelude to nationalization of General of General Insurance Business. With effect from 13th May, 1971 under the provisions of General Insurance (Emergency
Provisions) Act, 1971, the Government of India took over the management of all General Insurance companies operating in India whether they belonged to Indian or non-Indian shareholders. Subsequently, the General Insurance (Emergency Provisions) Amendment Act, 1971 was passed withdrawing certain rights of the Directors and Members of the Companies, which they were enjoying under the Companies Act. General Insurance (Nationalization) Act, 1972 shortly followed and with effect from 2nd January, 1973, the provisions of the Act became effective. The functions of the Corporation are enumerated in Section 18 of the Act. Some of these functions are as follows:

9.3.2 Functions of Corporation

(1) The functions of the Corporation shall include:
   (a) The carrying on of any part of the general insurance business, if it thinks it desirable to do so
   (b) Aiding, assisting and advising the acquiring companies in the matter of setting up of standards of conduct and sound practice in general insurance business and in the matter of rendering efficient services to holders of policies of general insurance
   (c) Advising the acquiring companies in the matter of the controlling their expenses including the payment of commission and other expenses
   (d) Advising the acquiring companies in the matter of the investment of their funds
   (e) Issuing directions to acquiring companies in relation to the conduct of general insurance business

(2) In issuing any directions under sub-section (1), the Corporation shall keep in mind the desirability of encouraging composition amongst the acquiring companies as far as possible in order to render their services more efficient.

9.3.3 Functions of Acquiring Companies

(1) Subject to the rules, if any, made by the Central Government in this behalf and to its memorandum and articles of association, it shall be the duty of every acquiring company to carry on general insurance business.

(2) Each acquiring company shall so function under this Act as to secure that general insurance business is developed to the best of the community.

(3) In the discharge of any of its functions, each acquiring company shall act so far as may be on business principles and where any directions have been issued by the Corporation shall be guided by such directions.

(4) For the removal of doubts, it is hereby declared that the Corporations and any acquiring company may, subject to the rules, if any, made by the Central Government in this behalf, ‘enter into such contracts of reinsurance treaties as it may think fit for the protection of its interests’.
Under Sec. 35, the Central Government may by notification specify the application of the provision of the Insurance Act with such modifications which are deemed necessary to the Corporation and the acquiring companies. The Central Government is also empowered to make rules to carry out the provisions of the Act and such rules may provide for:

(a) Manner in which the profits and other moneys received by the Corporation may be dealt with

(b) The conditions subject to which the Corporation and the acquiring companies shall carry on general insurance business

(c) The terms and conditions subject to which any re-insurance contract or treaties may be entered into

(d) Form and manner in which any notice or application may be made to the Central Government

(e) The reports which may be called for by the Central Government from the Corporation and acquiring companies

(f) Any other matter which is required to be or may be prescribed

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. There are five elements which constitute a partnership. These are: (1) there must be a contract; (2) between two or more persons; (3) who agree to carry on a business; (4) with the object of sharing profits; and (5) the business must be carried on by all or any of them acting for all (i.e., there must be mutual agency).

2. Those who by agreement with other partners have no voice in the management of the partnership business are called ‘silent’ partners. They share profits and losses, are fully liable for the debts of the firm and may take active part in the conduct of the business.

3. The Registrar is empowered to rectify any mistake in the Register of Firms (Sec. 64). The Registrar is bound to amend the entry in the Register, if so directed by the Court as a consequence of its decision relating to a matter concerning the registered firm (Sec. 65). The Register of Firms shall be open to inspection by any person on payment of the prescribed fee (Sec.}
66). The Registrar is bound to supply on demand, on payment of the
prescribed fee, a copy of any entry in the Register of Firms (Sec. 67).

4. Life Insurance was nationalized in 1956.

9.5 SUMMARY

- There are five elements which constitute a partnership. These are: (1) there
  must be a contract; (2) between two or more persons; (3) who agree to
  carry on a business; (4) with the object of sharing profits; and (5) the business
  must be carried on by all or any of them acting for all (i.e., there must be
  mutual agency).

- Persons who have entered into partnership with one another are called
  individually ‘partners’ and collectively a ‘firm’ and the name under which
  their business is carried on is called the ‘firm name’ (Sec. 4).

- A partnership is governed by the provisions of the Indian Partnership Act,
  1932. A joint Hindu family business is governed by the principles of Hindu
  law.

- A partnership firm can be wound up at any time by any partner, if it is ‘at
  will’, without legal formalities. In the case of a company, no one member
  can wind it up ‘at will’ and winding up involves legal formalities.

- The document in which the respective rights and obligations of the members
  of a partnership are set forth is called a ‘partnership deed’. It should be
  drafted with care and be signed by all the partners. It must be stamped in
  accordance with the Indian Stamp Act.

- It is to be emphasized that in order to entitle a person to bring an action
  under the doctrine of holding out, it must be shown that he acted on the faith
  of the representation while giving credit to the firm.

- Prior to the passing of the Indian Partnership Act, 1932, there was no
  provision for the registration of partnership firms in India. As a result it was
  difficult for a third person to prove the existence of partnership and make
  his claim against all the members of the firm.

- The procedure of registration is very simple. An application in the prescribed
  form along with the prescribed fee has to be submitted to the Registrar of
  Firms of the State where business of the firm is situated or proposed to be
  situated.

- If an unregistered firm institutes a suit for the reduction of rent against its
  landlord, such a suit is not maintainable because the suit falls under the
  disability relating to ‘other proceeding’ to enforce a right arising from a
  contract.

- Section 14 provides that subject to contract between the partners, the
  property of the firm includes all property and rights and interest in property
originally brought into the stocks of the firm, or acquired by purchase or otherwise.

- Under Sec. 35, the central government may by notification specify the application of the provision of the insurance act with such modifications which are deemed necessary to the Corporation and the acquiring companies.

### 9.6 KEY WORDS

- **Estoppel**: The principle which precludes a person from asserting something contrary to what is implied by a previous action or statement of that person or by a previous pertinent judicial determination.
- **An official assignee**: An officer in the law court who distributes a bankrupt’s assets to the creditors.
- **Third party**: Someone who may be indirectly involved but is not a principal party to an arrangement, contract, deal, lawsuit, or transaction.
- **Registrar of Firms**: It is the body which regulates the registration of Partnership Firm. It also checks the functions of the Registered Partnership Firms.

### 9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

#### Short-Answer Questions

1. Write a short note on the law of partnership.
2. Write in brief about the role of a contract in partnership.
3. Write in brief about various types of partners in a partnership firm.
4. Write a brief note on the function of Registrar of Firms.

#### Long-Answer Questions

1. Discuss the various provisions in Indian Partnership Act, 1932.
2. “Sharing of profits is not the conclusive test of partnership.” Justify this statement.
3. Analyse the rules which govern the partners in any partnership.
4. Discuss in detail the formation and registration of a partnership.
5. Analyse the process of registration of firms.
6. Discuss the effects of non-registration in partnership.
9.8 FURTHER READINGS


NOTES

Indian Partnership Act, 1932
UNIT 10 PARTNERS RELATIONS

10.0 INTRODUCTION

As a concept, Limited Liability Partnership (LLP) was initiated as an alternative to the traditional partnership. This form of business organization permits individual partners to be insulated from joint liability of any partner’s business decision. The LLP enters into a contract in its name and the liability of its partners is limited to their agreed contribution in the LLP. It is thus a hybrid entity between a company and a partnership firm. The law of Limited Liability Partnership (LLP) is contained in the Limited Liability Partnership Act, 2008. The Act contains 81 Sections and 4 Schedules. The LLP Rules, 2009 covering the procedural and operational aspects of the LLP Act, 2008 have been made effective from 1st April, 2009.

This unit aims at analysing LLP, partners’ relations, incorporation of companies. It also elaborates the role of memorandum and association articles of association.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand Limited Liability Partnership (LLP)
• Analyse the Limited Liability Partnership Act, 2008
• Learn the characteristics of LLP
• Explain the difference between LLP and traditional partnership
• Know the partners relations
• Analyse the registration of change in a partner
• Understand the dissolution of firms
• Learn Memorandum of Association
• Understand Articles of Association

10.2 LIMITED LIABILITY PARTNERSHIP ACT

Limited Liability Partnership (LLP) is a new form of business entity that enables professional expertise and entrepreneurial initiative to combine, organize and operate in an innovative and efficient manner. For a long time, a need has been felt to provide for a business format that would combine the advantages of limited liability of a company and the flexibility of organizing their internal management on the basis of mutually arrived agreement, as is the case in a partnership firm, at a low compliance cost.

Several expert Committees have recommended for legislation on Limited Liability Partnerships (LLPs). These include the Abid Hussain Committee, 1997, the Naresh Chandra Committee, 2003 and the Dr. J.J. Irani Committee, 2005.

Consequently the Limited Liability Partnership (LLP) concept was initiated as an alternative to the traditional partnership where partners are exposed to unlimited personal liability on the one hand, and statute based governance structure of the limited liability company on the other. This form of business organization permits individual partners to be insulated from joint liability of any partner’s business decision. The LLP enters into a contract in its name and the liability of its partners is limited to their agreed contribution in the LLP. An LLP is thus a hybrid entity between a company and a partnership firm. The LLP Act incorporates all the flexibility available under the Partnership Act and all the beneficial aspects of the Companies Act.

The Limited Liability Partnerships can be formed to carry on a lawful ‘business’. Under Section 2(1)(e), the term ‘business’ has been defined to include every trade, profession, service and occupation. LLPs are essentially and eminently suited to small and medium entrepreneurs (SMEs) in business and industry and to professional service providers like Chartered Accountants, Company Secretaries, Cost Accountants, Advocates and the like.

Section 2(1)(n) of the LLP Act defines LLP as “limited liability partnership means a partnership formed or registered under this Act.”
The above definition does not explain the substance of what constitutes a limited liability partnership. In the light of the nature of a LLP, as stated in Section 3, a comprehensive definition of a LLP giving its main essentials may be given as follows:

‘A limited liability partnership is a body corporate, which is an artificial person, having a separate legal entity, with a perpetual succession, a common seal and carrying limited liability.’

10.2.1 Limited Liability Partnership Act, 2008

The law of Limited Liability Partnership (LLP) is contained in the Limited Liability Partnership Act, 2008. The Act contains 81 Sections and 4 Schedules. The LLP Act came into force, for most of the provisions, on 31st March, 2009 and remaining provisions on 31st May, 2009. Let us discuss the various aspects of the LLP Act, 2008. These are:

A. Schedules: The nature of four Schedules that have been added at the end of the LLP Act may briefly be stated as follows:

1. The First Schedule: It contains provisions regarding matters relating to mutual rights and duties of partners and limited liability partnership and its partners applicable in the absence of any agreement on such matters (the model set of terms of LLP agreement) [refers to Section 23(4)].

2. The Second Schedule: It contains provisions for conversion from firm into limited liability partnership (refers of Section 55).

3. The Third Schedule: It contains provisions for conversion from private company into limited liability partnership (refers to Section 56).

4. The Fourth Schedule: It contain provisions for conversion from unlisted public company into limited liability partnership (refers to Section 57).

Note: References to Sections in this Part III, unless otherwise indicated, are references to Sections of the “Limited Liability Partnership Act, 2008”. The word ‘Act’ wherever used in this Part III means LLP Act, 2008.

LLP Rules, 2009: The LLP Rules, 2009 covering the procedural and operational aspects of the LLP Act, 2008 have been made effective from 1st April, 2009. The forms to be filed under the Act are annexed to these Rules and the fees to be paid in various circumstances is prescribed in Annexure A to the Rules. The filing requirement under the Act shall be complied using digital signature in prescribed electronic mode. The Central Government have launched a website, namely, www.llp.gov.in for operationalising various processes under the Rules.

B. Administrative Machinery

The Ministry of Corporate Affairs (MCA) and the Registrar of Companies (ROC) are entrusted with the task of administration of the Limited Liability Partnership Act, 2008 and the Rules framed thereunder. The Registrar of Companies is appointed by the Central Government in each State. The Registrar of Companies
shall act as Registrars of LLPs at the State level and shall register and control LLPs. The office of the Registrar of Companies is a public office where LLPs are required to file documents and returns and the public is authorized to inspect the same according to the provisions of law.

C. Salient Features of LLP Act, 2008

The salient features of the LLP Act 2008, *inter alia*, are as follows:

1. The LLP shall be a body corporate and a legal entity separate from its partners.
2. Any two or more persons, associated for carrying on a lawful business with a view to profit, may by subscribing their names to an incorporation document and filing the same with the Registrar, form a Limited Liability Partnership. Every registered LLP shall be assigned a LLP identification number (LLPIN).
3. The LLP will have perpetual succession.
4. The mutual rights and duties of partners of an LLP *inter se* and those of the LLP and its partners shall be governed by an agreement between partners or between the LLP and the partners subject to the provisions of the LLP Act 2008. The Act provides flexibility to devise the agreement as per their choice. However, in the absence of any such agreement, the mutual rights and duties shall be governed by the provisions of the LLP Act, 2008.
5. The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.
6. No partners would be liable on account of the independent or un-authorized actions of other partners or their misconduct.
7. The liabilities of the LLP and partners who are found to have acted with intent to defraud creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.
8. Every LLP shall have at least two partners and shall also have at least two individuals as Designated Partners, of whom at least one shall be resident in India.
9. The duties and obligations of Designated Partners shall be as provided in the law.
10. There shall not be any upper limit on number of partners in an LLP.
11. The LLP shall be under an obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A statements of accounts and solvency shall be filed by every LLP with the Registrar every year.
12. The accounts of LLPs shall be audited, subject to any class of LLPs being exempted from this requirement by the Central Government.
13. The Central Government shall have powers to investigate the affairs of an LLP, if required, by appointment of competent Inspector for the purpose.

14. The compromise or arrangement including merger and amalgamation of LLPs shall be in accordance with the provisions of the LLP Act 2008.

15. A firm, private company or an unlisted public company is allowed to be converted into LLP in accordance with the provisions of the Act. Upon such conversion, on and form the date of certificate of registration issued by the Registrar in this regard, the effects of the conversion shall be such as are specified in the LLP Act.

16. Upon conversion into LLP, on and form the date of registration specified in the certificate of registration, all tangible (moveable or immovable) and intangible property vested in the firm or the company, all assets, interests, rights, privileges, liabilities, obligations relating to the firm or the company, and the whole of the undertaking of the firm or the company, shall be transferred to and shall vest in the LLP without further assurance, act or deed and the firm or the company, shall be deemed to be dissolved and removed from the records of the Registrar of Firms or Registrar of Companies, as the case may be.

17. The winding up the LLP may be either voluntary or by the Tribunal to be established under the Companies Act, 1956. Till the Tribunal is established, the power in this regard has been given to the High Court.

18. The LLP Act 2008 confers powers on the Central Government to apply provisions of the Companies Act, 1956, as it thinks appropriate, by notification with such changes or modifications as deemed necessary. However, such notifications shall be laid in draft before each house of Parliament for a total period of 30 days and shall be subject to any modification as may be approved by both Houses.

19. The Indian Partnership Act, 1932 shall not be applicable to LLPs.

20. The Tax issues of LLP shall be addressed under the Income Tax Act, 1961 separately. The Budget of 2009-10, has laid tax provisions for LLP.

21. Every LLP shall use the Forms annexed to the LLP Rules, 2009 for the purpose of the LLP Act, 2008 and shall specify therein its limited liability partnership identification number (LLPIN). The electronic form shall be authenticated by authorized signatories using electronic or digital signatures.

D. Incorporation of LLP and availability of proposed name

Before a limited liability partnership can be incorporated, the persons desirous of forming an LLP should find out the availability of the proposed name from the Registrar of Companies (RoC). Any suitable name can be chosen by an LLP, subject, however, to the following restrictions:

1. Every limited liability partnership shall have either the words “limited liability partnership” or the acronym ‘LLP’ as the last words of its name.
2. The name chosen must not be undesirable in the opinion of the Central Government or a name which is identical or too nearly resembles to that of any other partnership firm, or limited liability partnership or body corporate or a registered trade mark or a trade mark the application of which is pending. The reason for this rule is that the reputation of a company, LLP or partnership firm may be injured, if a new LLP adopts an allied name. (Sec. 15)

Keeping in view the above restrictions, an application for reservation of name with which the proposed LLP is to be registered shall be made to the Registrar of Companies having jurisdiction where the registered office of the LLP is to be situated. It is advisable that six names in order of priority should be submitted to afford flexibility to the Registrar. Where the Registrar informs the applicant about reservation of name with which the LLP is to be registered, such name shall be available for reservation for a period of three months from the date of intimation by the Registrar (Sec. 16).

If inadvertently or otherwise an LLP’s name is wrongly registered by a name which, in the opinion of the Central Government, is identical with the name of another existing LLP or body corporate or is undesirable, the Central Government may direct such LLP to change the name and the LLP must comply with the said direction within three months from the date of direction (Sec. 17). An LLP may change its name voluntarily by filing with the Registrar a notice of such change in such form as may be prescribed (Sec. 19).

Once the name is chosen and the LLP is registered in that name, section 21 requires that every LLP shall ensure that its name, address of its registered office, registration number and a statement that it registered with limited liability is mentioned on all its invoices, official correspondence and publications.

Check Your Progress
1. What do you mean by Limited Liability Partnership (LLP)?
2. What is the LLP Act, 2008?

10.3 PARTNERS RELATIONS: INTRODUCTION, ELIGIBILITY AND REGISTRATION OF CHANGE IN PARTNER

As per Section 5, any individual or body corporate may be a partner in a limited liability partnership.

As per Section 2(1)(d), ‘body corporate’ means a company formed and incorporated under the Companies Act, 1956 and includes an LLP registered under this Act or an LLP incorporated outside India or a company incorporated outside India.
Thus the following can be partners in an LLP:

- (i) Any individual;
- (ii) An Indian company;
- (iii) Any other LLP;
- (iv) A foreign LLP; and
- (v) A foreign company.

Some of essentials of a partner are:

**i. Disqualifications of becoming a Partner (Sec. 5)**

An individual shall not be capable of becoming a partner of an LLP, if:

- (a) He has been found to be of unsound mind by a Court;
- (b) He is an undischarged insolvent;
- (c) He has applied to be adjudged insolvent.

**ii. Number of Partners (Sec. 6)**

Every limited liability partnership shall have at least two partners. There shall not be any upper limit on number of partners in an LLP.

*Reduction of number of partners below statutory minimum:* Section 6 also provides that if at any time the number of partners of an LLP is reduced to one and such LLP carries on business with such sole partner for more than six months, then such sole partner, if he has knowledge of such a situation, shall be liable personally for the payment of the whole debts of the LLP contracted during that period.

**10.3.1 Designated Partners (Sec. 7)**

Every limited liability partnership is required to have at least two ‘designated partners’ who are individuals and at least one of them shall be a resident in India, provided in case of an LLP in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such LLP or nominees of such bodies corporate shall act as designated partners.

*Explanation:* For the purposes of this Section, the term ‘resident in India’ means a person who has stayed in India for a period of not less than one hundred and eighty-two days during the immediately preceding one year.

**i. Appointment**

The designated partners can be named in the Incorporation Document and such persons shall be designated partners on incorporation. If the incorporation document states that each of the partners, from time to time, is to be designated partner, then every partner of the LLP shall be a designated partner. Any partner may become or cease to be designated partner in accordance with the LLP
agreement. The designated partner is required to give his prior consent to act as such to the LLP. Every LLP shall file with the Registrar of Companies the particulars of every designated partner who agrees to act as such in such form and manner as may be prescribed with 30 days of the appointment. However, if no partner of LLP has been intimated to the Registrar as designated partner, or if at any time there is only one designated partner, then every partner of LLP would be deemed to be a designated partner.

ii. Designated Partner’s Identification Number (DPIN)

Every designated partner would be required to obtain a “Designated Partner’s Identification Number” (DPIN) on the lines similar to “Director’s Identification Number” (DIN) required in case of directors of companies. Rule 10, as substituted by the LLP (Amendment) Rules, 2010, prescribes the conditions and the procedure which would have to be fulfilled by an individual for obtaining Designated Partner Identification Number (DPIN). The DPIN so allotted is valid for life time of the applicant. Issuing DPIN in Limited Liability Partnerships will help the government to keep track of the people who run the LLPs. It shall help prevent a defaulting designated partner from hiding his past deeds and joining another LLP. This would also facilitate effective legal action against the designated partners, keeping in view the possibility of fraud by LLPs.

iii. Eligibility Conditions for the Appointment of Designated Partner

Rule 9 of the Limited Liability Partnership Rules, 2009 provides that a person shall not be capable of being appointed as a designated partner of an LLP, if:

1. He has at any time within preceding five years been adjudged insolvent; or
2. He suspends, or has at any time within the preceding five years suspended payment to his creditors or has not at any time within the preceding five years made, a composition with them; or
3. He has been convicted by a Court for any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months; or
   (Anything done contrary to justice, honesty or good morals is done with turpitude, so that embezzlement involves moral turpitude).
4. He has been convicted by a Court for an offence involving Section 30 of the Act.
   (Section 30 deals with punishment for carrying out acts by the LLP or its partners with intent to defraud its creditors or for a fraudulent purpose).

iv. Liabilities of Designated Partners (Sec. 8)

Unless expressly provided otherwise in the Act, a designated partner shall be:

(a) Responsible for doing all acts, matters and things as are required to be done by the limited liability partnership in respect of compliance of the
provisions of the Act including filing of any document, return, statement, report, etc., as may be specified in the Act and LLP agreement; and

(b) Liable to all penalties imposed on the limited liability partnership for any contravention of any provisions of the Act and LLP agreement.

Looking to the responsibilities and liabilities of the designated partner, it can be said that he is a Compliance Officer accountable for regulatory and legal compliances.

v. Changes in designated partners (Sec. 9)

A limited liability partnership may appoint a designated partner within 30 days of a vacancy arising for any reason.

vi. How can a Person become a Partner of an LLP?

The persons, who subscribed their names to the ‘Incorporation Document’ at the time of incorporation of LLP, shall be partners of LLP. Subsequent to incorporation new partners can be admitted in the LLP as per the conditions and requirements of LLP Agreement. (Sec. 22)

vii. LLP Agreement (Sec. 23)

The LLP Agreement is of fundamental importance to a LLP, as it lays down the mutual rights and duties of the partners and their rights and duties in relation to the LLP. If is not mandatory by law to enter into a formal LLP agreement, but it should be done as it avoids unnecessary disputes in future. Where no LLP Agreement has been executed between the partners of LLP or the agreement is silent on certain issues, the provisions of the First Schedule to the LLP Act, 2008 shall apply.

viii. How can a Partner Cease to be a Partner?

A person may cease to be a partner of an LLP in either of the following two ways:

(i) In accordance with an agreement with the other partners; or

(ii) In the absence of agreement with the other partners in this respect, by giving a notice of not less than 30 days to the other partners of his intention to resign as partner [Sec. 24(1)].

A person may also cease involuntarily to be a partner of an LLP in the following circumstances:

(a) On his death or dissolution of the LLP; or

(b) If he is declared to be of unsound mind by a court; or

(c) If he has applied to be adjudged insolvent; or

(d) If he is declared an insolvent [Sec. 24(2)].

ix. Effect of Cessation of Partnership Interest

Where a person has ceased to be a partner of a limited liability partnership (hereinafter referred to as ‘former partner’), the ‘former partner’ continues to be
liable for the acts of the LLP unless the person dealing with the LLP has notice of the fact that the ‘former partner’ has ceased to be a partner of the LLP or a notice of the afore-stated fact has been delivered to the Registrar [Sec. 24(3)].

The fact of cessation of a partner of a LLP by itself does not discharge the ‘former partner’ from any obligation (i) to the LLP or, (ii) to other partners or, (iii) to any other person — which he incurred while being a partner [Sec. 24(4)].

Unless the LLP agreement provides otherwise, the ‘former partner’ or the person entitled to his share in consequence of his death or insolvency shall be entitled to receive from the LLP an amount equal to his capital contribution along with his share in accumulated profits of the LLP after the deduction of its losses, if any [Sec. 24(5)].

Section 24(6) provides that a ‘former partner’ or a person entitled to his share in the case of his death or insolvency shall not have any right to interfere in the management of the LLP.

x. Registration of Changes in Partners (Sec. 25)

Every partner shall inform the limited liability partnership of any change in his name or address within a period of 15 days of such change. The LLP, in turn, would be under obligation to file such details with the Registrar within 30 days of such change. An LLP will also be required to file a notice with the Registrar within 30 days from the date on which any person becomes or ceases to be a partner. The documents delivered to the Registrar will be available for public inspection at the Registrar’s office on payment of prescribed fee (Sec. 36).

10.3.2 Dissolution of Firms

At the very outset, it may be mentioned that throughout the discussion relating to Winding Up the word “Court” wherever used means the “High Court” of the State in which the Registered Office of the Limited Liability Partnership (LLP) concerned is situated.

Section 67 of the Limited Liability Partnership Act, 2008 confers powers on the Central Government to direct that any of the provisions of the Companies Act, 1956 specified in the notification shall apply to any LLP or shall apply to any LLP with such modification and adaptation as may be specified, in the notification.

In exercise of powers conferred by the Section 67, the Central Government issued Notification No. GSR 6(E) dated 6th January, 2010 directing that the provisions of the following Sections of the Companies Act, 1956 shall apply to ‘winding up’ of LLPs, with the modifications specified in the Notification: 441, 443, 445, 446, 448, 450, 451, 453 to 458, 458A, 460, 463 to 468, 471, 474, 476, 477 to 479, 481 to 484, 486 to 488, 493, 497, 511, 511A, 512, 514, 515, 517 to 519, 528 to 556, 558 to 560 and 584.

Thus, in the discussion of winding up provisions reference to any of the above Sections means ‘Section of the Companies Act, 1956’.
Now we shall discuss the processes of winding up and dissolution. These are:

i. Meaning of Winding Up

A Limited Liability Partnership (LLP) being an artificial person cannot die a natural death. An LLP comes into existence by a legal process known as incorporation and likewise ceases to exist also by another legal process called dissolution.

The ‘winding up’ of an LLP is a process to bring about an end to the life of a LLP. The process of winding up involves the realization of the assets, payment of the liabilities and distribution of surplus, if any, amongst the partners of the LLP by the LLP Liquidator.

ii. Winding UP vs. Dissolution

Winding up should not be taken to mean the same thing as dissolution of the LLP. Winding up of a LLP precedes its dissolution. Prior to dissolution and after winding up, the legal entity of the LLP remains and it can be sued in a Court of law. On dissolution, the LLP ceases to exist, its name is actually struck off the ‘Register of Limited Liability Partnerships’ by the Registrar of Companies and the fact is published in the Official Gazette.

iii. Modes of Winding Up

Section 63 of the LLP Act provides that a Limited Liability Partnership may be wound up in the following two ways:

I. Winding up under order of the Court.
II. Voluntary winding up

We shall now discuss the modes of winding up, in brief, one by one.

I. A. Winding up by the court: Grounds for Winding Up (Sec. 64)

A limited liability partnership may be wound up by the Court under the following circumstances:

(1) Petition by LLP: If the LLP has resolved that the LLP be wound up by the Court and makes a petition of the Court. The resolution may be passed by a majority vote (every partner shall have one vote) unless by the LLP agreement such a decision should be of any other specified majority or to be unanimous. The power of the Court is, however, discretionary and may not be exercised by the Court if it finds that winding up would be opposed to public interest or LLP’s interest. It is not a popular mode of winding up because whenever partners decide for winding up of the LLP, they opt for ‘voluntary winding up’ in which case the interference of Court is least.

(2) Number of partners below minimum: If the number of partners is reduced below the legal minimum limit, i.e., below 2 in the LLP. The Court is bound to make a winding up order on this ground.
(3) **Inability to pay debts:** A LLP may be ordered to be wound up, if it is unable to pay its debts. The prescribed amount of debt has to be notified by the Central Government. The Court in its discretion may make a winding up order or refuse to make a winding up order if the majority in value of the creditors oppose the petition for good reason and prove to the satisfaction of the Court that in view of the total assets and liabilities of the LLP it must continue to trade.

(4) **LLP acting against the national interest:** If the LLP has acted against the interests of the sovereignty and integrity of India, the security of the State or public order. If any of these circumstances be proved, the Court may make a winding up order.

(5) **Default in filing the Statement of Account and Solvency or Annual Return with the Registrar:** If the LLP has made a default in filing with the Registrar its Statement of Account and Solvency or Annual Return for five consecutive financial years. The Court is bound to make a winding up order on this ground.

(6) **Just and Equitable:** A LLP may also be ordered to be wound up, if the Court is of the opinion that it is just and equitable that the LLP should be wound up. The Court enjoys very wide discretionary power under this clause. What is a ‘Just and Equitable’ cause depends upon the facts of each particular case. The Court shall give regard to the interest of the LLP, its partners, employees, creditors and the public interest in granting or refusing the winding up order sought on this ground.

**B. Commencement of the Winding Up**

Winding up commences not from the date of the winding up order of the Court but it shall be deemed to commence at the time of the presentation of the petition. Where, before the presentation of the petition a resolution has been passed by the Limited Liability Partnership for voluntary winding up, the winding up shall be deemed to have commenced at the time of the passing of the resolution (Sec. 441).

The date of commencement of winding up is important for various matters such as avoidance of objectionable voluntary transfers and fraudulent preferences.

**C. Powers of the Court on Presentation of the Petition**

An application to the Court for the winding up of a limited liability partnership shall be by a petition presented by the LLP, or by any creditor(s) or by the Registrar. An LLP shall file with the Court a statement of its affairs in such form as may be prescribed along with the petition for winding up [Sec. 454(1)(i)].

After receiving the petition for winding up of the Limited Liability Partnership, the Court fixes a date for hearing of petition and at least 14 days before the date so fixed, will issue notice to the LLP to appear and state its case for the winding up.
and shall also cause the issue of public notice of the same in order to notify all the creditors and partners of the LLP about the winding up petition, so that they may put their objections, if any, on the date of hearing.

On the specified date, upon hearing all the connected parties and on keeping in mind all the circumstances of the case, the Court may, within 90 days from the date of presentation of the petition, act in any of the following ways:

(a) Dismiss the petition, with or without costs; or
(b) Make any interim order that it thinks fit; or
(c) Direct the action for revival or rehabilitation of the LLP in accordance with procedure laid down in Sections 60 to 62 of LLP Act, 2008; or
(d) appoint a “liquidator” as provisional liquidator of the LLP till the making of a winding up order; or
(e) Make an order for the winding up of the LLP with or without costs (Sec. 443).

D. Liquidator

The liquidator is an officer who helps to complete the liquidation proceedings, i.e., in realizing the assets of a business organisation and distributing them amongst the creditors most fairly. If any assets remain, these are distributed between the owners of the business unit.

For the purposes of winding up of a limited liability partnership by the Court or for the purpose of appointment of provisional liquidator, there shall be a “liquidator” who may be either an Official Liquidator or a Liquidator appointed by an order of the Court from the panel of such professionals, firms or bodies corporates consisting of such professionals as may be prescribed. The Central Government shall constitute the panel for the above purpose in such manner as may be prescribed. In the absence of any such order the Official Liquidator shall become or act as “liquidator” of the LLP (Sec. 448). The Central Government has appointed for each High Court an ‘Official Liquidator’.

i. Provisional Liquidator

After receiving the winding up petition and before passing the winding up order, the Court may appoint the Liquidator as ‘Provisional Liquidator’ for the time being, who shall have the same powers as a ‘Liquidator’ unless the Court limits and restricts his powers by the order appointing him or by a subsequent order. As soon as winding up order is made, the ‘provisional liquidator’ shall become the ‘Liquidator’ of the limited liability partnership (Sec. 450).

ii. Powers of Liquidator (Sec. 457)

In a winding up by the Court, the Liquidator can exercise certain powers with the sanction of the Court, unless expressly exempted, and can exercise certain powers on his own account without the sanction of the Court.
(a) **With the sanction of the Court:** He can exercise the following powers with the sanction of the Court unless expressly exempted by an order of the latter:

1. To institute or defend any suit, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the limited liability partnership;
2. To carry on the business of the limited liability partnership so far as may be necessary for the beneficial winding up of the limited liability partnership. In this connection it may be seen that all liabilities incurred by the liquidator in carrying on the business shall rank for payment in priority to the general debts and liabilities of the company [*Re Davis & Co. Ltd. (1945)*];
3. To sell the immovable and movable property and actionable claims of the limited liability partnership either by private contracts or by public auction, with power to sell whole of the undertaking of the LLP as a going concern;
4. To raise on the security of the assets of the LLP any money requisite;
5. To do all such other things as may be necessary for winding up the affairs of the limited liability partnership and distributing its assets, e.g., settling the the lists of creditors and partners;
6. to disclaim an onerous property (i.e., burdensome property which in effect has ceased to be an asset and has become a liability, for instance, partly paid-up shares of an unsuccessful company) or unprofitable contracts (Sec. 535);
7. To pay any class of creditors in full or to make any Compromise or Arrangement with creditors [Sec. 546(1)(a)(ii)];
8. To compromise partners’ outstanding contributions, debts and other pecuniary liabilities with partners or debtors and take any security in discharge of any such claim and give a complete discharge in respect thereof [Sec. 546(1)(a)(iii)].

(b) **Without the sanction of the Court:** He can exercise the following powers without obtaining any previous approval of the Court:

1. To do all acts in the name and on behalf of the limited liability partnership and to execute all deeds, receipts and other documents and to use seal of the limited liability partnership when necessary;
2. To inspect the records and returns of the limited liability partnership on the files of the Registrar without payment of any fee;
3. To prove, rank and claim in the insolvency of any partner, for any balance against his estate, and to receive dividends in the insolvency;
4. To draw, accept, make and endorse any negotiable instrument (e.g., B/E or P/N, etc.) in the name of the LLP;
(5) To take out, in his official name, letters of administration to the estate of a deceased partner and to do necessary things to obtain payment;

(6) To appoint an agent to do any business which he is unable to do himself;

(7) To avoid fraudulent preference done within six months before the commencement of winding up, as per Section 531;

(8) To avoid objectionable voluntary transfers, made within one year before the commencement of winding up, as per Section 531A.

It should be noted that the exercise of all the above powers is subject to the control of the Court and any creditor or partner may apply to the Court with respect to the exercise of any power [Sec. 457(3)]. Further, to check the liquidator from abusing his powers, Section 460(6) provides that any person aggrieved by any act or decision of the liquidator, may apply to the Court and the Court may confirm, reverse or modify the act or decision complained of, and make such further order as it thinks just in the circumstances.

iii. Duties of Liquidator

Powers and duties go hand in hand. The Liquidator has to perform various duties. He must act and function in an honest and impartial manner because there exists a fiduciary relationship between the Liquidator on the one side and the partners and creditors on the other.

To enumerate, the following are the most important duties of the Liquidator:

1. To conduct the proceedings in winding up (Sec. 451)

2. To submit report to the Court after the receipt of the ‘Statement of Affairs’

3. Custody of LLP’s property

4. To give regard to the resolutions of the creditors or partners or to any directions given by the ‘Committee of Inspection’

5. To summon meetings of creditors and partners

6. To submit information as to pending liquidation

Thus the Liquidator is required to perform his varied duties most faithfully and honestly keeping in view the directions of the Court, requirements of the Act and using his own discretion whenever necessary. If he is found lacking in the proper discharge of his duties, any creditor or partner may file a complaint with the Central Government, which shall enquire into the matter and take necessary action (Sec. 463).

iv. Committee of Inspection

The Court may, at the time of making an order for the winding up of a limited liability partnership or at any time thereafter, direct that there shall be appointed a ‘committee of inspection’ to act with the Liquidator (Sec. 464).
The Committee of Inspection shall consist of such number of members not exceeding twelve, as the Court may order, who shall be creditors and partners of the limited liability partnership, in such proportions as may be agreed on by the meetings of creditors and partners or in case of difference of opinion between the meetings, as may be determined by the Court. The procedure to be adopted by the Committee shall be as may be prescribed (Sec. 465).

II. Voluntary winding up

Where a limited liability partnership is wound up by the partners, without any interference by the Court, it is called voluntary winding up. In voluntary winding up, the LLP is left free to settle its affairs without going to a Court, although it may apply to the Court for directions or orders, if and when necessary [Sec. 518(1)].

A. Ground for Voluntary Winding Up

According to Section 484, a limited liability partnership may be wound up voluntarily if the LLP passes a resolution to wind up the LLP with approval of at least three-fourths of total number of its partners.

However, if the limited liability partnership has creditors, whether secured or unsecured, then such winding up shall not take place unless approval of such creditors takes place in such manner as may be prescribed.

B. Consequences of Voluntary Winding Up

The consequences of voluntary winding up are as follows:

(1) A voluntary winding up shall be deemed to commence from the date of the passing of the resolution to that effect (Sec. 486).

(2) From the commencement of voluntary winding up, the LLP ceases to carry on its business, except so far as may be required for the beneficial winding up thereof (Sec. 487).

(3) The possession of the assets of the LLP vests in the Liquidator for realisation and distribution among the creditors. The status of the LLP and its powers shall, however, continue until it is dissolved (Secs. 456 and 487).

(4) A resolution to wind up voluntarily operates as notice of discharge to the employees of the LLP, except when the business is continued by the Liquidator for the beneficial winding up of the LLP.

(5) The LLP’s creditors cannot file suits or continue any pending suits against the LLP. They are required to lodge their claims and prove their debts to the Liquidator. In the case of disputed claims, however, a voluntary winding up does not operate as a stay of any existing proceedings or prevent the institution of new proceedings.

(6) Any transfer of partner’s contribution or any alteration in the status of the partners, made after the commencement of the winding up of the LLP, shall be void except when it is made with the permission of the LLP Liquidator (Sec. 536).
C. Voluntary Winding Up

A voluntary winding up is possible only when the limited liability partnership is solvent and is able to pay its liabilities in full. It requires:

(a) The filing of a statutory ‘Declaration of Solvency’ by the majority of designated partners of the LLP with the Registrar, and
(b) The passing of a special resolution by the partners and filing a copy thereof, with the Registrar. Approval of creditors, if any, shall also be required in such manner as may be prescribed.

Declaration of Solvency: The ‘declaration of solvency’ has to be made by a majority of the designated partners or all of them if there are only two designated partners. They have to declare that the LLP has no debts or that it will be able to pay its debts in full within such period not exceeding one year from the commencement of winding up as may be specified in the declaration. Designated partners making a false ‘declaration of solvency’ are punishable with imprisonment for a term which may extend to six months or with fine up to ₹50,000, or with both (Sec. 488).

D. Powers and Duties of LLP Liquidator in Voluntary Winding Up

Section 512 provides that the powers and duties of the LLP Liquidator in voluntary winding up are just the same as those of the Liquidator in winding up under order of the Court (discussed earlier). We saw in the case of winding up by Court that the Liquidator can exercise certain powers with sanction of the Court and certain powers without the sanction of the Court. Similarly here, the LLP liquidator can exercise certain powers with the prior sanction and certain powers without any sanction; the line of demarcation being exactly the same as that in winding up by Court; with one important difference that here instead of sanction of the Court, the LLP liquidator has to obtain the sanction of a special resolution of partners of the LLP and approval of the Court. [Refer to the headings ‘Powers of Liquidator’ and ‘Duties of Liquidator’ discussed earlier].

In addition to the above powers, the LLP liquidator in voluntary winding up, shall without obtaining the sanction referred to above, exercise the following powers which are enjoyed by the Court in Winding Up by Court:

(1) The power of settling the list of partners.
(2) The power of realization of partners’ outstanding contributions.

E. Power of Court to Appoint and Remove LLP Liquidator in Voluntary Winding Up

(1) If from any cause whatever, there is no LLP liquidator acting, the Court may appoint any person from the panel (constituted by the Central Government for the appointment of liquidator) as a liquidator on such fees as may be determined by it, on the application made by a LLP liquidator or creditor or partner of the LLP.
(2) The Court may, on cause shown (e.g., fraud, etc.) remove a LLP liquidator and appoint any other person from the panel (constituted by the Central Government for the appointment of liquidator) as LLP liquidator, in place of the removed LLP liquidator, on the application made by a LLP liquidator or creditor or partner of the LLP.

(3) The Court may also appoint or remove a LLP liquidator on the application made by the Registrar in this behalf. (Sec. 515)

Section 529 contains special provisions regarding the winding up of insolvent LLPs.

Check Your Progress
3. Who are referred as designated partners’ in LLP?
4. What is the period within which there could be a change in partner?
5. List the modes of winding up of an LLP.

10.4 INCORPORATION OF COMPANIES

Section 3(i)(i) and (ii) of the Companies Act, 1956, define a company as 'a company formed and registered under this Act or an existing company. An 'existing company’ means a company formed and registered under any of the former Companies Acts'.

The clearest description of a company is given by Lord Justice Lindley:

By 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 therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute to 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 L.H. Haney, 'A company is an incorporated association, which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal.'

A company, thus, may be defined as an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.

10.4.1 Characteristics of Company

An examination of the definitions reveals the following characteristics of a company:

(i) Incorporation: A company must necessarily be incorporated or registered under the prevalent Companies Act. Registration creates a
joint stock company and it is compulsory for all associations or partnerships, having a membership of more than 10 in banking and more than 20 in any other trading activity, formed for carrying on a business with the object of earning profits.

(ii) Artificial legal person: A company is an artificial legal person in the sense that on the one hand, it is created by a process other than natural birth and does not possess the physical attributes of a natural person, and on the other hand, it is clothed with many of the rights of a natural person. It is invisible, immortal (law alone can dissolve it) and exists only in the eyes of law. It has no body, no soul, no conscience, neither is it subject to the imbecilities of the body. It is because of these physical disabilities that a company is called an artificial person. However, it cannot be treated as a fictitious entity because it really exists. As a rule, a company may acquire and dispose of property; it may enter into contracts through the agency of natural persons and it may be fined for the contravention of the provisions of the Companies Act. Thus, for most legal purposes, a company is a legal person just like a natural person, who has rights and duties at law. In short, it may be said, therefore, that a company being an artificial legal person can do everything like a natural person, except of course that, it cannot take oath, cannot appear in its own person in the court (must be represented by counsel), cannot be sent to jail, cannot practice a learned profession like law or medicine, nor can it marry or divorce.

(iii) Separate legal entity: A company is a legal person having a juristic personality entirely distinct from and independent of the individual persons who are for the time being its members (Kathiawar Industries Ltd vs C.G. of Evacuee Property). It has the right to own and transfer the title to property in any way it likes. No member can either individually or jointly claim any ownership rights in the assets of the company during its existence or in its winding up (Mrs B.F. Gazdar vs the Commissioner of Income Tax). It can sue and be sued in its own name by its members as well as outsiders. Creditors of the company are creditors of the company alone and they cannot directly proceed against the members personally.

A company is not merely the sum total of its component members, but it is something superadded to them. In mathematical language, it may be defined as \( n + 1 \)th person, where \( n \) stands for the total number of members and the \( 1 \)th person for the company itself. Even if a shareholder owns virtually the whole of its shares, the company is a separate legal entity in the eyes of law as distinguished from such a shareholder.

(iv) Perpetual existence: A company is a stable form of business organization. Its life does not depend upon death, insolvency or retirement of any or all shareholder(s) or director(s). The provision for transferability of shares in case any shareholder wishes to drop out, as also for transmission of shares to the successor(s) of the deceased in case any shareholder dies, helps to
preserve the perpetual existence of a company. Law creates it and law alone can dissolve it. Members may come and go, but the company can go on forever. The company may be compared with a flowing river where water keeps changing continuously, still the identity of the river remains the same. Thus, a company has a perpetual existence, irrespective of changes in its membership.

(v) **Common seal:** 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 persons who are termed as directors. However, 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 a 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.

(vi) **Limited liability:** The liability of the members for the debts of the company is limited to the amount unpaid on their shares howsoever heavy losses the company might have suffered. For instance, if a shareholder buys 100 shares of ₹10 each and pays ₹5 on each share, he has paid ₹500 and can be made no pay another ₹500, but he cannot be made to pay more than ₹1,000 in all. No shareholder can be called upon to pay more than the nominal or face value of shares held by him, in case of a company with limited liability. Thus, by virtue of this characteristic the personal property of the shareholder cannot be seized for the debts of the company, if he holds a fully paid-up share.

(vii) **Transferability of shares:** The shares of a public company are freely transferable and members can dispose of their shares whenever they like without seeking any permission from the company or the other members. In a private company, however, some restriction on the right to transfer is essential in its articles as per Section 3(l) (iii) of the Act, but absolute restriction on the right of the members to transfer shares contained in the articles shall be void.

It may, however, be noted here that a company possesses all these characteristics by virtue of its incorporation or registration under the Companies Act. Although a partnership—the main alternative to the company as a form of business organization, may also be registered under the Indian Partnership Act, 1932, yet it does not possess any of these characteristics.

### 10.5 MEMORANDUM OF ASSOCIATION

The memorandum of association of a company is its principal document. ‘It is a document of great importance in relation to the proposed company’. No company can be registered without a memorandum of association and that is why it is
sometimes called a *life giving document*. Under Section 2(28) of the Act 'memorandum means the memorandum of association of a company as originally framed or as altered from time to time in pursuance of any previous company laws or of this Act'.

Lord Cairns in the leading case of *Ashbury Railway Carriage Co. vs Riche* observed that "the memorandum of association of a company is its charter and defines the limitation of the powers of a company." The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporated.

According to Lord Macmillan, "The purpose of the memorandum is to enable the shareholders, creditors and those who deal with the company, to know what is its permitted range of enterprise".

These definitions clearly indicate the scope and the importance of the document. In fact, the Memorandum of Association is the foundation on which the structure of a company is based. It states the name of the company, the address of its registered office, whether the company has a share capital or not, whether it is limited by guarantee or otherwise, and defines the scope of activities within which the company can function. It is this document that delimits the *capacity to contract* of the company. A company cannot undertake operations that are not mentioned in its memorandum. Any act of the company outside the scope of activities as laid down in the memorandum is said to be *ultra vires* and not binding on it.

Further, the memorandum of association is the constitution of the company in its relation to the outside world. It is a public document and persons dealing with the company may ask for its copies on payment of a nominal charge. Every person who deals with the company is presumed to have sufficient knowledge of its contents (as it is open to public inspection) and anybody dealing with the company shall be bound by its provisions and cannot bind the company for *ultra vires* acts. It is perhaps for this reason that no company is allowed to tamper with its contents without the sanction of the Central Government or the Company Law Board or the Court of Law. The Act prescribes complicated procedure to be followed by a company intending to alter any of its provisions and that is why this document is regarded as an *unalterable charter* of a company.

As per Section 15 of the companies Act, it should be printed, divided into paragraphs numbered consecutively, signed by each subscriber duly attested by a witness (not being a subscriber himself).

### 10.5.1 Contents of Memorandum

Section 13 sets out the contents of the memorandum. The document must contain the following clauses: (1) the name clause, (2) the registered office clause, (3) the objects clause, (4) the liability clause, (5) the capital clause, and (6) the association clause or subscription clause. We shall now consider each of these clauses in detail.
1. **The Name Clause:** Under this clause, the corporate name of the company is stated. Any suitable name can be chosen by a company, subject to the following restrictions:

   (a) In the case of companies limited by shares or limited by guarantee, the word ‘Limited’ or ‘Private Limited’ must be the last word in the name of every public or private company respectively. There is, however, one exception to this rule as provided in Section 25 of the Act, which permits charitable companies formed to promote commerce, art, science, religion, etc., (prohibiting the payment of dividends and applying all the profits to the promotion of their objects) under a licence granted by the Central Government, to register with limited liability, but without the word ‘limited’ as part of its name. In the case of **unlimited companies**, only the name is to be given. It should be noted that the inclusion of the word ‘company’ is not essential in the proposed name of the company.

   (b) As per Section 20, the name chosen must not be **undesirable** in the opinion of the Central Government. The Act does not state what names shall be considered undesirable and as such gives very wide discretion to the Central Government. Ordinarily a name is considered undesirable and therefore not allowed if it is either:

      (i) Too identical or similar to the name of another existing company or firm (whether registered or unregistered) so as to lead to confusion (**British Vacuum Cleaner Co. vs New Vacuum Cleaner Co. Ltd**). The reason for this rule is that the reputation of a company may be injured, if a new company adopts an allied name; or

      (ii) Misleading, e.g., suggesting that the company is connected with a Government department or any municipality or other local authority, or that it is an association of a particular type, e.g., ‘Cooperative Society’, ‘Building Society’, when this is not the case.

If, however, a company is registered by an almost identical name, the court will grant an injunction restraining it from using the name. An injunction will not be granted, however, to prevent the use of purely descriptive word with a definite meaning and in common use. Thus, in **Aerators Ltd. vs Tollitt**, the plaintiff was not granted an injunction restraining the defendant from using the name of **Automatic Aerators Ltd.**, because both companies were manufacturers of apparatus for the instantaneous automatic aeration of liquids under distinct patents.

Once the name is chosen and the company is registered in that name, Section 147 requires that it, along with the address of registered office, must appear on the outside of every office or place of business (though inside the building).
of the company in a conspicuous manner in one of the local languages and on all cheques, bills, letters, notices and other official publications, etc., of the company.

2. The registered office clause: The second clause of the memorandum must mention the name of the state in which the registered office of the company is to be situated [Sec. 13(1)(b)]. This is required in order to fix the domicile of the company, i.e., the place of its registration. Domicile must be distinguished from residence. While domicile is the place of its registration, residence is the place of its management and control, i.e., where the Board of Directors meets (Daimler Co. Ltd vs Continental Tyre Rubber Co.). Although the actual address of the registered office of the company is not required to be stated in the memorandum, every company must have specified premises in a town fixed as its registered office either from the day on which it begins to carry on business or as from the thirteenth day after the date of its incorporation, whichever is earlier (Sec. 146(1)). Notice of the situation of the registered office and of every change therein is to be given to the Registrar for record within 30 days of incorporation or date of change, as the case may be [Sec. 146(2)]. Usually, the notice of the situation of registered office is filed at the same time as the memorandum.

The importance of the registered office is that it is the address of the company where all communications and notices are to be sent and where register of members, register of debenture-holders, register of charges, minutes' books of general meetings, etc., are kept.

3. The objects clause: It is the most important clause of the memorandum because it sets out the objects or vires of the company. A company is not legally entitled to do any business other than that specified in its objects clause. This rule is meant to protect first, the members, who can at once know the purpose for which their money is to be employed and can be sure that their money is not going to be risked in an unknown activity or project and second, the public at large, who deal with the company, can at once know the extent of the company's powers and whether a particular transaction which is to be entered into with them is ultra vires or not. Moreover, the fact that the company's capital cannot be spent on any project outside the objects clause of the company gives a feeling of security to the creditors.

4. The liability clause: This clause states that the liability of members is limited to the amount, if any, unpaid on their shares. If the memorandum so provides, the liability of the directors may be unlimited (Sec. 322). If it is proposed to register the company limited by guarantee, this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its winding up. A company registered with unlimited liability need not give this clause in its memorandum of association.
5. **The capital clause.** Every limited company (whether limited by shares or whether limited by guarantee), having a share capital must state the amount of its share capital with which the company is proposed to be registered and the division thereof into shares of a fixed denomination in this clause. It is usually expressed as follows: ‘the share capital of the company is ₹ 10,00,000 divided into 1,00,000 shares of ₹ 10 each.’

This capital is variously described as registered, authorized or nominal capital and the stamp duty is payable on this amount. There is no legal limit to the amount of share capital.

6. **The association or subscription clause:** Under this clause, we have the ‘declaration of association’, which is made by the signatories of the memorandum under their signatures duly attested by witness, that they desire to be formed into a company and that they agree to the purchase of qualification shares, if any. Each subscriber must take at least one share.

The above-mentioned clauses are referred to as the compulsory clauses, of the memorandum as per Section 13. Other provisions relating to Managing Director or Manager, etc., may also be given in the memorandum but they can be altered in the same manner as the Articles of the company [Sec. 16(3)].

10.5.2 Alteration of Memorandum

As per Section 16 ‘a company shall not alter the conditions contained in its memorandum except in the cases, in the mode, and to the extent, for which express provision is made in the Companies Act’. As such alteration in any compulsory clause of the memorandum is possible only by strictly following the procedure laid down in the Act. We shall now see the procedure and extent of alteration of different clauses of memorandum as given in the Companies Act.

1. **Alteration of name clause:** A company may, by passing a ‘special resolution’ and with the approval of Central Government in writing, change its name. But no approval of Central Government is needed where the only change in the name is the addition thereto or the deletion therefrom, the word ‘private’ consequent on the conversion of a public company into a private company or vice versa (Sec. 21).

   Within 30 days of passing the resolution, a copy of the same shall be filed with the Registrar. Also, a copy of the Central Government’s order of approval shall be filed with the Registrar within three months of the order. The Registrar shall enter the new name on the ‘Register’ in place of the former name and shall issue a fresh incorporation certificate with the new name. It is only after this that the change becomes effective and the company can use the new name (Sec. 23).

2. **Alteration of registered office clause:** A company may change its registered office within the same city by passing a Board’s resolution only...
to that effect. A notice is, however, to be given to the Registrar within 30 days of the change.

If a company wants to shift its registered office from one city to another city
within the same state, it must pass a special resolution authorizing the change and file its copy with the Registrar within 30 days. A notice of address of new location of the office must be given to the Registrar within 30 days of the shifting of the office [Sec. 146(2)].

Regional Director’s approval for shifting of Registered Office within the same State in certain cases: Section 17A has been added by the Companies (Amendment) Act, 2000, to provide that shifting of the registered office by a company from the jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies within the same state shall, in addition to passing a special resolution under Section 146, also require confirmation of the Regional Director. For this purpose, an application shall be made in the prescribed form seeking approval for the shifting of the registered office. The Regional Director shall communicate confirmation or otherwise, after giving necessary opportunity of being heard to the parties, within four weeks.

3. Alteration of objects clause: Section 17(1) of the Companies Act states that the objects clause and the registered office clause (in case transfer is contemplated from one State to another) can be altered only if the change enables the company:
   (i) To carry on its business more economically or more efficiently
   (ii) To attain its main purpose by new or improved means
   (iii) To enlarge or change its local area of operations
   (iv) To carry on some business which can be suitably combined with the present business of the company
   (v) To restrict or abandon any of its objects specified in the memorandum
   (vi) To amalgamate the company with any other company
   (vii) To sell or dispose of the whole or any part of the undertaking of the company

4. Alteration of liability clause: Liability of shareholders of a limited company, or a company limited by guarantee, cannot be made unlimited unless the same is expressly agreed to by each and every member concerned (Sec. 38). The liability of Directors, Managing Director or Manager can be made unlimited by passing a special resolution, if the Articles so permit and if the officer concerned has accorded his consent to the liability becoming unlimited (Sec. 323). The change becomes effective from the date of passing the resolution. Information to Registrar must, however, be sent together with relevant papers within 30 days of passing the special resolution.
Partners Relations

Shareholders of unlimited liability company can make their liability limited by passing a special resolution and obtaining the Court’s sanction. A copy of special resolution must be filed within 30 days of its passing and a copy of the Court’s confirmation order must be filed within three months of the order with the Registrar. Alteration is effective from the date of registration by the Registrar.

5. Alteration of capital clause: According to Section 94, a company limited by shares or a company limited by guarantee and having a share capital can alter the capital clause of its memorandum, in any of the following ways:

(a) It may increase its authorized share capital. It is to be noted that further issue of unissued shares within the authorized capital is governed by Section 81 of the Act and shall not alter the memorandum. The Board of Directors, if so authorized by the Articles, may increase the issued capital within the limit of authorized capital, by passing a board’s resolution.

(b) It may consolidate or sub-divide the whole or any part of its existing shares into shares of larger or smaller denominations.

(c) It may convert its fully paid-up shares into ‘stock’ or vice versa.

(d) It may cancel its unissued shares, i.e., shares which have not been subscribed for by any person, and diminish the amount of its authorized share capital by the amount of the shares so cancelled. It is to be remembered that diminution of authorized share capital by cancellation of unissued shares does not amount to reduction of share capital, for the cancelled shares have never been issued to anyone. The object of such cancelling may be to get rid of an unissued class of shares carrying inconvenient rights.

A company can make any of these alterations by simply passing an ordinary resolution, provided it is authorized by its articles to do so. If the articles do not provide for it, then firstly articles must be changed by passing a special resolution. Within 30 days of the date of passing the resolution, notice must be given to the Registrar together with a copy of resolution and altered memorandum, who will then register the altered memorandum. It is from the date of passing the ordinary resolution that the change becomes effective.

10.6 ARTICLES OF ASSOCIATION

Articles of Association is another document of paramount significance in the life of a company. It contains regulations for the internal administration of a company’s affairs. Articles of Association may well be compared with the ‘Partnership Deed’ in a partnership. They prescribe rules and bye-laws for the general management of the company and for the attainment of its objects as given in its memorandum.
The general functions of Articles of Association were clearly stated by Lord Cairns in *Ashbury Railway Carriage Co. vs Riche* where he observed: 'The Articles play a part subsidiary to the memorandum of association. They accept the memorandum as the charter of incorporation of the company; and so accepting it, the Articles proceed to define the duties, the rights and the powers of the governing body as between themselves and the company at large, and the mode and form in which the business of the company is to be carried on, and the mode and form in which changes in the internal regulations of the company may, from time to time, be made.'

Being subordinate to the memorandum, they cannot extend the objects as defined in the memorandum. Distinguishing between the functions of the memorandum and the Articles of Association, Lord Justice Bowen observed in *Guinness vs Land Corporation of Ireland*: 'The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors, and the outside public, as well as of the shareholders. The Articles of Association are the internal regulations of the company and are for the benefit of shareholders.'

To quote Lord Cairns again, 'The memorandum is, as it were, the area beyond which the actions of the company cannot go; inside that area the shareholders may make such regulations for their own management as they think fit in the form of the Articles of Association.'

### 10.6.1 Obligation to Register Articles

Section 26 states that a public company limited by shares may register articles, while a company limited by guarantee or an unlimited company or a private company limited by shares must register articles along with the memorandum at the time of registration. In other words, it is optional for a public company limited by shares to register articles, whereas other types of companies are required to do so compulsorily. There arises a question as to what happens if a public company limited by shares does not register any articles. The answer to this question is provided by Section 28(2) which states that if a public company limited by shares does not register any articles, *Table A* (the model set of 99 articles given at the end of the Companies Act) shall automatically apply to such a company. Even if such a company registers articles of its own, 'Table A' will still apply automatically on all such points on which the said articles are silent, unless its regulations have expressly been excluded by the company in its articles. Most companies find it best to register a special set of articles. Companies, other than a public limited company, have to register articles compulsorily because they cannot adopt 'Table A' in its entirety but in their case also the regulations of 'Table A' will, so far as they are applicable, apply automatically on all such points on which their own articles are silent, unless their own articles expressly exclude those regulations.
A. Form and signature of Articles

The Articles of Association of every company must be: (i) printed, (ii) divided into paragraphs, numbered consecutively, and (iii) signed by each subscriber to the Memorandum, who shall add his address, description and occupation, if any, in the presence of at least one witness who will attest the signature and shall likewise add his address, description and occupation, if any (Sec. 30).

B. Contents of Articles

Articles usually contain rules and bye-laws on matters like:

1. The extent to which ‘Table A’ is applicable
2. Different classes of shares and their rights
3. Procedure of making an issue of share capital and allotment thereof
4. Procedure of issuing share certificates
5. Lien on shares
6. Forfeiture of shares and the procedure of their re-issue
7. Procedure for transfer and transmission of shares
8. The time lag in between calls on shares
9. Conversion of shares into stock
10. Payment of commission on shares and debentures to underwriters
11. Rules for adoption of preliminary contracts, if any
12. Reorganization and consolidation of share capital
13. Alteration of share capital
14. Borrowing powers of directors
15. Procedure for convening, holding and conducting different kinds of general meetings
16. Voting rights of members, proxies and polls
17. Payment of dividends and creation of reserves
18. Appointment, powers, duties, qualifications, remuneration, etc., of directors
19. Use of the Common Seal of the company
20. Keeping of books of accounts and their audit
21. Appointment and remuneration, etc., of auditors
22. Capitalization of profits
23. Board meetings and proceedings thereof
24. Rules as to resolutions
25. Appointment, powers, duties, qualifications, remuneration etc., of managing director, manager and secretary, if any
26. Arbitration provision, if any

27. Provision for such powers which cannot be exercised without the authority of Articles, for example, the issue of redeemable preference shares; issuing share warrants to bearer; refusing to register the transfer of shares; reducing share capital of the company

28. Winding up

In addition to the above matters, the Articles of an unlimited company should state the number of members with which the company is to be registered and if it has a share capital, the amount of share capital with which it is to be registered [Sec. 27(1)]. In the case of a company limited by guarantee, the Articles must state the number of members with which the company is to be registered [Sec. 27(2)]. The articles of a private company having a share capital must contain the four restrictions as given by Section 3(1)(iii) of the Act.

C. Alteration of Articles

The Articles, being the internal regulations of the company, can be freely altered by the company. The right to alter or add to the articles is expressly conferred by Section 31 which states that a company may alter its articles, as often as required, by passing a special resolution only. A copy of special resolution authorizing the alteration together with a printed copy of the altered articles must be filed with the Registrar within 30 days of passing the said resolution. The alteration will be effective from the date of registration by the Registrar.

D. Limitations Regarding Alteration of Articles

1. The alteration must not be inconsistent with the provisions of the Companies Act or any other statute (Sec. 31)

2. The alteration must not be inconsistent with the conditions contained in the memorandum (Sec. 31)

3. The alteration must not be inconsistent with the alteration ordered by the Company Law Board

4. Approval of the Central Government must also be obtained in certain cases

5. The alteration must not deprive any person of his rights under a contract

6. The alteration must not constitute a fraud on the minority

7. The alteration must be bona fide for the benefit of the company as a whole

Check Your Progress

6. What do you mean by a company?

7. How can a company change its registered office?

8. What do you mean by Articles of Association in a company?
10.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Limited Liability Partnership (LLP) is a new form of business entity that enables professional expertise and entrepreneurial initiative to combine, organize and operate in an innovative and efficient manner.

2. The law of Limited Liability Partnership (LLP) is contained in the Limited Liability Partnership Act, 2008. The Act contains 81 Sections and 4 Schedules. The LLP Act came into force, for most of the provisions, on 31st March, 2009 and remaining provisions on 31st May, 2009.

3. Every limited liability partnership is required to have at least two ‘designated partners’ who are individuals and at least one of them shall be a resident in India, provided in case of an LLP in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such LLP or nominees of such bodies corporate shall act as designated partners.

4. Every partner shall inform the limited liability partnership of any change in his name or address within a period of 15 days of such change. The LLP, in turn, would be under obligation to file such details with the Registrar within 30 days of such change. An LLP will also be required to file a notice with the Registrar within 30 days from the date on which any person becomes or ceases to be a partner.

5. Section 63 of the LLP Act provides that a Limited Liability Partnership may be wound up in the following two ways:
   I. Winding up under order of the Court.
   II. Voluntary winding up

6. A company may be defined as an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.

7. A company may change its registered office within the same city by passing a Board’s resolution only to that effect. A notice is, however, to be given to the Registrar within 30 days of the change.

8. Articles of Association is another document of paramount significance in the life of a company. It contains regulations for the internal administration of a company’s affairs. Articles of Association may well be compared with the ‘Partnership Deed’ in a partnership. They prescribe rules and bye-laws for the general management of the company and for the attainment of its objects as given in its memorandum.
Limited Liability Partnership (LLP) is a new form of business entity that enables professional expertise and entrepreneurial initiative to combine, organize and operate in an innovative and efficient manner.

A limited liability partnership is a legal person having a juristic personality, entirely distinct from and independent of the individual persons who are for the time being its partners.

Every partner shall inform the limited liability partnership of any change in his name or address within a period of 15 days of such change. The LLP, in turn, would be under obligation to file such details with the Registrar within 30 days of such change.

The Court enjoys wide powers after making the winding up order under Sections 466-481 and Section 559 of the Companies Act.

A company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them is termed ‘a company limited by shares’ [Sec. 12(2)(a)]. Such a company is popularly called a limited liability company.

Section 13 sets out the contents of the memorandum. The document must contain the following clauses: (1) the name clause, (2) the registered office clause, (3) the objects clause, (4) the liability clause, (5) the capital clause, and (6) the association clause or subscription clause.

As per Section 16 ‘a company shall not alter the conditions contained in its memorandum except in the cases, in the mode, and to the extent, for which express provision is made in the Companies Act’.

Section 26 states that a public company limited by shares may register articles, while a company limited by guarantee or an unlimited company or a private company limited by shares must register articles along with the memorandum at the time of registration.

10.9 KEY WORDS

- **Pari passu**: This is a Latin phrase that literally means “with an equal step” or “on equal footing”. It is sometimes translated as “ranking equally”.

- **The Company Law Board (CLB)**: This is a quasi-judicial body, exercising equitable jurisdiction, which was earlier being exercised by the High Court or the Central Government. The Board has powers to regulate its own procedures.
10.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions
1. Write a short note on the evolution of Limited Liability Partnership (LLP) as business entity.
2. Write in brief about characteristics of LLP.
3. Write a short note on registration of change in partner in LLP.
4. Write in brief about the various grounds for winding up of an LLP by the Court.
5. Write in a brief about the memorandum of association of a company.

Long-Answer Questions
1. Discuss the various provisions in the Limited Liability Partnership Act, 2008.
2. Analyse the rules of dissolution of firms.
3. Analyse the scope of alteration in memorandum of association.

10.11 FURTHER READINGS

UNIT 11 THE COMPANIES ACT, 1956

Structure

11.0 Introduction
11.1 Objectives
11.2 Nature And Kinds Of Companies
11.3 Prospectus and Disclosure Needs
11.3.1 Contents of a Prospectus
11.4 Management and Administration: Director’s Appointment, Powers and Duties
   11.4.1 Appointment of Directors
   11.4.2 Powers of Directors
   11.4.3 Duties of Directors
   11.4.4 Other Managerial Personnel
11.5 Answers to Check Your Progress Questions
11.6 Summary
11.7 Key Words
11.8 Self Assessment Questions and Exercises
11.9 Further Readings

11.0 INTRODUCTION

A ‘company’ is the most suitable form of organization for large-scale enterprises requiring heavy investment and also for enterprises involving heavy risks. The Companies Act, 2013 define a company as ‘a company formed and registered under this Act or an existing company. An ‘existing company’ means a company formed and registered under any of the former Companies Acts’. A company, thus, may be defined as an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.

In this unit, you will study about the meaning and definition of a company. Besides, this unit will discuss the constitution of the board of company, law administration and incorporation of companies.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand the nature and kinds of companies
- Describe the provisions regarding prospectus and disclosure under the Companies Act
- Discuss the provisions regarding appointment, powers and duties of directors of companies
11.2 NATURE AND KINDS OF COMPANIES

A ‘company’ is the most suitable form of organization for large-scale enterprises requiring heavy investment and also for enterprises involving heavy risks. The Companies Act, 2013 defines a company as ‘a company formed and registered under this Act or an existing company. An ‘existing company’ means a company formed and registered under any of the former Companies Acts’. A company, thus, may be defined as an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.

An examination of the definitions reveals the following essential characteristics of a company:

(i) Incorporated association. A company must necessarily be incorporated or registered under the prevalent Companies Act. Registration creates a joint stock company and it is compulsory for all associations or partnerships, having a membership of more than 10 in banking and more than 20 in any other trading activity, formed for carrying on a business with the object of earning profits.

(ii) Artificial legal person. A company is an artificial legal person in the sense that on one hand, it is created by a process other than natural birth and does not possess the physical attributes of a natural person, and on the other hand, it is clothed with many of the rights of a natural person. It is invisible, immortal (law alone can dissolve it) and exists only in the eyes of law. It has no body, no soul, no conscience, neither is it subject to the imbecilities of the body. It is because of these physical disabilities that a company is called an artificial person.

(iii) Separate legal entity. A company is a legal person having a juristic personality entirely distinct from and independent of the individual persons who are for the time being its members (Kathiawar Industries Ltd vs C.G. of Evacuee Property). It has the right to own and transfer the title to property in any way it likes. No member can either individually or jointly claim any ownership rights in the assets of the company during its existence or in its winding up (Mrs B.F. Gazdar vs the Commissioner of Income Tax). It can sue and be sued in its own name by its members as well as outsiders. Creditors of the company are creditors of the company alone and they cannot directly proceed against the members personally.

(iv) Perpetual existence. A company is a stable form of business organization. Its life does not depend upon death, insolvency or retirement of any or all shareholder(s) or director(s). The provision for transferability of shares in case any shareholder wishes to drop out, as also for transmission of shares to the successor(s) of the deceased in case any shareholder dies, helps to
preserve the perpetual existence of a company. Law creates it and law alone can dissolve it. Members may come and go, but the company can go on forever. The company may be compared with a flowing river where water keeps changing continuously, still the identity of the river remains the same. Thus, a company has a perpetual existence, irrespective of changes in its membership.

(v) **Common seal.** 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 persons who are termed as directors. However, 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 a 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.

(vi) **Limited liability.** The liability of the members for the debts of the company is limited to the amount unpaid on their shares however heavy losses the company might have suffered. For instance, if a shareholder buys 100 shares of ₹ 10 each and pays ₹ 5 on each share, he has paid ₹ 500 and can be made no pay another ₹ 500, but he cannot be made to pay more than ₹ 1,000 in all. No shareholder can be called upon to pay more than the nominal or face value of shares held by him, in case of a company with limited liability. Thus, by virtue of this characteristic the personal property of the shareholder cannot be seized for the debts of the company, if he holds a fully paid-up share.

(vii) **Transferability of shares.** The shares of a public company are freely transferable and members can dispose of their shares whenever they like without seeking any permission from the company or the other members. In a private company, however, some restriction on the right to transfer is essential in its articles as per the Act, but absolute restriction on the right of the members to transfer shares contained in the articles shall be void.

It, may, however, be noted here that a company possesses all these characteristics by virtue of its incorporation or registration under the Companies Act. Although a partnership—the main alternative to the company as a form of business organization, may also be registered under the Indian Partnership Act, 1932, yet it does not possess any of these characteristics.

11.2.1 Types of Companies

A company may be incorporated either by a special Act of legislature or under the Companies Act and accordingly a company may be: (i) statutory company, or (ii) incorporated company.

(i) **Statutory company.** It is incorporated by a special Act passed either by the Central legislature or state legislature. Companies intending to carry on
some business of national importance are formed in this way. Examples of such companies include: Reserve Bank of India, State Bank of India, Life Insurance Corporation, Food Corporation of India, Unit Trust of India, etc. The powers which are to be exercised by such companies are defined by the Acts constituting them and therefore, they are not required to have a memorandum of association (a document which defines the limitation of the powers of a company), as also to use the word ‘Limited’ as part of their names. The audit of such companies is conducted under the supervision and control of the Auditor General of India. Although each statutory company is governed by the provisions of its special Act, the provisions of the Companies Act, 1956, also apply to them, in so far as the said provisions are not inconsistent with the provisions of the special Acts under which these companies are formed (Sec. 616).

(ii) Incorporated or registered company. A company registered under the Companies Act is known as ‘incorporated’ or ‘registered’ company. All existing companies in India, except the statutory companies, have been formed in this way and are governed by the provisions of the Companies Act, 1956. It may, however, be noted that insurance, banking and electric supply companies though incorporated under the Companies Act are also governed for most of their operative matters by provisions of their special Acts, viz., the Insurance Act, 1938, the Banking Regulation Act, 1949, and the Electricity Supply Act, 1948, and the provisions of the Companies Act will be applicable to these companies only to such extent as these are not inconsistent with those contained in the special Acts governing them.

Registered companies can further be classified in two ways: (i) on the basis of the number of the members, and (ii) on the basis of liability of members.

Types of registered companies on the basis of number of members

On the basis of the number of members, a registered company may be: (i) private company or (ii) public company.

(i) Private company. According to the Companies Act, a ‘private company’ means a company which has a minimum paid-up capital of Rs 1 lakh or such higher paid-up capital as may be prescribed, and by its articles of association:

- Restricts the right of the members to transfer shares, if any;
- Limits the number of its members to 50, excluding members who are or were in the employment of the company;
- Prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company; and
- Prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.
The Companies Act, 1956

NOTES

The significance of the words *if any* used in sub-clause (a) above may be borne in mind. As a result of these words, the articles of association of a private company *having no share capital* shall have to place restrictions specified in the aforesaid sub-clauses (b), (c) and (d) only. In other words, in the case of a private company having no share capital, articles of association need not contain restriction regarding the right of the members to transfer shares.

(ii) **Public company.** As per the Companies Act a ‘public company’ means a company which:

(a) is not a private company;

(b) has a minimum paid-up capital of ₹ 5 lakh or such higher paid-up capital, as may be prescribed;

(c) is a private company which is a subsidiary of a company which is not a private company, i.e., which is a subsidiary of a public company.

Elaborating Clause (a) of the above definition, a ‘public company’ is one, which:

(i) does not have any restriction on the transfer of shares, if any:

(ii) does not limit the maximum number of members,

(iii) can invite public for the subscription of its shares and debentures (of course it is under no obligation to invite public for this purpose if it is confident of obtaining the required capital privately); and

(iv) can invite or accept deposits from the public.

The minimum number of members required to form a public company is 7.

Types of registered companies on the basis of liability of members

On the basis of liability of members, the Companies Act, 2013, makes provision for the registration of three types of companies, namely:

1. **Companies limited by shares.** A company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them is termed ‘a company limited by shares’. Such a company is popularly called a *limited liability company*. The liability can be enforced at any time during the existence and also during the winding up of the company. Such a company must have share capital as the extent of liability is determined by the face value of shares. Most of the companies in India are of this type and it is with companies of this class that we are mainly concerned.

2. **Companies limited by guarantee.** A company limited by guarantee may be defined as ‘a company having the liability of its members limited by its memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its
being wound up’. The amount guaranteed by each member cannot be demanded until the company is wound up, hence it is in the nature of a ‘reserve capital’.

3. Unlimited companies. A company having no limit on the liability of its members is an unlimited company. Thus, the liability of members in such companies is unlimited, i.e., it may extend to the personal property of the members. Like a partnership, every member is liable to contribute, in proportion to his interest in the company, towards the amount required for payment in full of the total liabilities of the company, and if one is unable to contribute anything then the additional deficiency is to be shared among the remaining members in proportion to their capital in the company. However, it is different from an ordinary partnership in one important respect, i.e., creditors of such a company cannot sue members directly and they can only resort to the winding up of the company on default, the reason is that being a registered company it has a separate entity in law. It must be noted, however, that here also the liability of a member is enforceable only at the time of winding up.

Other types of companies

Some other types of companies which are referred to under the Companies Act, 1956, are as follows:

1. Licensed companies or companies not for profit. Licensed companies are also registered under the Companies Act like any other company but before they are registered a licence may be obtained from the Central Government. Any association formed for promoting commerce, art, science, religion, charity or any other useful object and which does not intend to apply its profits, if any, for payment of any dividend to its members but instead to apply its income in promoting its objects can obtain a licence from the Government and can get itself registered as a company with limited liability. On registration, it enjoys certain exemptions and privileges as compared to an ordinary limited company.

2. One-man company or family company. Where one man holds practically the whole of the share capital of a company and takes a few more dummy members (usually family members), simply to meet the statutory requirement of the minimum number of persons (six more persons in case of a public company and one other person in case of a private company), such a company is known as ‘one-man company’.

3. Foreign company. A foreign company means a company incorporated outside India but having a place of business in India.

4. Government company. A government company is defined as ‘any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or by any State Government or governments of
partly by the Central Government and partly by one or more State governments and includes a company which is a subsidiary of a Government company as thus defined”.

5. **Holding company and subsidiary company.** Where one company controls the management of another company the former is called the ‘holding company’, and the latter over which the control is exercised is termed as a ‘subsidiary company’.

### Check Your Progress

1. Define a company.
2. How is a company a legal artificial person?
3. What is the minimum number of members required to form a public company?

## 11.3 PROSPECTUS AND DISCLOSURE NEEDS

After the certificate of incorporation has been obtained, the promoters and directors of public company, if unable to raise the necessary capital for the company, invite the public to subscribe to its shares or debentures. This is done by issuing of a document called ‘Prospectus’. The object of a prospectus is to arouse the interest of the potential investors in the company and induce them to invest in its shares or debentures. Lest the prospective investors be misled, there are a large number of statutory provisions, aimed at their protection, relating to the form and contents of a prospectus. If a company needs more funds for expansion in future, a prospectus may also be issued at a later stage.

### Definition of Prospectus

The Companies Act defines the term ‘Prospectus’ in these words: ‘a prospectus means any document described or issued as a prospectus and includes any notice, circular, advertisement, or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a company’. The term ‘prospectus’, therefore, includes any document, however informal, which invites deposits from the public or offers shares or debentures of a company for subscription to the public.

### The Offer for Sale to be Deemed Prospectus

Even if the whole of the share capital of a company is allotted to an intermediary known as an ‘Issue House’—a company or firm whose main business is the handling of new issues, which then offers the shares to the public by means of an advertisement of its own, a document by which such an offer for sale to public is made shall be deemed to be a prospectus by implication, provided it is shown:
The Companies Act, 1956

(i) That the offer was made within six months after the allotment or agreement to allot to the Issue House; or

(ii) That at the date of offer to the public, the whole consideration in respect of the shares has not been received by the company.

The responsibility of the company, its directors and promoters remains the same in the case of offer for sale to public by an Issue House as that in the case of direct issue of prospectus by a company.

The meaning of the phrase ‘offer to the public’: ‘Offer to the public’ is an important condition in the above definition which determines whether a document is a prospectus or not. It is difficult to say exactly how many persons constitute ‘the public.’ Any number from two to infinity, perhaps even one, may serve to indicate public. The Companies Act clarifies the position and states that ‘public’ includes any Section of the public, however selected. For example, if a document inviting persons to buy shares is issued, to all teachers, or to all students of commerce, or to all the clients of a particular sharebroker or to all the shareholders of a company concerned, it is still issued to ‘the public’ and therefore is a prospectus. It follows from this that even if there were only one person in the particular Section of the public selected, he alone shall constitute public. The Act, however, limits the effect of this Section by stating that: (a) if the offer can be accepted only by persons to whom it is made, the offer is not one made to the public; or (b) if the offer is made to a few friends of the directors or if it is the domestic concern of those making and receiving the offer, the offer is not made to the public.

The meaning of the word ‘subscription or purchase.’ The word subscription in the definition means taking the shares for cash. Hence a circular by a company offering the new shares to the shareholders of two existing companies in exchange for their shares in those companies was not an offer for subscription within the definition (Government Stock Investment Co. Ltd. vs Christopher). Therefore, the document making the offer could not be called a prospectus within the meaning of the term in the Act.

Issue of Prospectus

The legal requirements as to the issue of a prospectus are as follows:

1. The ‘guidelines for disclosure and investor protection’ issued by SEBI (Securities and Exchange Board of India), as amended from time to time, regarding capital issues to the public must have been complied with for the proposed issue of shares or debentures to the public, and a statement to that effect must be made in the prospectus.

2. A copy of the prospectus, duly dated and signed by all the directors, must have been registered with the Registrar. The copy for registration must be accompanied with:
   
   (i) The consent in writing of the expert if his report is to be published in the prospectus. The expert should be unconnected with the formation or management of the company;

NOTES
The Companies Act, 1956

NOTES

(ii) A copy of every material contract and of every contract relating to appointment and remuneration of managerial personnel;

(iii) A written statement relating to adjustment, 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.;

(iv) The consent in writing of auditors, legal advisor, banker and broker etc., of the company to Act in that capacity.

(3) The prospectus must be issued within 90 days of the date on which a copy thereof is delivered for registration. If it is not issued within this period, it shall be deemed to be a prospectus, a copy of which has not been delivered to the Registrar. The reason for imposing the time limit is that if the issue of the prospectus is delayed too long, conditions may alter and what is stated in the prospectus may no longer be valid. The company and every person who is knowingly a party to the issue of a prospectus without registration shall be punishable with fine up to ₹50,000 (Sec. 60).

11.3.1 Contents of a Prospectus

Prospectus is the only window through which the potential investor can look into the soundness of the company’s venture (New Brunswick, etc. Co. vs Muggeridge). Hence the Companies Act intends to secure the fullest disclosure of all material and essential particulars in a prospectus. The Act provides that every prospectus issued by or on behalf of a company must state the matters and set out the reports specified in ‘Schedule II’ given at the end of the Companies Act, 1956.

The Government has revised the format of prospectus given in Schedule II of the Companies Act, 1956. The revised format has been made effective from 1st November 1991. This has been done to provide for greater disclosure of information regarding the company, its management, the project proposed to be undertaken by the company and the management perception of risk factors so as to enable the investors to take an informed decision regarding investment in shares or debentures offered through public issue.

Matters to be specified: Briefly stated, a prospectus must contain at least the following particulars:

1. Company’s name and address of its registered office.
2. The names and addresses etc., of company promoters and their background.
3. The main objects of the company, its history and present business.
4. The names, addresses and occupation of manager, managing director and other directors (giving their directorships in other companies).
5. The size of present issue giving separately reservation for preferential allotment to promoters and others.
6. The date of opening and closing of the subscription list and the date of earliest closing of the issue.
7. The names and addresses of the company secretary, legal advisor, auditors, lead managers, bankers and brokers to the issue.

8. The name and address of the trustee under debenture trust deed (in case of debenture issue).

9. Consent of directors, auditors, solicitors, managers to the issue, bankers to the company, bankers to the issue and experts.

10. Contents of the Articles or any contract relating to the appointment of managing director or manager, the remuneration payable to him or them and the compensation, if any, payable to him or them for loss of office.

11. The amount payable on application and allotment of each share, along with details about availability of forms, prospectus and mode of payment.

12. The details of option to subscribe for securities in the ‘depository mode’.

13. The procedure and time schedule for allotment and issue of certificates.

14. The rights, privileges and restrictions attached to several classes of shares.

15. Minimum Subscription Clause. The following statements must appear:

   (a) For non-underwritten public issues: If the company does not receive the minimum subscription of 90% of the issued amount on the date of closure of the issue, or if the subscription level falls below 90% after the closure of issue on account of cheques having been returned unpaid or withdrawal of applications, the company shall forthwith refund the entire subscription amount received. If there is a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest for the delayed period at the rate of 15% per annum, as prescribed under the Act.

   (b) For underwritten public issues: If the company does not receive the minimum subscription of 90% of the net offer to public including devolvement of underwriters within 60 days from the date of closure of the issue, the company shall forthwith refund the entire subscription amount received. If there is a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest for the delayed period at the rate of 15% per annum, as prescribed under the Act.

16. The names of Regional Stock Exchange and other stock exchanges where application has been made for listing of present issue.

17. The names and addresses of the underwriters, underwritten amount, underwriting commission and declaration by Board of Directors that the underwriters have sufficient resources to discharge their respective obligations.

18. The material details about the project, namely, its location, plant and machinery, technology, process etc., collaboration, any performance
guarantee or assistance in marketing by the collaborators, infrastructure facilities for raw materials and utilities like water, electricity etc., schedule of implementation of the project and progress so far.

19. The nature of the product(s)—whether consumer or industrial, approach to marketing and proposed marketing set up and export possibilities and export obligations, if any.

20. Future prospects—expected capacity utilisation during the first three years from the date of commencement of production, and the expected year when the company would be able to earn cash profits and net profits.

21. Stock exchange quotations—the high/low stock exchange price in each of the last three years and monthly high/low during last six months (where applicable).

22. The particulars of public issues made during the last three years by the company and other listed companies under the same management.

23. The particulars of outstanding litigation and criminal prosecution.

24. The particulars of default, if any, in meeting statutory dues, institutional dues and towards instrument holders like debentures, fixed deposits, etc., in relation to the company and other companies promoted by the same private promoters and listed on stock exchanges.

25. Management perception of risk factors, e.g., sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time over-run, etc.

26. The disclosure of credit rating obtained from CRISIL (Credit Rating and Information Services of India Limited) or any recognised rating agency for the proposed debenture/preference shares issue. If the company has not obtained any rating, the prospectus should state that no rating has been obtained.

27. Expenses of the issue giving separately fee payable to advisors, registrars and managers to the issue and trustees for the debentureholders.

28. Particulars of any property to be acquired by the company and the price whereof is to be paid out of the proceeds of the issue, together with the names, addresses, etc. of the vendors, the purchase price and the mode of payment.

29. Amount of benefit paid or given within two preceding years to any promoter or officer of the company, and the consideration thereof.

30. Particulars of any property acquired within two preceding years in which any director or promoter was interested.

31. Particulars of the length during which the business has been carried on by the company—profit and loss and balance sheet particulars for the last five years.
32. Particulars of any revaluation of the assets of the company during the last five years.
33. Any special tax benefits for company and its shareholders.
34. A reasonable time and place at which copies of all balance sheets and profit and loss accounts, if any, on which the report of auditors is based, may be inspected.
35. A declaration that all the relevant provisions of the Companies Act and the guidelines issued by the Government or the guidelines issued by the Securities and Exchange Board of India, as the case may be, have been complied with and no statement made in prospectus is contrary to the provisions of the aforesaid act or rules or guidelines.

**Reports to be set out.** In appropriate cases, the following reports are required to be set out in a prospectus:

1. A report by the auditors of the company relating to profits and losses and assets and liabilities of the company, as also of the company’s subsidiaries, if any, for the last five years.
2. A report by the auditors of the company with respect to the rates of dividends, if any, paid by the company in respect of each class of shares for the last five years.
3. If the company proposes to acquire any business, a report by a Chartered Accountant, whose name should be disclosed in the prospectus, upon the profits and losses and assets and liabilities of the business, for the preceding five years.
4. A similar report by a Chartered Accountant named in the prospectus, if the proceeds of the issue are to be applied in the acquisition of shares in any other company, about such company.

The Companies Act further provides that the following provision must be prominently printed in every prospectus and in every application form for shares issued by the company: *Any person, who makes in a fictitious name an application to a company for acquiring any shares therein, or otherwise induces a company to allot or register any transfer of shares therein to him or any other person in a fictitious name, shall be punishable with imprisonment up to five years.*

**Application Forms to be accompanied by an Abridged Prospectus**

The Act states that no application form can be issued for shares or debentures of a company unless it is accompanied by *an abridged prospectus* which complies with the requirements of the Act. However, the full prospectus is to be furnished on a request being made by any person before the closing of the subscription list. If any person acts in contravention of this provision, he shall be punishable with fine up to ₹ 50,000.
4. What is the objective of a prospectus?
5. Why does the Companies Act intend to secure the fullest disclosure of all material and essential particulars in a prospectus?

11.4 MANAGEMENT AND ADMINISTRATION: DIRECTOR’S APPOINTMENT, POWERS AND DUTIES

Under the Companies Act while the Board of Directors is a must for the management and administration of a company. Other kinds of managerial personnel—managing director(s) or manager—are only optional, the company may or may not have them. The companies can be managed either by the Board of Directors itself, or by the Board of Directors with the help of managing director(s) or manager. Of these two modes of management the companies prefer the latter mode of management.

It is surprising that the law does not precisely define the term director. The Companies Act defines a director as any person occupying the position of director, by whatever name called. This is not a satisfactory definition. We can define him thus, ‘a director is one of those persons, who are responsible for directing, governing or controlling the policy or management of a company.’ Directors collectively are called as ‘Board of Directors’ or ‘Board’. The board of directors is the top administrative organ of the company. If company is the body, then directors are the brain of the company and the company can and does act only through them. The Act expressly vests the management of the business of a company in its directors. The task of the shareholders is almost over with the selection of directors. Only the most important matters of the Board’s policy may be referred to the shareholders for decision at the periodical general meetings. In fact, the ‘Board’ is the supreme policy framing and decision making organ of a company.

Number of Directors

Every public company must have at least three directors and every private company must have at least two directors. The Act does not fix any maximum number. Subject to this statutory minimum number of directors, the articles of a company may prescribe the maximum and minimum number of directors for its Board. Within the limits prescribed by the articles, the company may reduce or increase the number of its directors by an ordinary resolution in general meeting.

In the case of a public company, any increase beyond the maximum limit fixed by the Articles must be approved by the Central Government except where the increase in the number of directors does not make the total number of directors more than twelve (Sec. 259).
Qualifications of Directors

The Companies Act does not lay down any academic or shareholding qualifications for a director. There is a widespread misconception that a director must necessarily be a shareholder of the company. But it is not so. Unless the articles provide otherwise, a director need not be a shareholder of the company. Financial prudence, however, requires that directors must have some stake in the company. It is why that articles usually provide for certain qualification shares for a director. If the articles so provide then, as per the Companies Act, the directors must obtain their qualification shares, within two months after their appointment unless they already hold shares of that amount.

Disqualifications of Directors

The Companies Act, states that a person shall not be capable of being appointed director of a company, if:

(i) He has been adjudged to be of unsound mind;
(ii) He is an undischarged insolvent;
(iii) He has applied to be adjudged insolvent;
(iv) He has been convicted by a court and sentenced to at least six months of imprisonment for an offence involving moral turpitude and five years have not elapsed from the date of expiry of the sentence;
(v) He has failed to pay any calls on his shares for six months; and
(vi) He has been disqualified by the court for fraudulent activities in company promotion or management under the Act.
(vii) He is already a director of a public company which:

(a) Has not filed the annual accounts and annual returns for any continuous three financial years commencing on or after 1st April 1999; or
(b) Has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; any such director shall not be eligible to be appointed as a director of any other public company for a period of five years from the date of default committed by the company. However, the nominee directors appointed by Public Financial Institutions, Central or State Government and Banking Companies are exempt from this disqualification (stated under sub-clause vii above). Further, the Central Government has notified that this disqualification shall not be applicable to directors of a government company.

The disqualifications mentioned in sub-clauses (iv) and (v) above may be waived by Central Government by notification in the Official Gazette. The Section further authorises a private company to add any other additional disqualifications.
in its articles for appointment as a director. Implicitly, it means that a public company, cannot prescribe additional disqualifications in its articles, for appointment as a director.

11.4.1 Appointment of Directors

Legally, no firm or association or company can be appointed as director, only individuals can be so appointed provided he has been allotted a Director Identification Number under Section 266B the Act. Any individual competent to contract who is not disqualified under the Act stated above and who holds the minimum qualification shares, if any, may be appointed as director of a company.

First directors. The first directors of a company are appointed by the subscribers to the memorandum and their names are mentioned in the articles. If it is not done, the articles may prescribe the method of appointing them. If the articles neither contain the names of the first directors nor any provision for appointing them, the subscribers to the memorandum, who are individuals, shall be deemed to be the first directors. Such directors shall retire at the first annual general meeting of the company, when directors will be appointed in accordance with the provisions of the Act.

Subsequent directors. Regarding the appointment of subsequent directors the Act states that unless the articles provide for the retirement of all the directors at every annual general meeting, at least two-thirds of the total number (any fraction to be rounded off as one) of directors of a public company shall be rotational directors, i.e., liable to retire by rotation and shall be appointed by the shareholders in general meeting. The remaining directors, not exceeding one-third of the total number, in the case of any such company, and all the directors in the case of a private company may be appointed on non-rotational basis in such manner and for such duration of time as provided in the articles of the company. In the absence of any regulations in the articles in this regard, these directors shall also be appointed by the shareholders in general meeting.

It may thus be noted that the Act permits one-third of the total number of directors of public company and all the directors of a private company to be appointed, otherwise than by the shareholders at a general meeting, in such manner as provided in the articles. It follows that within the aforesaid limit as to the number of directors, a power of appointment of directors can be validly conferred by the articles on a third party, e.g., debentureholders or other specified creditor or any other specified person, and such nominee directors may be appointed on a non-rotational basis for any duration of time, even for life as permanent directors.

At every subsequent annual general meeting, out of the two-thirds directors liable to retire by rotation, one-third or the number nearest to one-third, must retire. The directors longest in office shall retire in the first place, but as between persons who became directors on the same day, those who are to retire shall be determined by lot, if there is no agreement among them. The directors who are to
retire by rotation at an annual general meeting would automatically vacate office on the last day on which the annual general meeting ought to have been held. They cannot prolong their tenure by not holding a meeting in time (*B.R. Kundra vs Motion Pictures Association*).

The retiring directors shall be eligible for re-election. If a new person *i.e.*, one who is not a retiring director, is to be appointed, a notice in writing must be given to the company at least 14 days before the meeting. The notice must be given by the person seeking appointment as director or by some member intending to propose him as director, provided the said member is eligible to vote on the resolution of such appointment. The person sending such notice must also deposit Rs500 with the company. The company is then required to inform the members at least 7 days before the annual general meeting about the candidature. The deposit referred above shall be refunded to the depositor if the person succeeds in getting elected as a director, otherwise it would be forfeited by the company.

The vacancies thus created must be filled up at the same meeting but if the company fails to do this, the meeting shall be deemed to have been adjourned for a week. If at the reassembled meeting also, the places of retiring directors are not filled up, the retiring directors shall be deemed to have been re-elected automatically, unless:

- (a) It is resolved not to fill the vacancy, or
- (b) A resolution for his re-election is lost, or
- (c) He has expressed in writing his unwillingness to continue, or
- (d) He had incurred a disqualification.

It should, however, be noted that each director has to be elected through a separate resolution passed by simple majority, unless the meeting unanimously resolves otherwise. Again, the appointment of a director, who is not a retiring director will not be valid unless written consent to act as a director is filed with the Registrar within 30 days of appointment.

**Appointment by proportional representation.** The Act provides for option to companies to adopt the system of proportional representation for the appointment of directors so that the minority interests could also be represented on the Board of Directors. This Section states that the articles of a public company may provide for the appointment of at least two-thirds of the total number of the directors according to the principle of proportional representation, *whether* by the system of cumulative voting *or* by the system of single transferable vote *or* otherwise. But where this principle is adopted, appointments are to be made only once in every three years as no form of proportional representation can work on the basis of an annual renewal of portion of the directorate. However, casual vacancies which arise during the three year period may be filled in the manner provided under the Act.

Inspite of the merit of the system of proportional representation, there are hardly any companies which have in practice adopted this system so far.
Appointment of Directors by the Board

The Board of Directors may appoint directors in the following circumstances:

1. **Casual vacancies**: If the office of a director falls vacant for some reason (i.e., death or resignation, etc.) before his term expires the same may, subject to any regulations in the articles, be filled by the Board of Directors. But a director so appointed, will cease to act the moment the term of the original director is completed.

2. **Additional directors**: If the articles so permit, the Board of Directors can also appoint additional directors, subject to maximum number fixed in the articles, who shall hold office only up to the date of next annual general meeting.

3. **Alternate directors**: Similarly, the articles may empower the Board to appoint an alternate director, during the absence of a director for more than three months, from the State in which the meetings of the Board are ordinarily held. Such an alternate director shall vacate office either on expiry of the original director’s term or on return of the original director to the state.

Appointment of Directors by Central Government

With a view to preventing oppression and mismanagement, the Central Government may appoint such number of directors as the Company Law Board may, by order in writing, specify as being necessary to effectively safeguard the interests of the company, or its shareholders, or the public interest, for a period not exceeding three years. The Company Law Board may pass the above order on a reference made to it by the Central Government or on the application of at least one hundred members of the company or of members holding at least ten per cent voting rights. Any directors appointed by the Central Government shall neither be required to hold any qualification shares nor they shall be subject to retirement by rotation. They will also not be included in the total number of directors for the purpose of counting two-thirds or any other proportion. Further no change in the Board of Directors, after such appointment as aforesaid, shall have effect unless confirmed by the Company Law Board.

Appointment of Directors by Third Parties

The Companies Act provides that one-third of the total number of directors of a public company and all the directors of a private company may be appointed by third parties on a non-rotational basis, if the Articles so authorise. The Articles may give such a right to debentureholders or other specified creditors. If for any reason the non-rotational directors have to be increased beyond one-third of the total number of directors, then the number of rotational directors shall also have to be increased so as to comply with the requirement as regards the two-thirds proportion of rotational directors.
Companies Act, 2013 and Number of Directorships

Under Section 165 of the Companies Act, 2013, maximum number of directorships, including any alternate directorship a person can hold is 20. It has come with a rider that number of directorships in public companies/ private companies that are either holding or subsidiary company of a public company shall be limited to 10. Further the members of a company may restrict abovementioned limit by passing a special resolution. Any person holding office as director in more than 20 or 10 companies as the case may be before the commencement of this Act shall, within a period of one year from such commencement, have to choose companies where he wishes to continue/resign as director. Thereafter he shall intimate about his choice to concerned companies as well as concerned Registrar.

Woman Director

Every listed company shall appoint at least one woman director within one year from the commencement of the second proviso to Section 149(1) of the Companies Act, 2013. Every other public company having paid up share capital of Rs. 100 crores or more or turnover of Rs. 300 crore or more as on the last date of latest audited financial statements, shall also appoint at least one woman director. A period of six months from the date of company’s incorporation, has been provided to enable the companies incorporated under Companies Act, 2013 to comply with this requirement. It is better to say that existing companies (under the previous companies Act) have to comply the above requirements within one year and new companies (under the new companies Act) has to comply within six months from the date of its incorporation. Further, if there is any intermittent vacancy of a woman director then it shall be filled up by the board of directors within three months from the date of such vacancy or not later than immediate next board meeting, whichever is later.

11.4.2 Powers of Directors

Subject to the articles of the company and to the provisions of the Companies Act, the directors of a company have the power to do all such Acts as the company is authorised to do. Once the articles set out their powers, only they may exercise them. The shareholders of the company cannot interfere and control the way in which the directors choose to act, provided they act within the scope of the authority conferred upon them and exercise the powers bona fide in the best interests of the company. If the shareholders disapprove the Board’s actions strongly enough, they can alter the articles to restrict the Board’s power or they can refuse to re-elect the directors of whose action they disapprove, but they cannot themselves unlawfully seize and possess those powers which by the articles are vested in the directors [John Shaw & Sons (Salford) Ltd. vs Shaw].

There are certain exceptional cases, however, where the majority of shareholders in a general meeting may intervene and exercise a power vested in the Board:
(a) When the directors act for their own personal interests in complete disregard to the interests of the company.

(b) When the Board has become incompetent to act, e.g., where all the directors are interested in a dealing.

(c) When the directors are either unable or unwilling to act.

It is to be remembered that individual directors have no authority to bind the company and they have to act as Board in a meeting for exercising their powers, unless the articles provide otherwise (Re Cleadon Trust Ltd.). The articles, however, usually authorise the Board of Directors to delegate some of their powers to a Committee of Directors or to the managing director or manager.

Statutory Provisions Regarding Directors’ Powers

Under the Act, the following powers, subject to any restriction placed by the articles, can be exercised by the Board only by means of resolutions passed at meetings of the Board and not by circulation:

1. The power to make calls;
2. The power to authorise the company to buyback its own shares or other specified securities upto 10% of the total of its paid-up equity capital and free reserves;
3. The power to issue debentures;
4. The power to borrow moneys otherwise than on debentures;
5. The power to invest the funds of the company; and
6. The power to make loans.

The Board may, however, by a resolution passed at a meeting, delegate to any committee of directors, the managing director, the manager or any other principal officer of the company, the powers to borrow money, to invest the funds and to make loans. The resolution should specify the extent, nature and purpose in each case.

Besides the above-mentioned powers, the Companies Act, under several other Sections, provides for some other powers which must also be exercised at the Board meetings only. For example:

(i) The power to fill up casual vacancies among directors, to appoint alternate directors, and to appoint additional directors, subject to any regulations in the articles.

(ii) The power to accord sanction to such contracts in which any directors or their relatives, etc., are interested.

(iii) The power to recommend the rate of dividend to be declared by the company at the Annual General Meeting, subject to the approval by the shareholders.
(iv) The power to appoint the first auditors of the company and to fill any casual vacancy in the office of the auditor unless such a vacancy is caused by resignation of the auditor.

In the exercise of certain powers, however, unanimous consent of all the directors present at the Board meeting and entitled to vote thereon is required, for example:

(a) The power to appoint a person as ‘managing director’ if he is the ‘managing director’ or ‘manager’ of one and not more than one other company.

(b) The power to appoint a person as ‘manager’ if he is the ‘managing director’ or ‘manager’ of one and not more than one other company.

(c) The power to make loans to, or to invest in any shares and debentures of, any other body corporate under the Act.

Restrictions on the Powers of Directors

The restrictions on the powers of directors are contained in Section 293 of the Act. In case of public companies, the Board of Directors cannot exercise any of the following powers without the consent of the shareholders in general meeting:

1. Sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company;

   Under the Act, it has been further provided that the title of innocent purchasers and lessees who have acted in good faith and after exercising due care and caution (i.e., who have acted without the knowledge of non-compliance of the above restriction) will not be affected. Moreover, this restriction does not apply to the case of a company whose ordinary business is to sell or lease property.

2. Remit or give time for the repayment of any debt due by a director;

3. Investment of any compensation received in respect of compulsory acquisition of any fixed assets of the company, in securities other than trust securities;

4. Borrow moneys exceeding the aggregate of the paid-up capital of the company and its free reserves (i.e., reserves not set apart for any specific purpose). Borrowing, here, does not include temporary loans from the company’s bankers;

   Sub-section 5 grants protection to a lender who has advanced the loan, in excess of the above limit, in good faith and without knowledge that the limit had been exceeded.

5. Contributions in any year to charitable and other funds not directly relating to company’s business or the welfare of its employees, of amount exceeding ₹50,000 or 5 per cent of the average net profits for the last three financial years, whichever is greater. It is worth noting here that the Companies Act
The Companies Act, 1956

NOTES

empowers the Board of Directors of companies or any persons or other authorities exercising the powers of the Board of Directors, to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of national defence, without any limit and without obtaining the sanction of the company in general meeting.

The above powers of the shareholders cannot be curtailed by the articles of the company. If the directors exceed their powers, their acts shall bind the company only after the shareholders have ratified them, provided that such acts are within the scope of the memorandum.

11.4.3 Duties of Directors

The duties of directors are many and varied and difficult to describe in general terms. There are numerous statutory duties of the directors under the Companies Act on the one hand and on the other, there are duties of a general nature under the general law. To enumerate their statutory duties in detail is not possible as they are spread up throughout the Companies Act, right from incorporation of the company till its liquidation. Moreover, these statutory duties have been discussed at appropriate places in the text. For the sake of example, however, a few statutory duties of directors are enumerated below:

(i) It is the duty of the Board to see that all moneys received from applicants for shares is deposited in a scheduled bank until the ‘certificate to commence business’ is obtained under the Act or the money is returned to the applicants.

(ii) The Act requires the Board of Directors to forward a copy of the Statutory Report at least 21 days before the Statutory Meeting to every member of the company and to the Registrar.

(iii) The Board is required to call, on the requisition of the specified number of members, an extraordinary general meeting of the company [Sec. 169(1)].

(iv) At every Annual General Meeting of a company, the Board shall lay before the company a Balance Sheet and a Profit and Loss Account.

(v) The Board of Directors has to make a ‘declaration of solvency’ of the company in the case of members voluntary winding up.

(vi) At the meeting of the creditors in a creditors’ voluntary winding up, the Board of Directors of the company must (a) cause a full statement of the position of the company’s affairs together with a list of creditors and the estimated amount of their claims to be laid before the meeting; and (b) appoint one of their number to preside at the said meeting.

The duties of directors under the general law may briefly be put as follows:

1. They must always act bona fide for the benefit of the company. They stand in a fiduciary relationship with the company and therefore must not make any secret profit.

2. They must discharge their duties with such care as is reasonable in a person of their knowledge and experience.
3. They must not be negligent. The directors must attend Board’s meetings unless impossible otherwise.

4. They must perform their duties personally. The maxim *delegatus non potest delegare* (a delegate cannot delegate further) applies to them like all agents. Hence, unless permitted by the articles specifically, the directors must not delegate any of their powers to some other person.

**11.4.4 Other Managerial Personnel**

If empowered by the articles, in addition to the Board of Directors, a company may employ *any one* of the following managerial personnel for day to day administration:

1. Managing Director
2. Manager

It may be emphasised that the Companies Act prohibits simultaneous appointment of a ‘managing director’ and ‘manager’ in a company. Only one of these categories of managerial personnel can be employed at a time in any company, public or private. However, employment of ‘whole-time director(s)’ along with the managing director(s) or a manager is not prohibited.

**Managing Director**

The Companies Act defines a managing director as ‘a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of Directors or, by virtue of its memorandum or articles of association, is entrusted with substantial powers of management which would not otherwise be exercisable by him, and includes a director occupying the position of a managing director, by whatever name called.’

It follows from the above definition that a managing director must be a director enjoying ‘substantial powers of management’ (other than administrative acts of routine nature like power to affix the company seal or to sign any share certificate, etc.) Such routine nature acts are usually done by directors but they are not called as managing directors) and such powers may be conferred upon him by (a) agreement, or (b) memorandum, or (c) articles, or (d) Board resolution, or (e) general meeting resolution.

Normally the articles empower the Board of Directors to appoint one of their body to the office of the managing director, by a resolution passed at the Board meeting, under a separate service contract setting out his powers and duties and terms of employment. As such a managing director is a *service director* and he is to act under the control and supervision of the Board. As a managing director must necessarily be a director, his appointment is automatically terminated if he ceases to act as a director either because of any disqualification, e.g., not purchasing qualification shares within two months of his appointment as director or because of his retirement by rotation.
There can be more than one managing director in a company on functional basis. But usually there is only one managing director in a company of moderate size in which case he is the chief executive officer of the company.

Check Your Progress

6. What should be the minimum number of directors in private and public companies?
7. What is the provision in the Companies Act regarding the appointment of a woman director in a listed company?

11.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A company may be defined as an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.
2. A company is an artificial legal person in the sense that on the one hand, it is created by a process other than natural birth and does not possess the physical attributes of a natural person, and on the other hand, it is clothed with many of the rights of a natural person.
3. The minimum number of members required to form a public company is 7.
4. The objective of a prospectus is to arouse the interest of the potential investors in the company and induce them to invest in its shares or debentures.
5. Prospectus is the only window through which the potential investor can look into the soundness of the company’s venture. Hence the Companies Act intends to secure the fullest disclosure of all material and essential particulars in a prospectus.
6. Every public company must have at least three directors and every private company must have at least two directors.
7. Every listed company shall appoint at least one woman director within one year from the commencement of the second proviso to Section 149(1) of the Companies Act, 2013.

11.6 SUMMARY

- A company must necessarily be incorporated or registered under the prevalent Companies Act. Registration creates a joint stock company and it is compulsory for all associations or partnerships, having a membership of more than 10 in banking and more than 20 in any other trading activity, formed for carrying on a business with the object of earning profits.
The Companies Act, 1956

NOTES

1. Statutory company is incorporated by a special Act passed either by the Central legislature or state legislature. Companies intending to carry on some business of national importance are formed in this way.

2. A company registered under the Companies Act is known as ‘incorporated’ or ‘registered’ company. All existing companies in India, except the statutory companies, have been formed in this way and are governed by the provisions of the Companies Act, 1956.

3. On the basis of the number of members, a registered company may be: (i) private company or (ii) public company.

4. According to the Companies Act, a ‘private company’ means a company which has a minimum paid-up capital of Rs 1 lakh or such higher paid-up capital as may be prescribed, and by its articles of association.

5. A company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them is termed ‘a company limited by shares’. Such a company is popularly called a limited liability company.

6. The term ‘prospectus’ includes any document, however informal, which invites deposits from the public or offers shares or debentures of a company for subscription to the public.

7. The ‘guidelines for disclosure and investor protection’ issued by SEBI (Securities and Exchange Board of India), as amended from time to time, regarding capital issues to the public must have been complied with for the proposed issue of shares or debentures to the public, and a statement to that effect must be made in the prospectus.

8. The companies can be managed either by the Board of Directors itself, or by the Board of Directors with the help of managing director(s) or manager. Of these two modes of management the companies prefer the latter mode of management.

9. The first directors of a company are appointed by the subscribers to the memorandum and their names are mentioned in the articles. If it is not done, the articles may prescribe the method of appointing them.

10. The shareholders of the company cannot interfere and control the way in which the directors choose to act, provided they act within the scope of the authority conferred upon them and exercise the powers bona fide in the best interests of the company.

11.7 KEY WORDS

- **Company**: It refers to an incorporated association, which is an artificial legal person, having a separate legal entity, with a perpetual succession, a common seal, a common capital comprising transferable shares and carrying limited liability.
NOTES

- **Company limited by guarantee:** It refers to ‘a company having the liability of its members limited by its memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its being wound up’.

- **Government company:** It refers to ‘any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or by any State Government or governments or partly by the Central Government and partly by one or more State governments and includes a company which is a subsidiary of a Government company as thus defined’.

- **Holding company and subsidiary company:** Where one company controls the management of another company the former is called the ‘holding company’, and the latter over which the control is exercised is termed as a ‘subsidiary company’.

- **Foreign company:** A foreign company means a company incorporated outside India but having a place of business in India.

- **Prospectus:** It refers to any document described or issued as a prospectus and includes any notice, circular, advertisement, or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a company

### 11.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short Answer Questions**

1. What are essential characteristics of a company?
2. List the types of registered companies on the basis of liability of members.
3. What do you understand by a prospectus by implication?
4. Write a short note on ‘offer to the public’.
5. How does the Board of a company appoint its Director?

**Long Answer Questions**

1. Discuss the characteristics of various types of companies.
2. Explain the legal requirements as to the issue of a prospectus.
3. Describe the powers and duties of a director.
4. Identify and discuss the restrictions on the powers of directors.
11.9 FURTHER READINGS


UNIT 12  FORMATION OF A COMPANY

Structure
12.0  Introduction
12.1  Objectives
12.2  Formation of a Company: Introduction and Process
12.2.1  Promotion Stage
12.2.2  Registration and Incorporation Stage
12.2.3  Commencement of Business Stage
12.3  Meetings: Types and Requirements
12.3.1  AGM and EGM
12.3.2  Extraordinary or Emergency General Meeting (EGM)
12.3.3  Board Meeting
12.3.4  Requirements
12.3.5  Minutes and Resolutions
12.3.6  E-Fillings of Documents under Ministry of Corporate Affairs (MCA) 21
12.4  Answers to Check Your Progress Questions
12.5  Summary
12.6  Key Words
12.7  Self Assessment Questions and Exercises
12.8  Further Readings

12.0  INTRODUCTION

The Companies Act, 2013 comprises 29 Chapters, 470 Sections and 7 Schedules as against 658 Sections and 15 Schedules in the Companies Act, 1956. It is substantively a law based on Rules to be prescribed by the Central Government, i.e., Ministry of Corporate Affairs (MCA). It is evident from the fact that the expression “as may be prescribed” has been used in the text of the Act at around 340 places. In this unit, you will learn about the various provisions with regard to formation, Board Meeting, AGM, EGM and many other company affairs.

12.1  OBJECTIVES

After going through this unit, you will be able to:

- Understand how a company is formed and incorporated under the Companies Act.
• Describe the various provisions for Board Meeting under the Companies Act.
• Differentiate between an AGM and an EGM
• Discuss the initiative of e-filing of documents under the Ministry of Corporate Affairs (MCA)

12.2 FORMATION OF A COMPANY: INTRODUCTION AND PROCESS

A company may be formed for any lawful purpose either as a public or a private company. A one person company (OPC) may be formed as a private company. A company is a creature of law. The formation of a company is a legal process, which involves a series of steps and legal formalities. These steps are taken by a person or a group of persons interested in the formation of the company. This whole process of formation of a company may be divided into the following three stages:

- Promotion stage
- Registration and incorporation stage
- Commencement of business stage

12.2.1 Promotion Stage

The term ‘promotion’ is used in the Companies Act but it has not been defined in the Act. In fact, it is not a term of law but of business. It includes all those activities by which a company is brought into existence. According to Gerstenberg, ‘Promotion is the discovery of business opportunities and the subsequent organisation of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.’ In the words of Henry E. Hugland, ‘Promotion is the process of creating a specific business enterprise. The aggregate of activities contributed by all those who participate in the building of the business constitutes promotion.’

The term ‘promoter’ has been in use in company law for centuries but the Companies Act, 2013 is the first Act in India that defines this term. According to this Act, promoter means a person who fulfils any of the following conditions:

(a) Who has been named as promoter in a prospectus?
(b) Who is identified as promoter by the company in its annual return?
(c) Who has control over the affairs of the company directly or indirectly whether as a shareholder, director, or otherwise?
(d) In accordance with whose advice, directions, or instructions the Board of directors of the company is accustomed to act. However, a person who advises and gives directions or instructions acting merely in a professional capacity shall not be a promoter of the company [Sec. 2(69)].
12.2.2 Registration and Incorporation Stage

The second stage of formation of a company is known as the registration and incorporation stage. A company comes into existence only after its registration and issue of certificate of incorporation to it. The registration and incorporation of a company usually involves the following steps:

- Preliminary steps.
- Application for registration and delivery of documents.
- Scrutiny and registration of documents by the Registrar.
- Issue of certificate of incorporation and CIN.

Preliminary Steps

In order to get a company registered, following preliminary steps are taken by the promoters:

1. **Deciding the Kind of Company:** A promoter is required to decide the kind of company he wants to get registered. Under the Companies Act, a public as well as a private company may be registered. The promoter may also register a One Person Company (OPC). But such a company may be registered only as a private company. Any public or private company (including OPC) may be registered as a company limited by shares, limited by guarantee with or without share capital. It may also be registered with unlimited liability. Therefore, a promoter needs to decide the kind of company he wants to register. In case promoter decides to register an OPC, he shall ensure that the proposed subscriber to the memorandum is an Indian citizen and resident in India. Moreover, he must not be a member of any other OPC.

2. **Deciding the Place of Registered Office:** A promoter must decide the place of the registered office of the company. If exact place cannot be decided, he will have to decide at least the State in which registered office of the company will be situated. This is necessary in order to identify the Registrar of Companies to whom the application for registration of company is to be made. After deciding the State, the promoter shall decide the address of the company for correspondence till its registered office is established [Sec. 7].

3. **Obtaining DIN by the Prospective Directors:** It is mandatory for every a person intending to be a director of a company to obtain a Director’s Identification Number (DIN). The DIN is a permanent and unique number. Prospective directors are required to state this number in the forms to be submitted to the Registrar. Every individual intending to become a director of a company may make an application for allotment of DIN to the Central Government in the prescribed manner along with the prescribed fee. The Central Government shall, within one month from the receipt of the application, allot a DIN [Secs. 153 and 154].
4. **Obtaining Digital Signature by Promoters/Prospective Directors, etc.:** Now companies are required to e-file many documents for the purpose of registration of a company, which cannot be signed manually. Therefore, the promoters/prospective directors as well as other authorized persons by a company (such as CA, CS, solicitor, etc.,) need to obtain digital signatures.

A digital signature is the electronic signature done by means of electronic procedure. The signature is duly certified by a certifying authority under the Information Technology Act. Obtaining certified digital signature is a prerequisite for e-filing of documents.

5. **Selecting and Reserving Name of the Company:** A promoter is required to select a proper and desirable name for his proposed company and get it reserved. To this end, he must make an application for reservation of a name in Form No. INC-1 along with the prescribed fee to the Registrar [Rule INC-9]. The application shall be made to the Registrar of the State in which registered office of the proposed company is to be situated. The Registrar shall decide about the desirability, availability, and reservation of the name.

The Registrar may, upon receipt of an application for reservation of a name of a proposed company, reserve the name for **a period of 60 days from the date of the application** [Sec. 4(5)].

6. **Drafting Memorandum:** Then, the promoter arranges to draft the memorandum of the proposed company. Tables A, B, C, D, and E of the Schedule I contain formats of memorandum for different kinds of companies. The relevant format should be considered while drafting the memorandum. The promoter, with the help of his solicitor, company secretary, etc., may draft the memorandum of the proposed company [Secs. 4 and 7(a)]. It may be noted that the memorandum of a OPC shall state the name of a nominee of the subscriber (member) to the memorandum with his prior written consent.

7. **Drafting Articles:** The other important document of the company is the articles of association. It contains regulations for internal management of the company. The articles shall also contain such matters, as may be prescribed. Additional matters may also be included in the articles if considered necessary.

The model articles for different kinds of companies have been prescribed in Tables F, G, H, I, and J of Schedule I. A promoter may adopt the model articles applicable to his proposed company either in totality or otherwise. If a promoter does not want to adopt model articles in totality, he will have to arrange for drafting the articles. For this purpose, promoter may seek the help and advice of his solicitor, company secretary in practice, etc., [Secs. 5 and 7(a)].
It may be pointed out that model articles given in Table F to J do not contain the regulations necessary for a private company. Therefore, every private company is compulsorily required to prepare its own articles and file with the Registrar. A OPC can be registered as a private company. Hence, it is also required to prepare its articles and file with the Registrar along with other documents at the time of registration of the company.

8. **Vetting of the Drafts**: It is desirable to get the drafts of memorandum and articles vetted by the Registrar. This helps avoid mistakes and unnecessary delay in registration of the company.

9. **Printing of the Documents**: The promoters must get the memorandum and articles printed as required by law. Alternatively, they may be computer laser printed.

10. **Stamping**: Both the documents must be stamped in accordance with the Stamp Laws applicable to them.

11. **Dating**: Both the documents must be dated. The date should be any date after the date of stamping of them and not before that date.

12. **Obtaining Signature of the Subscribers**: In case of a public company, there must be at least seven subscribers and two in case of a private company. However, in case of a OPC, there shall be one subscriber. The memorandum should be signed by each subscriber. Each subscriber should also add his address, description, and occupation in the presence of at least one witness. The witness shall attest the signature and likewise add his address and description of occupation. A subscriber may sign personally or through an agent authorized by power of attorney.

   In case of an illiterate subscriber, he may give his thumb impression or mark, which shall be described as such by the person writing for him. He shall place the name of the subscriber against or below the mark and authenticate it by his own signature. He shall also write against the name of the subscriber, the number of shares taken by him [Rule INC-13(2)]. In case a subscriber is foreign national residing outside India, certain other documents are required [Rule INC-13(4)].

13. **Obtaining Consent of the Nominee in Case of a OPC**: In the case of a OPC, the name of a nominee of the subscriber to the memorandum is indicated in its memorandum. Hence, his written consent should be obtained prior to including the name in the memorandum in Form No. INC-3 [Sec. 3(1) and Rule INC-4(2)].

14. **Obtaining Declaration as to Compliance with Legal Requirements**: A promoter also has to obtain a declaration in Form No. INC-8 [Sec. 7(1) (b) and Rule INC-14].

15. **Obtaining Affidavit from Subscribers and Persons Named as First Directors**: A promoter shall also obtain an affidavit in Form No. INC-9
from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles [Sec. 7(1)(c) and Rule INC-15].

16. **Obtaining Particulars of Subscribers, Directors, etc.:** The promoter shall obtain the particulars of (a) each of subscribers to the memorandum; (b) of the persons mentioned in the articles as the first directors of the company; and (c) of the interests of the persons mentioned in the articles as the first directors of the company in other firms or bodies corporate.

17. **Obtaining Consent of the Directors:** The promoter must get the written consent of the persons who agree to act as first directors of the company in such form and manner as may be prescribed [Sec. 7(1)(g) and Rule INC-17].

It may be noted that the particulars of directors, their interest in other firms, and their consent to act as directors shall be filed in Form No. DIR-122 [Rule INC-17].

18. **Obtaining Approval of the Sectoral Regulators:** Sometimes, a company intends pursue such objects that required registration or approval from sectoral regulators such as RBI and SEBI. In such a case, registration or approval from such regulators shall be obtained by the promoter [Proviso to Rule INC-12 inserted on 29th May, 2015].

19. **Drafting Contracts:** The promoter also gets the other contracts drafted, which he wants to include in the terms of incorporation of the company. Such contracts may include all the preliminary contracts.

**Application for Registration and Delivery of Documents**

The promoter of the company shall file an application for incorporation of his company in Form No. INC-2 in case of a OPC and Form No. INC-7 in case of a company other than an OPC along with the prescribed fee. The application shall be filed with the Registrar within whose jurisdiction the registered office of the company is proposed to be situated [Sec. 7(1) and Rule INC-12].

The application shall be accompanied by the following documents and information:

1. **Notice of Address for Communication:** Every company applying for registration should file with the Registrar a document containing the notice of the address for correspondence till registered office is established [Sec. 7(1)(d)].

2. **Memorandum of the Company:** Every company is required to file its memorandum to the Registrar for its registration. It should be duly signed by all the subscribers to the memorandum in such manner, as prescribed by Rule INC-13 [Sec. 7(1)(a) and Rule INC-13].

3. **Approval of Sectoral Regulators:** Sometimes, a company intends pursue objects that required registration or approval from sectoral regulators such
Formation of a Company

NOTES

4. Articles of the Company: Every company proposed to be registered shall file its articles with the Registrar for its registration. The articles of the company shall be duly signed by all the subscribers to the memorandum in such manner as prescribed by Rule INC-13 [Sec. 7(1)(a) and Rule INC-13].

It may be noted that a company may adopt all or any of the regulations contained in the model articles applicable to the company [Sec. 5(7)]. But a private company is required to prepare its articles and include the provisions in terms of Section 2(68).

5. Declaration as to Compliance with Legal Requirements: Every company shall file a declaration in Form No. INC-8. It shall declare that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with. Such declaration shall be by the following persons:

(i) An advocate, chartered accountant, cost accountant, or company secretary in practice, who is engaged in formation of the company.

(ii) A person who has been named in the articles as a director, manager, or company secretary of the company [Sec. 7(1)(b) and Rule INC-14].

6. Affidavit from Subscribers and Persons Named as First Directors: Every company shall also file with the Registrar an affidavit in Form No. INC-9 made by each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles. In such affidavit each of them shall declare the following:

(i) That he is not convicted of any offence in connection with the promotion, formation, or management of any company.

(ii) That he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the preceding five years.

(iii) That all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief [Sec. 7(1)(c) and Rule INC-15].

7. Particulars of Every Subscriber: The proposed company shall also file with the Registrar the particulars of name, including surname or family name, residential address, nationality, and such other particulars of every subscriber to the memorandum along with proof of identity, as may be prescribed. In the case of a subscriber being a body corporate, particulars as may be prescribed, shall be filed [Sec. 7(1)(e) and Rule INC-16].
8. **Particulars of First Directors:** The proposed company shall also submit the particulars of the persons mentioned in the articles as the first directors of the company in Form No. DIR-12. The particulars shall include their names, surnames or family names, the Director Identification Number, residential address, nationality, and such other particulars including proof of identity as may be prescribed [Sec. 7(1)(f) and Rule INC-17].

9. **Particulars of Interest of Directors:** The proposed company shall also file the particulars of the interests of the persons mentioned in the articles as the first directors of the company in other firms or bodies corporate in Form No. DIR-12 [Sec. 7(1)(g) and Rule INC-17].

10. **Consent to Act as Directors:** The company shall also file the consent of the persons who have agreed to act as directors of the company in Form No. DIR-12 [Sec. 7(1)(g) and Rule INC-17].

11. **Copy of the Letter Confirming Reservation of the Name:** The company shall also file a copy of the letter from the Registrar confirming reservation of the name. This may serve as ready reference at the time of registration of the company.

12. **Power of Attorney by the Subscriber:** Sometimes, power of attorney is executed by the subscriber authorizing any person to sign the memorandum and articles on their behalf. Such power of attorney is essential in case of a corporate subscriber. This is to be filed with the Registrar at the time of registration of the company.

13. **Power of Attorney to Make Corrections:** Usually a power of attorney is executed by all subscribers authorizing any individual to make corrections on the documents filed for registration. The same shall also be filed with the registrar along with other documents.

14. **Payment of Fees:** The company must also remit the prescribed registration fees to the Registrar. The fee payable may be remitted either electronically (by using credit/debit card or by electronic bank transfer) or by cash/draft through challan generated electronically on submission of e-form.

   All these documents should be filed with the Registrar **within 60 days from the date of confirmation of reservation of name of the company** because the reservation of name is **valid for 60 days only**.

   The Companies Act, 2013 imposes a duty on every company registered under this Act that it shall maintain and preserve at its registered office, copies of all documents and information as originally filed with the Registrar till its dissolution under this Act [Sec. 7(4)].

**Scrutiny and Registration of Documents**

After receiving the application and the delivery of documents for incorporation, the Registrar shall scrutinize the documents. When all the documents are found to
be in order, the Registrar on the basis of documents and information filed with him shall register all these documents and information in the register of companies [Sec. 7(2)].

If there is any minor defect in any document, the Registrar may require for its rectification by the authorized person. But if there is a **material defect**, he may return all the documents for rectification. He may refuse to register a company on only lawful grounds. But if he refuses to register on a ground which is not legitimate, **he may be compelled to register** [Exclusive Board of the Methodist Church v. Union of India (1985) 57 Comp Cases 43 Bom].

**Issue Certificate of Incorporation and CIN**

On registration of all the documents and information, the Registrar shall issue a certificate of incorporation in the Form No. INC-11 to the effect that the proposed company is incorporated under this Act [Secs. 7(2) and Rule INC-18].

On and from the date mentioned in the certificate of incorporation, the Registrar shall allot to the company a Corporate Identity Number (CIN). This CIN shall be a distinct identity for the company. The CIN shall also be included in the certificate of incorporation [Secs. 7(2) and (3)].

**Certificate of Incorporation: A Conclusive Proof of Date of Incorporation**

The certificate of incorporation brings the company into existence as a distinct legal entity. It is a proof of registration and existence of a company as a legal person. The date of incorporation mentioned in the certificate of incorporation is deemed to be the date of incorporation of the company. From the date of incorporation mentioned in the certificate, the company shall be a body corporate by the name contained in its memorandum [Sec. 9].

The life of a company commences from the date mentioned in the certificate of incorporation. The date appearing on it is conclusive evidence of the date of incorporation even if it is wrong.

**12.2.3 Commencement of Business Stage**

According to the latest provisions of the Companies Act, every company is entitled to commence its business as soon as it obtains its certificate of incorporation. No other formality is required to be complied with for commencement of business by any company after its incorporation.

If a company fails to commence its business within one year of its incorporation, the Registrar may initiate action for removing its name from the register of companies [Sec. 248].

**With effect from 1st May, 2015, the MCA has introduced a new process of incorporation of companies** which is called as the ‘integrated process of incorporation of companies’. It is an alternative process of incorporation by which a company may be registered within 24 hours of the application. One can still follow the usual lengthy procedure described earlier in the unit.
Check Your Progress

1. Identify the various stages of formation of a company.
2. List the steps involved in the registration and incorporation of a company.
3. What is the significance of the certificate of incorporation?

12.3 MEETINGS: TYPES AND REQUIREMENTS

It is the first official general meeting of the shareholders. All public companies having share capital except unlimited companies are required to hold a statutory meeting compulsorily. It implies that private companies, unlimited companies and companies limited by guarantee but not having a share capital are not required to hold such a meeting. Statutory meeting must be held after one month but within six months of obtaining the ‘certificate to commence business. Unlike other types of general meetings, this meeting is held only once in the lifetime of a company.

The objective of the statutory meeting is to provide an opportunity to the members, as early as possible, of acquainting themselves with the assets and properties acquired so far and to discuss the success of the flotation. The members are free to discuss any matter relating to the formation of the company or arising out of the statutory report. But they cannot pass any resolution without previous notice of at least 21 days.

12.3.1 AGM and EGM

Every company must in each year hold in addition to any other meetings a general meeting as its annual general meeting. It is the most important meeting of the members of a company. It is held each year with a view to reviewing and evaluating the overall progress of the company during a year. The annual general meeting is sometimes called ‘ordinary general meeting’ as usually it deals with the so-called ‘ordinary business.’ The following ordinary business must be transacted at the annual general meeting of a public company:

(a) The consideration of the Annual Accounts, Balance Sheet and the Reports of the Board of Directors and Auditors;
(b) The declaration of a dividend;
(c) The appointment of directors in the place of those retiring; and
(d) The appointment of, and the fixation of the remuneration of, the auditors.

Any other business on agenda except that listed above shall be considered as special business and may also be transacted at the Annual General Meeting, provided appropriate notice has been given. It is to be noted that in the case of extraordinary general meetings all business shall be treated as ‘special business. It is relevant to state that the ‘ordinary business’ requires an ordinary resolution.
While the ‘special business’ may require ordinary or special resolution as per Articles or the Act.

It may be noted that a private company may make its own provisions by its articles in respect of ‘ordinary business’ to be transacted at an annual general meeting.

If a company fails to call an annual general meeting within the prescribed time limits, the Company Law Board may, on the application of any member of the company, call or direct the calling of the meeting and give such ancillary or consequential directions as it thinks expedient in relation to the calling, holding and conducting of the meeting. The directions that may be given by the Company Law Board may include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

Further, the company and every officer who is in default is liable to a fine which may extend to Rs 50,000 and in the case of a continuing default, with a further fine which may extend to Rs 2,500 for every day after the first during which such default continues.

12.3.2 Extraordinary or Emergency General Meeting (EGM)

An extraordinary general meeting (EGM), also called a special general meeting or emergency general meeting, is a meeting other than a company’s annual general meeting (AGM) that regularly occurs among a company’s shareholders, executives and any other members.

Under Section 100 of the Companies Act, 2013, the Board may, whenever it deems fit, call an extraordinary general meeting of the company. The Board shall, at the requisition made by—

(a) in the case of a company having a share capital, such number of members who hold, on the date of the receipt of the requisition, not less than one-tenth of such of the paid-up share capital of the company as on that date carries the right of voting;

(b) in the case of a company not having a share capital, such number of members who have, on the date of receipt of the requisition, not less than one-tenth of the total voting power of all the members having on the said date a right to vote, call an extraordinary general meeting of the company within the specified period. If the Board does not, within twenty-one days from the date of receipt of a valid requisition in regard to any matter, proceed to call a meeting for the consideration of that matter on a day not later than forty-five days from the date of receipt of such requisition, the meeting may be called and held by the requisitonists themselves within a period of three months from the date of the requisition.
Extraordinary general meetings may be called:

1. **By the directors:** The directors, may, whenever they think fit, convene an extraordinary general meeting by passing a resolution to that effect in the Board’s meeting.

2. **By the directors on requisition:** The directors must convene an extraordinary general meeting on the requisition (written demand) of members holding not less than one-tenth of the total voting rights on the matter of requisition. The requisition must state the matters for the consideration of which the meeting is to be called. It must be signed by the requisitionists and deposited at the registered office of the company. The directors should within 21 days from the date of the deposit of a valid requisition, move to call a meeting and should give 21 days’ notice to members for calling such a meeting and the meeting should actually be held within 45 days from the date of the requisition.

   It may be noted that the requisitionists are not bound to disclose reasons for the resolution they propose to move at the meeting (Life Insurance Corporation vs Escorts Ltd.). Further, no business other than the business for which the meeting has been expressly convened can be transacted at the requisitioned meeting.

3. **By the requisitionists themselves:** If the directors fail to call the meeting within aforementioned time limits, the requisitionists or such of the requisitionists as represent not less than one-tenth of the total voting rights of all the members, may themselves convene a meeting within three months of depositing the requisition. Such a meeting should be called in the same manner, as nearly as possible, as that in which meetings are called by the Board. Any reasonable expenses incurred by the requisitionists must be repaid to them by the company, and any sum so paid shall be retained by the company out of any sums due or likely to become due to the directors in default.

4. **By the Company Law Board:** If for any reason it is impracticable to call or conduct an extraordinary general meeting, the Company Law Board may, either of its own motion 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 Company Law Board 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.

   It may be noted that unlike an annual general meeting an extraordinary general meeting can be convened on a public holiday and at a place other than the registered office of the company or the city in which the registered office is situated.
12.3.3 Board Meeting

We have observed earlier that the directors can only exercise their powers collectively at Board meetings, unless the articles otherwise provide (Re Celadon Trust Ltd.). As such as per the Companies Act, it has been made obligatory on the part of every company to hold a meeting of its Board of Directors at least once in every three months and at least four such meetings must be held in every year. The Central Government may, however, by notification in Official Gazette, direct that this provision shall not apply in relation to any class of companies.

Notice: The power to convene Board meetings normally vests in the Chairman of the Board. The managing director, manager or secretary of the company must, at any time, summon a meeting of the Board on the requisition of a director. The notice of every Board’s meeting has to be sent in writing to every director in India and at his usual address in India to every other director who is outside India for the time being. The Act, however, does not prescribe any form or mode of service or length of period of notice. The notice need only specify the place, time and date of the meeting, it is not necessary to set out the business to be transacted, unless the articles or the Act so require (Campagnie de Mayville vs Whitly). The Companies Act requires that the items of business requiring unanimous resolution of the directors present at the meeting and entitled to vote, must be mentioned in the notice of the meeting.

Quorum: The quorum (i.e., minimum number of qualified persons whose presence is necessary for transacting legally binding business at the meeting) for a meeting of the Board shall be one-third of its total strength (any fraction to be rounded off as one), or two directors, whichever is higher. While determining the total strength, the vacancies are not counted. Again, the directors who are interested in any of the resolutions to be passed at the Board meeting shall not be counted for the purpose of quorum of that resolution. If at any time the number of interested directors exceeds or is equal to two-thirds of the total strength of directors, then the remaining directors who are not interested will be the quorum for that item, provided their number is not less than two. The quorum must be present throughout the Board’s meeting (Henderson vs Louttit). Unless a quorum is present, the business transacted is void.

If a meeting of the Board could not be held for want of quorum, then, unless the articles otherwise provide, the meeting shall automatically stand adjourned till the same day in the next week and at the same time and place. If a meeting could not be held for want of a quorum, it shall alright be counted towards the minimum number of meetings which must be held in every year under the Act.

Resolution by circulation: Normally resolutions are moved and passed at the meeting of the Board. But as per the Act there may be a ‘resolution by circulation’ which shall be deemed as passed at the Board’s meeting if its draft together with necessary papers is circulated among all the directors and it has been approved by a majority of them as are entitled to vote on the resolution.
Manner of conducting business at a Board’s meeting: Unless the articles otherwise provide, all resolutions at a Board meeting are passed by a simple majority. In certain matters, however, unanimous consent of all the directors is required; for example,

(a) For approval of prospectus;
(b) For appointment of a person as Managing Director who is already a Managing Director or manager of another company;
(c) For making inter-corporate loans and investments;
(d) For appointment of a person as the manager who is already a managing director or manager of another company.

Each director has one vote for each resolution put to vote at the meeting. However, if the articles do not provide otherwise the Chairman has a ‘second’ or ‘casting vote’ in the event of an equality of votes. Voting normally takes place by show of hands, there being no provision for polls and proxies in the case of Board meetings.

12.3.4 Requirements

A general meeting of shareholders is said to be valid when it is properly convened (i.e., when proper notice is issued by a proper authority) and legally constituted (i.e., when there is a proper person in the chair, requisite quorum is present and the provisions of the Act and the articles are complied with). For transacting legally binding business, the meeting must be validly held. Any irregularity in convening or conducting the meeting shall invalidate the proceedings of the meeting. Such an invalidation, however, does not affect the interests of third parties, who have no notice of the irregularity, on the ‘Principle of Indoor Management’ as laid in the case of Royal British Bank vs Turquand.

The following are the requisites of a valid general meeting as per the Companies Act:

1. Proper convening authority: A valid meeting must be called by a proper authority. The proper authority to convene a general meeting of shareholders is the directors who should pass a resolution at a Board meeting for the same. Of course in the event of default by the directors, the requisitionists or the Company Law Board shall become the proper authority to call such a meeting. It may be noted that the resolution to call a general meeting must be passed at a valid Board’s meeting, otherwise the notice calling the general meeting will itself become invalid and the proceedings of the meeting shall not be effective.

2. Proper notice: The statutory provisions relating to ‘notice’ are as follows:
   (a) Notice to whom: A proper notice of the meeting must be given to every shareholder (equity and preference), auditors of the company, each director of the company and to every such person who is entitled to attend the meeting, i.e., the persons on whom the shares of any
deceased or insolvent member may have devolved. Deliberate omission to give notice to even a single member may invalidate the meeting, although an accidental omission to give notice to, or the non-receipt of notice by, any member or other persons to whom it should be given shall not invalidate the proceedings of the meeting.

(b) Length of notice: The notice should be in writing and must be given at least 21 days before the date of the meeting. In calculating 21 days, 48 hours from the date of posting should be excluded.

(c) Contents of notice: The notice must specify the place, day and hour of the meeting, and must contain ‘agenda’, namely, a statement of the business to be transacted at the meeting. It must also specify the date of notice, the name of the company, the type of meeting, the exact wording of any proposed resolution, the authority by which notice is issued and the name of the person issuing the notice.

(d) In the case of special business, there must be annexed to the notice of the meeting an Explanatory Statement mentioning all the material details concerning each such item of business, including in particular the nature of interest, if any, therein of every director or other managerial personnel.

(e) A notice sometimes includes the expressions like ‘any other business’ or ‘any other matter with the permission of the Chair.’ These expressions simply indicate that a general discussion on any matter may be allowed by the Chairman or the members may agree that certain important matters be put on the agenda for the next meeting or a vote of thanks may be moved. Certainly no resolution can be passed under this heading in the absence of a proper notice (Young vs Ladies Imperial Club).

(f) The notice may be sent to a member either personally or by post, to his registered address, or the address given by him for sending the notices to him, in India. The notice sent by post should be properly addressed, prepaid and posted. A notice may be sent to the joint-holders of shares by serving it on the joint-holder named first in the Register of Members in respect of those shares (Sec. 53).

3. Requisite quorum: The third important condition for a valid meeting is that the quorum must be present. A quorum is the specified minimum number of qualified persons (members) whose presence is necessary for transacting legally binding business at the meeting. The members constituting the quorum must be effective members entitled to vote at the meeting. Where no quorum is present the meeting is not legally constituted and the business transacted at the meeting or any resolution passed thereat becomes invalid. However, third parties without notice are not affected by reason of any irregularity in the quorum (County of Gloucester Bank vs Rudry Morthyr).
4. **Proper Chairman**: The fourth requisite for a valid meeting is that there must be a Chairman to preside over the proceedings of the meeting.

**Voting**

The word ‘vote’ means an expression of a wish or opinion in an authorised formal way for or against any proposal. After a ‘proposed resolution’ or a ‘motion’ has been discussed in the meeting by the members it is put to vote for ascertaining the sense of the house. The ‘articles’ prescribe regulations and procedure for voting at general meetings subject to the provisions of the Act.

**Voting Rights**

Every holder of ‘equity shares with voting rights’, whose name appears on the register of members has the right to vote on every resolution placed before the company at a general meeting. In other words, the holder of such equity shares possesses normal voting rights. Further, his voting rights on a ‘poll’ (a method of voting) shall be in proportion to his share of the paid-up equity capital of the company.

The preference shareholders do not possess normal voting rights. They are, however, entitled to vote in the following two cases:

(a) When any resolution directly affecting their rights is to be passed. It is worth noting here that any resolution for winding up of the company or for the repayment or reduction of its share capital is to be regarded as a resolution directly affecting the rights of the preference shareholders, and therefore they are entitled to vote on such a resolution.

(b) When the dividend due (whether declared or not) on their preference shares or part thereof has remained unpaid:

(i) In the case of cumulative preference shares, for an aggregate period of not less than two years preceding the date of the meeting; and

(ii) In the case of non-cumulative preference shares, either for a period of two consecutive years or for an aggregate period of not less than three years comprised in the six years ending with the expiry of the financial year immediately preceding the date of the meeting.

It may be observed that when the dividend due on their preference shares has remained unpaid for periods specified above, the preference shareholders become entitled to vote on every resolution placed before the company at any general meeting.

The Act further provides that where a preference shareholder has a right to vote on any resolution in accordance with the provisions mentioned above, his voting right on a ‘poll’ shall be in the same proportion as the capital paid-up in respect of the preference shares bears to the total paid-up equity capital of the company. It is important to note that the above provisions relating to voting rights of preference shareholders do not apply to a private company. Such a company
can issue preference shares carrying normal voting rights or even disproportionate voting rights.

In the case of joint shareholders, the vote of the senior joint-holder (whose name appears first in the register of members) shall be accepted. An insolvent shareholder is entitled to exercise the votes which are attributed to his status as a member provided his name appears on the Register of Members (Morgan vs Gray).

In the case of a public company, any restriction in the articles of the company on a member’s right to vote, except on the ground of non-payment of calls or other sums due against him, shall be void. A member can exercise his right to vote for his own interest and even against the interests of the company (Greenwell vs Porter).

12.3.5 Minutes and Resolutions

The term ‘minutes’ means a concise and accurate official record of the business transacted at company meetings. It normally includes only the resolutions actually passed. It is not necessary to record therein the discussion which preceded the adoption of a resolution. ‘Minutes are more analogous to a telegram than to a letter, to a precis than to a narrative.’

Section 193 requires every company to keep minutes of the proceedings of every general meeting in the books kept for that purpose within 30 days of every such meeting. The pages of the minutes books must be consecutively numbered and in no case there should be attached by pasting or otherwise any extra page. Any correction, cutting etc., in the minutes books must be initialled by the person signing the minutes. There should be no erasure. The minutes book must be kept by the secretary under proper custody so that there may not be any tampering of the minutes. Each page of every minutes book shall be signed and the last page of the record of proceedings of each meeting in such books shall be dated and signed by the Chairman of the same meeting within a period of 30 days of the conclusion of the meeting or in the event of death or inability of the chairman within that period, by a director duly authorised by the Board for that purpose. It is relevant to state that the minutes are not required to be read at a subsequent general meeting, and they require no approval from the members before they are signed by the chairman. It will be noticed that confirmation of minutes is not an item of agenda in the general meetings.

The minutes of each meeting shall contain a fair and correct summary of the proceedings thereat. The Chairman shall, however, enjoy an absolute discretion in regard to non-inclusion of any matter in the minutes which in his opinion is defamatory of any person, is irrelevant or detrimental to the interests of the company.

The minutes of meetings kept in accordance with the above provisions are prima facie evidence of the proceedings recorded therein and the meeting to which such minutes relate shall be deemed to have been duly called and held, the
proceedings threat to have duly taken place and the appointments of directors or liquidators made at the meeting shall be deemed to be valid, until the contrary is proved.

The minutes books of general meetings are to be kept at the registered office of the company and be open to inspection for at least two hours a day during business hours to any member without charge. Members are also entitled to obtain copies of minutes on request within seven days on payment of rupee one for every one hundred words or fractional part thereof required to be copied.

**Resolutions**

A ‘Proposed Resolution’ or ‘motion’ when passed by requisite majority of votes by the shareholders becomes a company resolution. Thus, a *resolution* may be defined as the formal decision of a meeting on any proposal before it.

The Companies Act provides for three kinds of resolutions that may be passed at the general meeting of a company:

1. **Ordinary resolution**
2. **Special resolution**
3. **Resolution requiring special notice**

The Companies Act and the Articles of Association lay down the type of resolution required for any particular matter.

### 1. Ordinary Resolution

A resolution shall be an ordinary resolution when the votes cast in favour of the resolution by members present in person or, where proxies are allowed, by proxy, exceed the votes, if any, cast against the resolution. In other words, this is a resolution passed by simple majority of votes of members present in person or by proxy. Those absenting or remaining neutral are not counted.

An ordinary resolution is normally used for the so-called ‘ordinary business’ done in the Annual General Meeting e.g., to pass the annual accounts, to declare dividend, to appoint directors in the place of those retiring and to appoint auditors. It is relevant to state that a special resolution is required for any appointment of auditors at an Annual General Meeting, although it is an item of ordinary business, in the case of a company in which at least 25 per cent of the subscribed share capital is held, whether singly or jointly, by Central Government or any State Government or a nationalised bank or a general insurance company or a public financial institution or a government company. Certain items of ‘special business’ also require ordinary resolutions under the Companies Act. For example:

(i) Issue of shares at a discount.
(ii) Alteration of the share capital
(iii) Increasing or reducing the number of directors within the limits fixed by the articles
NOTES

2. Special Resolution

A resolution shall be a special resolution when the votes cast in favour of the resolution by members present in person or, where proxies are allowed, by proxy, are not less than three times the number of votes, if any, cast against the resolution and the intention to propose the resolution as a special resolution has been duly specified in the notice calling the meeting. In other words, this is a resolution passed by a majority of at least 75 per cent of votes of members present in person or by proxy (those absenting or remaining neutral are not counted) and a mention of the fact that the resolution shall be passed as a special resolution must have already been made in the notice of the meeting and the notice should have been duly given at least twenty-one days before the date of the meeting.

The articles of the company may specify purposes for which a special resolution is required. The Companies Act has also specified certain matters for which a special resolution must be passed. For example:

(i) Alteration of Memorandum
(ii) Alteration of Articles
(iii) Issue of sweat equity shares
(iv) Issue of further shares without pre-emptive rights
(v) Creation of Reserve Capital

A copy of special resolution must be filed with the Registrar within 30 days of the date of its passing.

3. Resolution Requiring Special Notice

A ‘resolution requiring special notice’ is not actually an independent class of resolutions. It is a kind of ordinary resolution, with the difference that here the mover of the proposed resolution is required to give special notice of at least 14 days to the company (exclusive of the day on which the notice is served or deemed to be served and the day of the meeting) before moving the resolution and the company in turn, is required to give the notice of the resolution to the shareholders, at least seven days before the meeting either individually or through an advertisement in an appropriate newspaper. This provision is a sort of concession to the mover of a proposed resolution, because otherwise he is required to intimate the company about the proposed resolution he intends to move before the company issues Notice of the meeting, so that the same may be included in the Notice and Agenda of the meeting as an item of business. It may be recalled that a notice of at least twenty-one ‘clear days’ is required for convening a general meeting.
The articles of a company may specify purposes in respect of which special notice is required. Under the Act a special notice is required before moving a resolution relating to the following matters:

(a) Appointment of an auditor other than the retiring auditor
(b) Provision that a retiring auditor shall not be reappointed
(c) Removal of a director before the expiry of his term
(d) Appointment of another person as a director in place of the director removed

12.3.6 E-Fillings of Documents under Ministry of Corporate Affairs (MCA) 21

As part of the Government’s commitment to governance reforms, MCA21 program has been designated as the flagship e-Governance initiative of the Government of India under the National e-Governance Plan (NeGP). This outcome based program from the Ministry of Company Affairs (MCA) aims at fulfilling the aspirations of its stakeholders in the 21st century through adoption of a service centric approach. The bottom-line of this unique initiative is the improved speed and certainty in the delivery of MCA services. This improvement is primarily enabled through the mechanism of secure electronic Filing (e-Filing) for all the services provided by the Registrar of Companies (ROC) including incorporation of a company, annual filing, registration of charges and other event based filings.

Check Your Progress

4. State the ordinary business that must be transacted at the annual general meeting of a public company.
5. Which section of the Companies Act provide for the call of an extraordinary general meeting?
6. What is quorum for the Board meeting?
7. Which resolution is called an ordinary resolution?

12.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. This whole process of formation of a company may be divided into the following three stages:
   • Promotion stage
   • Registration and incorporation stage
   • Commencement of business stage
2. The registration and incorporation of a company usually involves the following steps:
Formation of a Company

NOTES

- Preliminary steps.
- Application for registration and delivery of documents.
- Scrutiny and registration of documents by the Registrar.
- Issue of certificate of incorporation and CIN.

3. The certificate of incorporation brings the company into existence as a distinct legal entity. It is a proof of registration and existence of a company as a legal person.

4. The following ordinary business must be transacted at the annual general meeting of a public company:
   - The consideration of the Annual Accounts, Balance Sheet and the Reports of the Board of Directors and Auditors;
   - The declaration of a dividend;
   - The appointment of directors in the place of those retiring; and
   - The appointment of, and the fixation of the remuneration of, the auditors.

5. Under Section 100 of the Companies Act, 2013, the Board may, whenever it deems fit, call an extraordinary general meeting of the company.

6. The quorum (i.e., minimum number of qualified persons whose presence is necessary for transacting legally binding business at the meeting) for a meeting of the Board shall be one-third of its total strength (any fraction to be rounded off as one), or two directors, whichever is higher.

7. Ordinary resolution is a resolution passed by simple majority of votes of members present in person or by proxy. Those absenting or remaining neutral are not counted.

12.5 SUMMARY

- A promoter is required to decide the kind of company he wants to get registered. Under the Companies Act, a public as well as a private company may be registered. The promoter may also register a One Person Company (OPC). But such a company may be registered only as a private company.
- The term ‘promoter’ has been in use in company law for centuries but the Companies Act, 2013 is the first Act in India that defines this term.
- The promoter of the company has to file an application for incorporation of his company in Form No. INC-2 in case of an OPC and Form No. INC-7 in case of a company other than an OPC along with the prescribed fee.
- Unless the articles otherwise provide, all resolutions at a Board meeting are passed by a simple majority. In certain matters, however, unanimous consent of all the directors is required.
• After a ‘proposed resolution’ or a ‘motion’ has been discussed in the meeting by the members it is put to vote for ascertaining the sense of the house.

• Section 193 requires every company to keep minutes of the proceedings of every general meeting in the books kept for that purpose within 30 days of every such meeting. The pages of the minutes books must be consecutively numbered and in no case there should be attached by pasting or otherwise any extra page.

• A ‘Proposed Resolution’ or ‘motion’ when passed by requisite majority of votes by the shareholders becomes a company resolution.

• The Companies Act provides for three kinds of resolutions that may be passed at the general meeting of a company:
  o Ordinary resolution
  o Special resolution
  o Resolution requiring special notice

• An ordinary resolution is normally used for the so-called ‘ordinary business’ done in the Annual General Meeting e.g., to pass the annual accounts, to declare dividend, to appoint directors in the place of those retiring and to appoint auditors.

• A resolution shall be a special resolution when the votes cast in favour of the resolution by members present in person or, where proxies are allowed, by proxy, are not less than three times the number of votes, if any, cast against the resolution and the intention to propose the resolution as a special resolution has been duly specified in the notice calling the meeting.

• A ‘resolution requiring special notice’ is not actually an independent class of resolutions. It is a kind of ordinary resolution, with the difference that here the mover of the proposed resolution is required to give special notice of at least 14 days to the company (exclusive of the day on which the notice is served or deemed to be served and the day of the meeting) before moving the resolution and the company in turn, is required to give the notice of the resolution to the shareholders, at least seven days before the meeting either individually or through an advertisement in an appropriate newspaper.

12.6 KEY WORDS

• Extraordinary general meeting (EGM): Also called a special general meeting or emergency general meeting, it is a meeting other than a company’s annual general meeting (AGM) that regularly occurs among a company’s shareholders, executives and any other members.

• Quorum: It is the specified minimum number of qualified persons (members) whose presence is necessary for transacting legally binding business at the meeting.
Formation of a Company

NOTES

- **Vote**: It means an expression of a wish or opinion in an authorised formal way for or against any proposal.
- **Minutes**: It means a concise and accurate official record of the business transacted at company meetings.
- **Resolution**: It is the formal decision of a meeting on any proposal before it.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. Write a short note on preliminary stage of formation of a company.
2. What do you understand by certificate of incorporation?
3. Differentiate between AGM and EGM.
4. Who can call EGMs?
5. What are minutes of a meeting?

**Long-Answer Questions**

1. Discuss the steps involved in the registration and incorporation stage of a company.
2. Identify and discuss the document that must accompany the application for incorporation of a company.
3. What is a resolution? Discuss the various types of resolutions and their features.
4. What is the significance of electronic Filing (e-Filing) for all the services provided by the Registrar of Companies (ROC)?

12.8 FURTHER READINGS


UNIT 13 LAW OF INFORMATION TECHNOLOGY, 2000

Structure
13.0 Introduction
13.1 Objectives
13.2 Overview of the Indian IT Act
  13.2.1 Rationale behind the IT Act, 2000
  13.2.2 Commencement of Information Technology Act, 2000
  13.2.3 Scheme of the IT Act, 2000
  13.2.4 Digital Signature
13.3 Attribution, Acknowledgement and Dispatch of Electronic Records
13.4 Regulation of Certifying Authorities
  13.4.1 Powers of Controller of Certifying Authorities
  13.4.2 Duties of Certifying Authority
  13.4.3 Digital Signature Certificates
13.5 Answers to Check Your Progress Questions
13.6 Summary
13.7 Key Words
13.8 Self Assessment Questions and Exercises
13.9 Further Readings

13.0 INTRODUCTION

The term ‘information technology’ (IT) does not have a precise meaning. It is generally applied to a broad area of activities and technologies associated with the use of computers and communication. We can explain IT as an application of computers to create, store, process and use information particularly in the field of commerce. Basically, it enables the corporate management to have access to timely, accurate and relevant data, with the use of computers, communication and telephone, Internet, etc., which helps in informed decision-making, minimizes the response time and enables better coordination in the organisation resulting in reduced costs or increased profits.

Cyber law is the law relating to communications and automatic control systems. Thus, cyber law covers: (i) Information technology law, which regulates transactions relating to computers and the internet, (ii) Communications Law, which regulates telecommunications and broadcasting, including radio, television, telephony and cable. It is covered by (i) the Indian Telegraph Act, 185, (ii) the Wireless Telegraphy Act, 1933, and (iii) the cable television networks regulation act, 1995.
13.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the rationale of IT Act, 2000
- Identify those documents where provisions of the IT Act, 2000, are not applicable
- Understand the law relating to digital signature
- Describe the provisions of IT Act, 2000 relating to e-governance
- Discuss the functions and duties of certifying authorities
- Explain the penalties for various offences under the IT Act, 2000

13.2 OVERVIEW OF THE INDIAN IT ACT

With a view to facilitating electronic governance, IT Act, 2000 accords legal recognition to electronic records, digital signatures and electronic form of dealing with Government offices and its agencies. The retention of information in electronic format has also been accorded legal recognition provided the information remains accessible and usable in future.

The term Electronic Governance refers to the application of information technology to the processes of Government functioning in order to bring about Simple, Moral, Accountable, Responsive and Transparent (SMART) governance. It involves electronic filing of documents with the government agencies and creating a network of e-services and e-administration.

13.2.1 Rationale behind the IT Act, 2000

The ‘Statement of Objects and Reasons’ appended to the ‘Information Technology Bill, 2000,’ explains the rationale behind the IT Act, 2000. Excerpts from the said statement are given below:

“New communication systems and digital technology have made dramatic changes in the way we live. A revolution is occurring in the way people transact business. Businesses and consumers are increasingly using computers to create, transmit and store information in the electronic form instead of traditional paper documents. Information stored in electronic form has many advantages. It is cheaper, easier to store, retrieve and speedier to communicate. Although people are aware of these advantages, they are reluctant to conduct business or conclude any transaction in the electronic form due to lack of appropriate legal framework. The two principal hurdles which stand in the way of facilitating electronic commerce and electronic governance are the requirements as to writing and signature for legal recognition. At present many legal provisions assume the existence of paper based records and documents, and records which should bear signatures. The
law of evidence is traditionally based upon paper based records and oral testimony. Since electronic commerce eliminates the need for paper based transactions, hence to facilitate e-commerce, the need for legal changes have become an urgent necessity. International trade through the medium of e-commerce is growing rapidly in the past few years and many countries have switched over from traditional paper based commerce to e-commerce.

‘There is a need for bringing in suitable amendments in the existing laws in our country to facilitate e-commerce. It is, therefore, proposed to provide for legal recognition of electronic records and digital signatures. This will enable the conclusion of contracts and the creation of rights and obligations through the electronic medium.’

‘With a view to facilitate Electronic Governance, it is proposed to provide for the use and acceptance of electronic records and digital signatures in the Government offices and its agencies.’

**13.2.2 Commencement of Information Technology Act, 2000**

The law relating to ‘information technology’ is contained in the Information Technology (IT) Act, 2000, which came into force on 17th October, 2000. It is the first Cyber Law in India. It is mainly based on the UNCITRAL Model Law. The United Nations Commission on International Trade Law (UNCITRAL) adopted the Model Law on Electronic Commerce in 1996. This Model Law provides for equal legal treatment of users of electronic communication and paper based communication.

The Information Technology (IT) Act, 2000 has been designed to give boost to Electronic Commerce (e-commerce), e-transactions and similar activities associated with commerce and trade, and also to facilitate Electronic Governance (e-governance) by means of reliable electronic records. With a view to making the citizens interaction with the Government offices hassle free, the IT Act provides for the use and acceptance of electronic records and digital signatures in the Government offices. To prevent the possible misuse arising out of the transactions and other dealings conducted over the electronic medium, the IT Act also provides for a regulatory regime to supervise the Certifying Authorities issuing Digital Signature Certificates. Briefly stated, it may be said that IT Act mainly contains provisions relating to e-commerce, e-governance, electronic record and digital signature.

A few minor amendments in the Act were made by Information Technology (Amendment) Act, 2002.

**Electronic Commerce**

The term Electronic Commerce (e-commerce) refers to the business transacted electronically. In common usage, the term refers to trading of goods over the Internet. It is online sale and purchase of goods and services for value by using
internet technologies, such as internet processing, e-mail and world wide web (www) or just web browsing. E-commerce in its present form is in the stage of infancy in India. During the eight years of post IT Act period, the increase in e-commerce is taking place at a slow rate. From e-commerce standpoint, the major challenges offered by the Internet Technology are reliability, bandwidth, speed and security of transactions.

13.2.3 Scheme of the IT Act, 2000

The Information Technology Act, 2000 consists of 13 Chapters divided into 94 Sections. Chapters I to VIII are mostly digital signature related. Chapters IX to XIII are regarding penalties, offences, etc. The Act has four Schedules on consequential amendments in respect of certain other Acts.

The First Schedule makes amendments to the Indian Penal Code, 1860, and the Second Schedule makes amendments to Indian Evidence Act, 1872 to provide for necessary changes in the various provisions which deal with offences relating to documents and paper based transactions. The Third Schedule makes amendments to the Bankers’ Books Evidence Act, 1891 to give legal sanctity for books of account maintained in the electronic form by the banks. The Fourth Schedule makes amendments to the Reserve Bank of India Act, 1934 to facilitate electronic fund transfers between the financial institutions and banks.

**Exceptions** [Sec. 1(4)]. The provisions of the IT Act, 2000 shall not apply to the following documents:

1. Execution of a Negotiable Instrument (other than a cheque) under the Negotiable Instruments Act, 1881.
3. Creation of a Trust under Indian Trusts Act, 1882.
4. Execution of a ‘Will’ under the Indian Succession Act, 1925 including any other testamentary disposition by whatever name called.
5. Entering into a contract for the sale or conveyance of immovable property or any interest in such property.
6. Execution of such class of documents or transactions as may be notified by the Central Government in the Official Gazette.

The reason for excluding the above-mentioned documents from the purview of the Act is that such documents are required to be authenticated only by the handwritten signatures. Moreover, these require special attestation and/or registration formalities, which also explain their exclusion.

With a view to facilitate electronic payments, the provisions of the IT Act, 2000 have been made applicable to a “cheque”. The concept of an electronic cheque and the truncated cheque was introduced by the Information Technology
(Amendment) Act, 2002, by inserting a new Section 81A. Accordingly, the definition of a cheque under the Negotiable Instruments Act was suitably amended, by the Amendment Act, 2002, and now it includes the electronic image of a truncated cheque and a cheque in the electronic form.

### 13.2.4 Digital Signature

The Law of Information Technology recognises the digital signature so that the Internet contract is authenticated and becomes binding on the parties. These are the electronic equivalent of the handwritten signatures. In an electronic message or transaction affixing handwritten signature is not possible. Authentication of the record has to be achieved by some electronic or digital method. 'Affixing digital signature' has been defined in Section 2(l)(d) of the Act to mean adoption of any methodology or procedure by a person for the purpose of authenticating an electronic record by means of 'digital signature'.

The expression 'digital signature' has been defined in Section 2(l)(p) of the Act to mean authentication of any electronic record by a subscriber, i.e., a person in whose name the ‘Digital Signature Certificate’ is issued, by means of an electronic method or procedure in accordance with the provisions of Section 3.

#### Authentication of Electronic Records (Sec. 3)

Any subscriber may authenticate an electronic record by affixing his digital signature. The authentication of the electronic record shall be effected by the use of ‘asymmetric crypto system’ and ‘hash function’ which envelop and transform the initial electronic record into another electronic record.

*Explanation* — For the purposes of this sub-section, *hash function* means an algorithm mapping or translation of one sequence of bits into another, generally smaller, set known as *hash result* such that an electronic record yields the same hash result every time the algorithm is executed with the same electronic record as its input making it computationally infeasible—

(a) to derive or reconstruct the original electronic record from the hash result produced by the algorithm;

(b) that two electronic records can produce the same hash result using the algorithm.

### Verification.

*Verification.* Any person by the use of a public key of the subscriber can verify the electronic record. The private key and the public key are unique to the subscriber and constitute a functioning key pair.

In the case of electronic transmission of business or legal message/documents, it is necessary to ensure that these are authentic and have not been tampered with by any person during transmission. With this end in view, the above stated Section 3 provides that authentication of the electronic record is to be effected by the use of ‘asymmetric crypto system’, *i.e.*, by using ‘encryption’ (coding) and ‘decryption’ (decoding) methodologies and software tools.
An ‘encryption software program’ takes the normal, readable text message (‘plaintext’) and scrambles the message into unreadable coded text or ‘ciphertext’. The recipient then uses another software program (the corresponding decryption program) to decrypt such ciphertext back into normal plaintext. Any one who intercepts the message will, therefore, not be able to read or tamper with the message, unless he has the key, i.e., the corresponding decryption program, thereby rendering it secure.

In ‘asymmetric crypto system’, each person will have two corresponding and matched keys — one called the ‘private key’ which is always kept secure with such person, and the other called the ‘public key’ which the person shares with others and makes available to others on specialised databases called ‘repositories’ or through Certification Authorities. These two keys, public key and private key, are used to encrypt and decrypt the message respectively. The sender uses the intended receiver’s public key (which he can freely obtain from the receiver or download from a public repository) to encrypt the message. The receiver, on receiving the coded message, uses his corresponding private key (which is available only with him) to decrypt the encrypted message. The public key and the private key of any person or entity would be so mathematically linked that a message encrypted using one key can only be decrypted by using the corresponding other.

Briefly stated, the use of digital signature involves the following procedure:

(i) To obtain digital signature, one has to apply in the prescribed form to the Certifying Authority (CA) together with the necessary documents such as proof of identity, proof of residence, etc., and the necessary fee.

(ii) The CA verifies the documents submitted. The case is approved if the documents are in order.

(iii) On approval, the CA issues a digital certificate to the applicant. It also provides a ‘private key’ and a ‘public key’ to the applicant. The certificate guarantees that the holder of the ‘public key’ is the same person who holds the ‘private key’. The certificate is digitally signed.

(iv) On receiving a digital certificate, the holder can use his distinct keys for the transmission of data or for other purposes. These keys are mathematically related and are used to encrypt and decrypt the digitally signed documents. One of the two keys can encrypt data and the other key can decrypt that data.

(v) The sender prepares the message to be sent including his name on a computer.

(vi) The sender applies a ‘hash function’ (‘hash function’ has already been defined above), i.e., a mathematical formula or algorithm, in the form of a computer software, on the message to encrypt it using addressee’s public key, which gives out a ‘hash result’, i.e., a unique mathematical value. This ‘hash result’ is also called the ‘message digest’.
(vii) The sender encrypts this ‘message digest’ further using his own ‘private key’. The outcome of this encryption is accepted as the digital signature of the sender. In other words, the digital signature consists of this encrypted ‘message digest’. This signature is unique to the message and will be different for each new message.

(viii) The sender typically attaches or appends his digital signature to the message.

(ix) The sender sends the digital signature and the encrypted message or unencrypted (original) message to the recipient electronically.

(x) The recipient uses the sender’s ‘public key’ to verify the sender’s digital signature. Verification using the sender’s ‘public key’ proves that the message is authentic, unaltered and sent by the sender only.

(xi) The recipient also creates a ‘message digest’ of the message, using the same secure hash algorithm. If this ‘message digest’ is the same as the ‘message digest’ received from the sender, the receiver can be sure that no alteration has been made in the original message. The recipient can read the message by decrypting it with his ‘private key’.

Digital signature is safer than a handwritten one as it cannot be forged. If a contract is signed by the parties on the last page, there is no way to find whether other pages have been tampered with. But digital signatures on the same contract will ensure that original contract is intact and not even a single letter is changed.

The various expressions used above have been defined in the Act as follows:

Asymmetric crypto system [Sec. 2(1)(f)]. It means a system of a secure key pair consisting of a private key for creating a digital signature and a public key to verify the digital signature.

Electronic record [Sec. 2(1)(t)]. It means data, record or data generated, image or sound stored, received or sent in an electric form or micro-film or computer generated micro-fiche.

Key pair [Sec. 2(1)(x)]. In an asymmetric crypto system, ‘key pair’ means a private key and its mathematically related public key, which are so related that the public key can verify a digital signature created by the private key.

Private key [Sec. 2(1)(zc)]. It means the key of a key pair used to create a digital signature.

Public key [Sec. 2(1)(zd)]. It means the key of a key pair used to verify a digital signature and listed in the Digital Signature Certificate.

Subscriber [Sec. 2(1)(cg)]. It means a person in whose name the Digital Signature Certificate is issued.

Verify [Sec. 2(1)(zh)]. ‘Verify’ in relation to a digital signature, electronic record or public key, with the grammatical variations and cognate expressions means to determine whether—
the initial electronic record was affixed with the digital signature by the use of private key corresponding to the public key of the sub-scriber;

(b) the initial electronic record is retained intact or has been altered since such electronic record was so affixed with the digital signature.

13.3 ATTRIBUTION, ACKNOWLEDGEMENT AND DISPATCH OF ELECTRONIC RECORDS

Under this heading, the IT Act, 2000 contains provisions regarding: (a) when the transmission of an electronic record shall be attributed to the originator?; (b) would the addressee/receiver be bound to acknowledge the receipt of that electronic record?; and (c) how to determine the time and place of despatch and receipt of electronic record?

Attribution of Electronic Records (Sec. 11)

An electronic record shall be attributed to the originator, if it was sent:

(a) by the originator himself:

(b) by a person who had the authority to act on behalf of the originator in respect of that electronic record; or

(c) by an information system programmed by or on behalf of the originator to operate automatically.

**Originator** [Sec. 2(l)(za)]. It means a person who sends, generates, stores or transmits any electronic message or causes any electronic message to be sent, generated, stored or transmitted to any other person but does not include an intermediary.

**Intermediary** [Sec. 2(l)(w)]. Intermediary, with respect to any particular electronic message, means any person who on behalf of another person receives, stores or transmits the message or provides any service with respect to that message.

**Addressee** [Sec. 2(l)(b)]. It means a person who is intended by the originator to receive the electronic record but does not include any intermediary.

Acknowledgement of Receipt (Sec. 12)

**No agreement.** Where the originator has not agreed with the addressee that the acknowledgement of receipt of electronic record be given in a particular form or by a particular method, an acknowledgement may be given by:

(a) any communication by the addressee, automated or otherwise; or

(b) any conduct of the addressee, sufficient to indicate to the originator that the electronic record has been received [Sec. 12(1)].
Stipulation by the originator. Where the originator has stipulated that the electronic record shall be binding only on receipt of an acknowledgement of such electronic record by him, then unless acknowledgement has been so received, the electronic record shall be deemed to have been never sent by the originator [Sec. 12(2)].

No stipulation by the originator. Where the originator has not stipulated that the electronic record shall be binding only on receipt of such acknowledgement, and the acknowledgement has not been received by the originator within the time specified or agreed or, if no time has been specified or agreed to within a reasonable time, then the originator may give notice to the addressee stating that no acknowledgement has been received by him and specifying a reasonable time by which the acknowledgement must be received by him and if no acknowledgement is received within the aforesaid time limit he may after giving notice to the addressee, treat the electronic record as though it has never been sent [Sec. 12(3)].

Time and Place of Despatch and Receipt of Electronic Record (Sec. 13)

Save as otherwise agreed to between the originator and the addressee, the despatch of an electronic record occurs when it enters a computer resource outside the control of the originator [Sec. 13(1)].

Save as otherwise agreed between the originator and the addressee, the time of receipt of an electronic record shall be determined as follows, namely:

(a) if the addressee has designated a computer resource for the purpose of receiving electronic records:
   (i) receipt occurs at the time when the electronic record enters the designated computer resource; or
   (ii) if the electronic record is sent to a computer resource of the addressee that is not the designated computer resource, receipt occurs at the time when the electronic record is retrieved by the addressee;

(b) if the addressee has not designated a computer resource along with specified timings, if any, receipt occurs when the electronic record enters the computer resource of the addressee [Sec. 13(2)].

Save as otherwise agreed to between the originator and the addressee, an electronic record is deemed to be despatched at the place where the originator has his place of business, and is deemed to be received at the place where the addressee has his place of business [Sec. 13(3)].

The provisions of sub-section (2) shall apply notwithstanding that the place where the computer resource is located may be different from the place where the electronic record is deemed to have been received under sub-section (3) [Sec. 13(4)].
For the purposes of this Section:

(a) if the originator or the addressee has more than one place of business, the principal place of business, shall be the place of business;

(b) if the originator or the addressee does not have a place of business, his usual place of residence shall be deemed to be the place of business;

(c) ‘usual place of residence’, in relation to a body corporate, means the place where it is registered [Sec. 13(5)].

Secure Electronic Records and Secure Digital Signatures

In view of the fact that the communicated electronic records and messages must be secure and reliable for giving boost to e-commerce, the IT Act, 2000 lays down the legal presumptions as to when the ‘electronic record’ and ‘digital signature’ are deemed secure.

Secure Electronic Record (Sec. 14)

Where any security procedure has been applied to an electronic record at a specific point of time, then such record shall be deemed to be a secure electronic record from such point of time to the time of verification.

Secure Digital Signature (Sec. 15)

If, by application of a security procedure agreed to by the parties concerned, it can be verified that a digital signature, at the time it was affixed, was:

(a) unique to the subscriber affixing it;

(b) capable of identifying such subscriber;

(c) created in a manner or using a means under the exclusive control of the subscriber and is linked to the electronic record to which it relates in such a manner that if the electronic record was altered the digital signature would be invalidated, then such digital signature shall be deemed to be a secure digital signature.

Security Procedure (Sec. 16)

The Central Government shall for the purposes of this Act prescribe the security procedure having regard to commercial circumstances prevailing at the time when the procedure was used, including:

(a) the nature of the transaction;

(b) the level of sophistication of the parties with reference to their technological capacity;

(c) the volume of similar transactions engaged in by other parties;

(d) the availability of alternatives offered to but rejected by any party;
(e) the cost of alternative procedures; and

(f) the procedures in general use for similar types of transactions or communications.


Check Your Progress

1. What do you understand by the term e-governance?
2. What do you understand by the term digital signature?

13.4 REGULATION OF CERTIFYING AUTHORITIES

With a view to creating regulations for certification, the IT Act, 2000 provides for the appointment, functions, powers and duties of ‘Controller of Certifying Authorities’ and other officers. The procedure for issuing a licence to a ‘Certifying Authority’, as well as the procedure for suspension or revocation or renewal of the licence has also been laid down. The Act also provides for the functions and duties of Certifying Authorities.

Appointment of Controller and other Officers (Sec. 17)

1. The Central Government may, by notification in the Official Gazette, appoint a Controller of Certifying Authorities for the purposes of this Act and may also by the same or subsequent notification appoint such number of Deputy Controllers and Assistant Controllers as it deems fit.
2. The Controller shall discharge his functions under this Act subject to the general control and directions of the Central Government.
3. The Deputy Controllers and Assistant Controllers shall perform the functions assigned to them by the Controller under the general superintendence and control of the Controller.
4. The qualifications, experience and terms and conditions of service of Controller, Deputy Controllers and Assistant Controllers shall be such as may be prescribed by the Central Government.
5. The Head Office and Branch Office of the office of the Controller shall be at such places as the Central Government may specify, and these may be established at such places as the Central Government may think fit.
6. There shall be a seal of the Office of the Controller.
### Functions of Controller (Sec. 18)

The Controller may perform all or any of the following functions, namely:

1. Exercising supervision over the activities of the Certifying Authorities;
2. Certifying public keys of the Certifying Authorities;
3. Laying down the standards to be maintained by the Certifying Authorities;
4. Specifying the qualifications and experience which employees of the Certifying Authorities should possess;
5. Specifying the conditions subject to which the Certifying Authorities shall conduct their business;
6. Specifying the contents of written, printed or visual materials and advertisements that may be distributed or used in respect of a Digital Signature Certificate and the public key;
7. Specifying the form and content of a Digital Signature Certificate and the key;
8. Specifying the form and manner in which accounts shall be maintained by the Certifying Authorities;
9. Specifying the terms and conditions subject to which auditors may be appointed and the remuneration to be paid to them;
10. Facilitating the establishment of any electronic system by a Certifying Authority either solely or jointly with other Certifying Authorities and regulation of such systems;
11. Specifying the manner in which the Certifying Authorities shall conduct their dealings with the subscribers;
12. Resolving any conflict of interests between the Certifying Authorities and the subscribers;
13. Laying down the duties of the Certifying Authorities;
14. Maintaining a database containing the disclosure record of every Certifying Authority containing such particulars as may be specified by regulations which shall be accessible to public.

### Recognition of Foreign Certifying Authorities (Sec. 19)

Subject to such conditions and restrictions as may be specified by regulations, the Controller may, with the previous approval of the Central Government, and by notification in the Official Gazette, recognise any foreign Certifying Authority as a Certifying Authority for the purposes of this Act [Sec. 19(1)].

Where any Certifying Authority is recognised under sub-section (1), the Digital Signature Certificate issued by such Certifying Authority shall be valid for the purposes of the Act [Sec. 19(2)].
Revocation of recognition. The Controller may if he is satisfied that any Certifying Authority has contravened any of the conditions and restrictions subject to which it was granted recognition under sub-section (1) he may, for reasons to be recorded in writing, by notification in the Official Gazette, revoke such recognition [Sec. 19(3)].

Controller to Act as Repository (Sec. 20)

A ‘repository’ is an online database of Digital Signature Certificates and other related information useful for those who conduct their business operations through the medium of computer internet or e-commerce.

The Controller shall be the repository of all Digital Signature Certificates issued under this Act [Sec. 20(1)].

To ensure that the secrecy and security of the digital signatures are assured the Controller shall:

(a) make use of hardware, software and procedures that are secure from intrusion and misuse;

(b) observe such other standards as may be prescribed by the Central Government [Sec. 20(2)].

The Controller shall maintain a computerised database of all public keys in such a manner that such database and the public keys are available to any member of the public [Sec. 20(3)].

Grant of Licence to Certifying Authorities to Issue

Digital Signature Certificates (Sec. 21)

Any person may make an application, to the Controller, for a licence to issue Digital Signature Certificate, provided he fulfils such requirements with respect to qualification, expertise, manpower, financial resources and other infrastructure facilities, which are necessary to issue Digital Signature Certificates as may be prescribed by the Central Government [Sec. 21(1) (2)].

A licence granted under this Section shall:

(a) be valid for such period as may be prescribed by the Central Government;

(b) not be transferable or heritable;

(c) be subject to such terms and conditions as may be specified by the regulations [Sec. 21(3)].

Application for licence (Sec. 22). Every application for issue of a licence shall be in such form as may be prescribed by the Central Government. The application for issue of a licence shall be accompanied by:

(a) a certification practice statement;
(b) a statement including the procedures with respect to identification of the applicant;

(c) payment of such fees, not exceeding twenty-five thousand rupees as may be prescribed by the Central Government;

(d) such other documents, as may be prescribed by the Central Government.

Certification practice statement [Sec. 2(l)(h)]. 'It means a statement issued by a Certifying Authority to specify the practices it employs in issuing Digital Signature Certificates.' This statement specifies a set of rules and requirements which are to be followed by a Certifying Authority (CA) in its operation and issuing certificates.

Procedure for grant or rejection of licence (Sec. 24). The Controller may, on receipt of an application for a licence to issue Digital Signature Certificate, after considering the documents accompanying the application and such other factors, as he deems fit, grant the licence or reject the application. However, no application shall be rejected under this Section unless the applicant has been given a reasonable opportunity of presenting his case.

Renewal of licence (Sec. 23). An application for renewal of a licence shall be:

(a) in such form;

(b) accompanied by such fees, not exceeding five thousand rupees, as may be prescribed by the Central Government and shall be made not less than forty-five days before the date of expiry of the period of validity of the licence.

Suspension of licence (Sec. 25). The Controller may, if he is satisfied after making an inquiry, revoke the licence where a Certifying Authority has,—

(a) made a statement in, or in relation to, the application for the issue or renewal of the licence, which is incorrect or false in material particulars;

(b) failed to comply with the terms and conditions subject to which the licence was granted;

(c) failed to maintain the procedures and standards specified in Section 30;

(d) contravened any provisions of this Act, rule, regulation or order made thereunder.

However, no licence shall be revoked unless the Certifying Authority has been given a reasonable opportunity of showing cause against the proposed revocation [Sec. 25(1)].

The Controller may, if he has reasonable cause to believe that there is any ground for revoking a licence under sub-section (1), by order suspend such licence pending the completion of any inquiry ordered by him. However, no licence shall
be suspended for a period exceeding ten days unless the Certifying Authority has been given a reasonable opportunity of showing cause against the proposed suspension [Sec. 25(2)]. Further, no Certifying Authority whose licence has been suspended shall issue any Digital Signature Certificate during such suspension [Sec. 25(3)].

**Notice of suspension or revocation of licence** (Sec. 26). Where the licence of the Certifying Authority is suspended or revoked, the Controller shall publish notice of such suspension or revocation, as the case may be, in the database maintained by him. Where one or more repositories are specified, the Controller shall publish notices of such suspension or revocation, as the case may be, in all such repositories. However, the database containing the notice of such suspension or revocation, as the case may be, shall be made available through a website which shall be accessible round the clock.

**13.4.1 Powers of Controller of Certifying Authorities**

The Controller of Certifying Authorities has the following powers:

1. Power to authorise, in writing, the Deputy or the Assistant Controller or any officer to exercise any of his powers (Sec. 27).

2. Power to take up for investigation any contravention of the Act or rules or regulations made thereunder. He may authorise any officer also in this behalf [Sec. 28(1)].

3. Power to exercise himself or through an authorised officer like powers which are conferred on Income-tax Authorities under Chapter XIII of the Income Tax Act, 1961 [Sec. 28(2)]. A few such powers are briefly stated below:

   (i) Powers as are vested in the Court when trying a suit in respect of matters relating to inspection, enforcing attendance of any person and examining him on oath, compelling the production of books of account, etc.

   (ii) Power to enter and search any building, place, etc., where books of account, documents or valuables are believed to be kept, and seize them.

   (iii) Power to requisition books of account or assets from any officer possessing them.

   (iv) Power to call for information.

   (v) Power to inspect and take copies of any Register of Members or Debentureholders.

   (vi) Power to make enquiries.

4. Power to direct, by order, a Certifying Authority or any employee of such Authority to take such measures or cease carrying on such activities as specified in the order, if those are necessary to ensure compliance with the provisions of the Act, rules or any regulations made thereunder [Sec. 68(1)].
5. Power to direct, by order, any agency of the Government to intercept any information transmitted through any ‘computer resource’ (i.e., computer, computer system and computer network, etc.), if it is necessary or expedient in the interest of the sovereignty or integrity of India, the security of the State, friendly relations with foreign States or public order or for preventing incitement to the commission of any cognizable offence [Sec. 69(1)].

Access to Computers and Data (Sec. 29)
If the Controller has reasonable cause to suspect that any contravention of the provisions of this Act, rules or regulations made thereunder has been committed, the Controller or any other person authorised by him shall have access to any computer system, any apparatus, data or any other material connected with such system, for the purpose of searching or causing a search to be made for obtaining any information or data contained in or available to such computer system. He may also, by order, direct any person incharge of, or otherwise concerned with the operation of, the computer system, data apparatus or material, to provide him with such reasonable technical and other assistance as he may consider necessary.

Certifying Authority to follow certain Procedures (Sec. 30)
The person to whom a licence has been granted by the Controller to issue Digital Signature Certificates is termed as a Certifying Authority [Sec.2(1)(g)].

Every Certifying Authority shall follow certain procedures relating to security of system, in performance of its services. It is required, to:

- make use of hardware, software, and procedures that are secure from intrusion and misuse;
- provide a reasonable level of reliability in its services which are reasonably suited to the performance of intended functions;
- adhere to security procedures to ensure that the secrecy and privacy of the digital signatures are assured; and
- observe such other standards as may be specified by regulations.

13.4.2 Duties of Certifying Authority
The Certifying Authority has the following duties:

1. To ensure that every person employed or otherwise engaged by it complies, in the course of his employment or engagement, with the provisions of the Act, rules, regulations and orders made thereunder (Sec. 31).
2. To display its licence at a conspicuous place of the premises in which it carries on its business (Sec. 32).
3. To surrender the licence to the Controller immediately after its suspension or revocation [Sec. 33(1)].
4. To disclose in the manner specified by the regulations:
   (a) its Digital Signature Certificate which contains the public key corresponding to the private key used by the Certifying Authority to digitally sign another Digital Signature Certificate;
   (b) any certification practice statement relevant thereto;
   (c) notice of the revocation or suspension of its Certifying Authority certificate, if any; and
   (d) any other fact that materially and adversely affects either the reliability of a Digital Signature Certificate, which that Authority has issued, or the Authority’s ability to perform its services [Sec. 34(1)].

5. To make reasonable efforts to notify any person who is likely to be affected by the occurrence of any event which, in the opinion of the Certifying Authority, may materially and adversely affect the integrity of its computer system or the conditions subject to which a Digital Signature Certificate was granted. He may also act in accordance with the procedure specified in its ‘certification practice statement’ to deal with such event or situation [Sec. 34(2)].

It may be noted that the Central Government has notified the ‘Information Technology (Certifying Authorities) Rules, 2000’ which may be referred with advantage. Schedule III of these Rules prescribes the ‘Security Guidelines for Certifying Authorities’.

At present, Safescrypt, Tata Consultancy Services (TCS), National Informatic Centre (NIC) and Mahanagar Telephone Nigam Ltd. (MTNL) are the major licensed Certifying Authorities authorised to issue digital signature certificates.

13.4.3 Digital Signature Certificates

The purpose of a digital signature certificate is to authenticate the identity of an individual. It ensures that the purported sender is in fact the person who sent the message. It is signed digitally by the Certifying Authority.

Certifying Authority to Issue Digital Signature Certificate (Sec. 35)

Application. Any person may make an application to the Certifying Authority for the issue of a Digital Signature Certificate in such form as may be prescribed by the Central Government. The application shall be accompanied:
   (a) by such fee not exceeding twenty-five thousand rupees as may be prescribed by the Central Government. However, different fees may be prescribed for different classes of applicants.
   (b) by a ‘certification practice statement’ or where there is no such statement, a statement containing such particulars, as may be specified by regulations.

Grant of certificate. On receipt of an application for the issue of Digital Signature Certificate, the Certifying Authority may, after consider-ation of the
certification practice statement’ or the other statement referred above and after making such enquiries as it may deem fit, grant the Digital Signature Certificate or for reasons to be recorded in writing, reject the application. However, no Digital Signature Certificate shall be granted unless the Certifying Authority is satisfied that:

(a) the applicant holds the private key corresponding to the public key to be listed in the Digital Signature Certificate;

(b) the applicant holds a private key, which is capable of creating a digital signature;

(c) the public key to be listed in the certificate can be used to verify a digital signature affixed by the private key held by the applicant.

Representations upon issuance of Digital Signature Certificate (Sec. 36)

While issuing a Digital Signature Certificate, the Certifying Authority certifies that, the information contained in it is accurate and that:

(a) it has complied with the provisions of this Act and the rules and regulations made thereunder;

(b) it has published the Digital Signature Certificate or otherwise made it available to such person relying on it and the subscriber has accepted it;

(c) the subscriber holds the private key corresponding to the public key, listed in the Digital Signature Certificate;

(d) the subscriber’s public key and private key constitute a functioning key pair; and

(e) it has no knowledge of any material fact, which if it had been included in the Digital Signature Certificate would adversely affect the reliability of the representations made in clauses (a) to (d).

Suspension of Digital Signature Certificate (Sec. 37)

The Certifying Authority which has issued a Digital Signature Certificate may suspend such Digital Signature Certificate:

(a) on receipt of a request to that effect from:

(i) the subscriber listed in the Digital Signature Certificate; or

(ii) any person duly authorised to act on behalf of that subscriber;

(b) if it is of opinion that the Digital Signature Certificate should be suspended in public interest.

A Digital Signature Certificate shall not be suspended for a period exceeding fifteen days unless that subscriber has been given an opportunity of being heard
in the matter. Further, on suspension of a Digital Signature Certificate under this Section, the Certifying Authority shall communicate the same to the subscriber.

Revocation of Digital Signature Certificate (Sec. 38)

A Certifying Authority may revoke a Digital Signature Certificate issued by it:

(a) where the subscriber or any other person authorised by him makes a request to that effect; or

(b) upon the death of the subscriber; or

(c) upon the dissolution of the firm or winding up of the company where the subscriber is a firm or a company.

The Certifying Authority may also revoke a Digital Signature Certificate which has been issued by it at any time, if it is of opinion that:

(a) a material fact represented in the Digital Signature Certificate is false or has been concealed;

(b) a requirement for issuance of the Digital Signature Certificate was not satisfied;

(c) the Certifying Authority’s private key or security system was compromised in a manner materially affecting the Digital Signature Certificate’s reliability;

(d) the subscriber has been declared insolvent or dead or where a subscriber is a firm or a company, which has been dissolved, wound-up or otherwise ceased to exist.

A Digital Signature Certificate shall not be revoked unless the subscriber has been given an opportunity of being heard in the matter. Further, on revocation of a Digital Signature Certificate under this Section, the Certifying Authority shall communicate the same to the subscriber.

Notice of suspension or revocation (Sec. 39). Where a Digital Signature Certificate is suspended or revoked under Section 37 or Section 38, the Certifying Authority shall publish a notice of such suspension or revocation, as the case may be, in the repository specified in the Digital Signature Certificate for publication of such notice. Where one or more repositories are specified, the Certifying Authority shall publish notices of such suspension or revocation, as the case may be, in all such repositories.

Check Your Progress

3. List some of the functions of the ‘controller’.

4. State two duties of the certifying authority.
13.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The term ‘e-governance’ or electronic governance refers to the application of information technology to the processes of Government functioning in order to bring about Simple, Moral, Accountable, Responsive and Transparent (SMART) governance. It involves electronic filing of documents with the government agencies and creating a network of e-services and e-administration. Electronic Governance (e-governance) is fast catching up and more and more government processes are going on-line resulting in less bureaucracy, more transparency and openness. Companies will be able to file any form, application or any other document in the electronic form and get Licenses/Certificates on-line.

2. Digital signatures are the electronic equivalent of the handwritten signatures. In an electronic message or transaction affixing handwritten signature is not possible. Authentication of the record has to be achieved by some electronic or digital method. ‘Affixing digital signature’ has been defined in Section 2(l)(d) of the Act to mean adoption of any methodology or procedure by a person for the purpose of authenticating an electronic record by means of ‘digital signature’.

3. The Controller may perform all or any of the following functions, namely:
   (a) exercising supervision over the activities of the Certifying Authorities;
   (b) certifying public keys of the Certifying Authorities;
   (c) laying down the standards to be maintained by the Certifying Authorities;
   (d) specifying the qualifications and experience which employees of the Certifying Authorities should possess;
   (e) specifying the conditions subject to which the Certifying Authorities shall conduct their business;

4. The two duties of the Certifying Authority are as follows:
   (a) To ensure that every person employed or otherwise engaged by it complies, in the course of his employment or engagement, with the provisions of the Act, rules, regulations and orders made thereunder (Sec. 31).
   (b) To display its licence at a conspicuous place of the premises in which it carries on its business (Sec. 32).

13.6 SUMMARY

- The law relating to ‘information technology’ is contained in the Information Technology (IT) Act, 2000, which came into force on 17th October, 2000. It is the first Cyber Law in India.
The Information Technology (IT) Act, 2000 has been designed to give boost to Electronic Commerce (e-commerce), e-transactions and similar activities associated with commerce and trade, and also to facilitate Electronic Governance (e-governance) by means of reliable electronic records.

The Information Technology Act, 2000 consists of 13 Chapters divided into 94 Sections. Chapters I to VIII are mostly digital signature related. Chapters IX to XIII are regarding penalties, offences, etc.

The expression ‘digital signature’ has been defined in Section 2(l)(p) of the Act to mean authentication of any electronic record by a subscriber, i.e., a person in whose name the ‘Digital Signature Certificate’ is issued, by means of an electronic method or procedure in accordance with the provisions of Section 3.

Digital signature is safer than a hand-written one as it cannot be forged. If a contract is signed by the parties on the last page, there is no way to find whether other pages have been tampered with. But digital signatures on the same contract will ensure that original contract is intact and not even a single letter is changed.

In view of the fact that the communicated electronic records and messages must be secure and reliable for giving boost to e-commerce, the IT Act, 2000 lays down the legal presumptions as to when the ‘electronic record’ and ‘digital signature’ are deemed secure.

The Central Government may, by notification in the Official Gazette, appoint a Controller of Certifying Authorities for the purposes of this Act and may also by the same or subsequent notification appoint such number of Deputy Controllers and Assistant Controllers as it deems fit.

The Controller shall maintain a computerised database of all public keys in such a manner that such database and the public keys are available to any member of the public.

If the Controller has reasonable cause to suspect that any contravention of the provisions of this Act, rules or regulations made thereunder has been committed, the Controller or any other person authorised by him shall have access to any computer system, any apparatus, data or any other material connected with such system, for the purpose of searching or causing a search to be made for obtaining any information or data contained in or available to such computer system.

13.7 KEY WORDS

- Electronic Commerce: Electronic commerce (e-commerce) is a type of business model, or segment of a larger business model, that enables a firm or individual to conduct business over an electronic network, typically the Internet.
NOTES

13.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What do you understand by the term Information Technology?
2. What is the rationale behind the Information Technology Act, 2000?
3. How is ‘Controller of Certifying Authorities’ appointed?
4. What are the functions of Controller of Certifying Authorities under the Information Technology Act, 2000?

Long-Answer Questions

1. Discuss the powers of ‘Controller of Certifying Authorities’ under the Information Technology Act, 2000.
2. Explain the terms ‘e-commerce’ and ‘e-governance’ with reference to Information Technology Act, 2000.
3. Discuss the duties of ‘Certifying Authority’ under the Information Technology Act, 2000.
4. Discuss the provisions of Information Technology Act, 2000 relating to ‘Digital Signature Certificate’.

13.9 FURTHER READINGS


- **Digital Signature**: It refers to a digital code (generated and authenticated by public key encryption) which is attached to an electronically transmitted document to verify its contents and the sender’s identity.
- **Electronic Records**: It refers to information captured through electronic means, and which may or may not have a paper record to back it up. Also called machine readable record.
UNIT 14 COMPANY LAW AND THE RIGHT TO INFORMATION ACT, 2005

Structure
14.0 Introduction
14.1 Objectives
14.2 Companies Act: Protection of Minority Interest
14.3 Companies Act: Methods of Winding Up
14.4 The Right to Information Act, 2005
14.4.1 Right to know and Salient Features
14.4.2 Obligation of Public Authority
14.4.3 Designation of Public Information Officer
14.4.4 Request for Obtaining Information
14.5 Answers to Check Your Progress Questions
14.6 Summary
14.7 Key Words
14.8 Self Assessment Questions and Exercises
14.9 Further Readings

14.0 INTRODUCTION

In this unit, you will learn about the protection of minority interest and the methods of winding up under the Companies Act. To overcome the problem of majority domination and suppression of minority shareholders’ rights in the decision making and management of the company, the Companies Act, 2013 came up with a solution. Under the Act, the minority shareholders are given 10 per cent of shares or minimum 100 shareholders, whichever is less with share capital and one-third of the total number of its members in case of companies without the share capital.

Winding up of company is defined as a process by which the life of a company is brought to an end and its property administered for benefit of its members and creditors. It is the last stage, putting an end to life of a company.

This unit will also introduce you to the Right to Information Act, 2005, which provides for right to information for citizens to secure access to information under the control of public authorities in order to promote transparency and accountability in the working of every public authority.
14.1 OBJECTIVES

After going through this unit, you will be able to:

- Understand how the interests of minority shareholders protected under the Companies Act
- Evaluate the provisions relating to winding up of companies
- Discuss the important provisions of the Right to Information Act, 2005

14.2 COMPANIES ACT: PROTECTION OF MINORITY INTEREST

The rule of supremacy of the majority was judicially recognised as early as 1843 in the leading case of *Foss vs Harbottle*.

**Facts of the case.** In this case, Foss and Turton, two of the shareholders of ‘The Victoria Park Company’ brought an action on behalf of themselves and the other shareholders (except the defendants) against the five directors, the solicitor and architect of the company, charging them with ‘concerting and effecting various fraudulent and illegal transactions, whereby the property of the company was misapplied, alienated and wasted.’ The plaintiffs wanted that the defendants might be ordered by the court to make good to the company the losses caused by the wrongful acts complained of. The Court dismissed the action holding that the conduct with which the defendants are charged is an injury not to the plaintiffs exclusively, but an injury to the whole corporation and therefore the corporation alone, and not the plaintiffs, could bring the action at law. Otherwise the Court might be acting vainly, for the alleged breach of duty could be ratified by the company (majority shareholders) in general meeting.

The judgement in the *Foss vs Harbottle* case established that on a suit filed by the minority, the court will not interfere with the internal management of companies acting within their powers even though negligence and inefficiency are proved. For, it is pointless to have legal actions based on matters which can be ratified by a general meeting. It was further expounded in this case that if any injury is done to the company, it is logical that the company itself should bring an action to get it redressed and individual members cannot assume to themselves the right of suing in the name of the company, because in law a company is a separate legal person from the members who compose it. Moreover, there will be no use in permitting the minority to bring a suit for any injury done to the company, if the majority of shareholders do not object to that, for, in such a case a meeting can be called and the injury be authorized by a majority vote.

From the rule in *Foss vs Harbottle* it becomes clear that the majority decisions are binding upon the company and a minority, even as great as 49 per cent, has no voice in the control and management of the company’s affairs.
Obviously there are dangers in such a situation. Suppose the majority are rogues and are not acting *bona fide* for benefit of the company as a whole, on a strict application of the Rule in *Foss vs Harbottle*, the minority could be exploited by the majority against which the former could take no action: it would be a shocking thing indeed. Certain *exceptions* have therefore been admitted in the interest of justice to the ‘rule of supremacy of the majority of shareholders’.

**Exceptions to the Rule of Supremacy of the Majority of Shareholders**

In the following circumstances, the will of the majority shall not prevail and an individual shareholder or minority shareholders may bring an action against the company to protect their interests:

1. **Where the act done is ultra vires the company or illegal:** As pointed out earlier, the basis of the Rule in *Foss vs Harbottle* is that it is pointless to have legal actions based on matters which can be ratified by a general meeting. It follows, therefore, that the Rule does not apply to acts which are *ultra vires* the company or which are illegal because no majority of shareholders can ratify such Acts. As such every shareholder has a right of preventing the company from doing such acts by filing a suit of injunction (*Bharat Insurance Company Ltd vs Kanhaya Lal*).

2. **Where the act done is supported by a resolution passed by an insufficient majority:** Certain resolutions, e.g., to alter the objects Cl. in the memorandum, require a three-quarters majority. If any such resolution has been passed by the simple majority, any shareholder may institute an action to restrain the company from acting on the resolution (*Nagappa Chettiar vs Madras Race Club*).

3. **Where the act complained of constitutes a fraud on the minority and those responsible for it are in control of the company:** This exception to the general principle of majority rule covers the passing of a resolution from some ulterior motive, so that the minority are improperly deprived of some benefit to which they are entitled. Majority stands in fiduciary position and, therefore, they must exercise their powers *bona fide* in the best interests of the company as a whole and not for the benefit of some section of the company. If the majority exercise their powers for their own benefit at the cost of the minority, there is a ‘fraud on the minority’ and any shareholder may bring an action to stop the company from acting on such resolution. For instance, the Court will certainly intervene if the majority pass resolution sanctioning a sale of the company’s property to themselves at an undervalue. Thus, in all such cases where the majority use the powers to defraud or oppress the minority, the Rule in *Foss vs Harbottle* will not hold good.

An illustration of fraud on the minority is found in *Menier vs Hooper’s Telegraph Works*. There, the majority of the members of company *A* were...
also members of company B. At a meeting of the company A the majority passed resolution to compromise an action against company B, in a manner alleged to be favourable to company B but unfavourable to company A. The court on the application of the minority, declared that the compromise was invalid and granted an injunction restraining further proceedings. It must be observed that in the instant case the majority tried to put something into their pockets at the cost of the minority.

It must be remembered that a resolution shall be perfectly valid and binding where it is passed *bona fide* for the benefit of the company as a whole, even though it is to the detriment of an individual shareholder or minority shareholders. Thus, in *Sidebottom vs Kershaw Leese & Co.*, the Court upheld a resolution, whereby a power was given to directors to enable them to require any shareholder, who carried on a competing business or was a director of any company carrying on a competing business, to transfer his shares at their full value to the nominees of the directors.

4. *Where the personal membership rights of an individual shareholder have been infringed.* Again, no majority of votes can deprive a shareholder from his individual membership rights, which have been conferred upon him either by the Companies Act or by the Articles of the company (*Nagappa Chettiar vs Madras Race Club*). Any individual shareholder can, therefore, sue the company in his own name where, for instance, he is prevented from exercising his right to vote or his name has been removed illegally from the Register of Members.

5. *Where the provisions of Sections 397 to 409 of the Companies Act, 1956, apply:* The Companies Act itself contains provisions which protect minority in the case of oppression and mismanagement. These provisions form the subject matter of the next heading.

### 14.3 COMPANIES ACT: METHODS OF WINDING UP

A company being an artificial person cannot die a natural death. Whenever it is desired to put an end to the life of a company, any one of the following three legal processes must be followed:

(i) Through a scheme of ‘reconstruction’ and ‘amalgamation’ under the Companies Act, where the undertaking of one company is transferred to another company and the Court orders for the dissolution of the transferor company without undergoing the process of winding up; or

(ii) Through the removal of its name from the Register of Companies by the Registrar, in case of a defunct company

(iii) Through the winding up machinery.
Meaning of Winding Up

The ‘winding up’ or ‘liquidation’ of a company is a process to bring about an end to the life of a company. In the words of Professor Gower,

‘Winding up of a company is the process whereby its life is ended and its property administered for the benefits 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, the process of winding up involves the realization of the assets, payment of the liabilities and distribution of surplus, if any, amongst the members of the company.

Winding Up vs Dissolution

Winding up should not be taken to mean the same thing as dissolution of the company. 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 the Register of Companies by the Registrar and the fact is published in the Official Gazette.

On completion of the winding up process, certain formalities prescribed by the Act are to be performed for the dissolution of the company. For example:

(a) in case of ‘compulsory winding up under order of the Court’, as well as in case of ‘voluntary winding up under supervision of the Court’, when the affairs of the company have been completely wound up and the Official Liquidator has made an application to the Court in that behalf, the company is dissolved from the date of the Court’s order; and

(b) in case of ‘voluntary winding up’ the company is deemed to be dissolved from the date of submission of a satisfactory report upon the conduct of winding up affairs by the Official Liquidator to the Court. The Official Liquidator is required to submit a report to the Court, after scrutinizing the final accounts and other records of winding up, submitted to him by the company’s liquidator.

It is to be noted that although in most of the cases ‘winding up’ is resorted to by companies having financial difficulties because a company cannot be declared insolvent under the Law of Insolvency. Yet there have been cases when perfectly solvent companies have been wound up voluntarily by the shareholders, for instance, where the object for which the company was formed has been accomplished or where a company is in danger of its takeover by the Government or where the company is to be amalgamated with another company.
Modes of Winding Up

The Act provides for winding up of a company in any of the following three ways: (i) Compulsory winding up under order of the Court; (ii) Voluntary winding up; and (iii) Voluntary winding up under supervision of the Court. We shall now discuss the modes of winding up, in brief, one by one.

Winding up by the court

Winding up under the order of the Court is also known as compulsory winding up. A company may be wound up by the Court under the following circumstances:

1. **Special resolution.** If the company has, by special resolution, resolved that the company be wound up by the Court. The power of the Court is, however, discretionary and may not be exercised by the Court if it finds that winding up would be opposed to public interest or company’s interests. It is not a popular mode of winding up because whenever members decide for winding up of the company, they opt for ‘voluntary winding up’, in which case the interference of the Court is least.

2. **Default in holding statutory meeting or in delivering statutory report to the registrar.** If a company has made a default in delivering the Statutory Report to the Registrar or in holding the Statutory Meeting, the Court may make a winding up order. A winding up petition on this ground can be presented either by the Registrar or by a contributory, on or after the expiration of 14 days after the last day on which the Statutory Meeting ought to have been held. Here again, the Court is not bound to order winding up. If the Court so wishes, it may extend the time and fix a date for holding the Statutory Meeting or to deliver the Statutory Report, after penalizing the officers at fault.

3. **Failure to commence business within one year of incorporation or suspending its business for a whole year.** If a company does not commence its business within a year from its incorporation, or suspends its business for a whole year, it may be ordered to be wound up. Here again, the Court is given discretionary power. The Court may not exercise its power if justifiable circumstances prevented the company to start its business or to suspend its business and the company has intention to start business within a reasonable time.

4. **Membership below minimum.** If the number of members is reduced below the legal minimum limit, i.e., below 7 in a public company and below 2 in a private company. The Court is bound to make a winding up order on this ground.

5. **Inability to pay debts.** A company may be ordered to be wound up if it is unable to pay its debts or honour its monetary commitments. According to the Act, a company is deemed to be unable to pay its debts in the following three cases:
NOTES

Company Law and the Right to Information Act, 2005

(i) Where the company fails to pay a creditor to whom it owes a sum exceeding ₹ 500 within three weeks of the demand for payment made by its creditor or his agent or legal adviser.

The debt, however must be real, immediately payable and without any bona fide and reasonable dispute with regard to it. If there is a bona fide dispute as to liability, there can be no ‘neglect to pay’ and therefore no order for winding up can be made on this ground (British India vs General Insurance Co. Ltd.).

Where, however, there is no doubt that the petitioner is a creditor for a sum which would otherwise entitle him to a winding up order, a dispute as to the precise amount owed to him by the company would not be a sufficient answer to the petition and a winding up order would be made.

(ii) Where the company fails to satisfy a court decree in favour of a creditor—either in whole or in part. Note that there is no condition of any amount in this case. Unsatisfied execution of a decree for any amount howsoever small will constitute inability to pay.

(iii) Where it is proved to the satisfaction of the Court that the company is ‘unable to pay its debts’. While determining that, the Court shall take into account the contingent and prospective liabilities of the company. Under this clause, the company may be wound up, if the applicant can prove that the company is commercially insolvent, even if the debt relied upon in the petition is disputed (O.P. Mohta vs Steel Equipment & Construction Co. Pvt Ltd.). A company is deemed to be ‘commercially insolvent’ when it is unable to meet its current liabilities. It need not necessarily be due to inadequacy of assets. The company may be having more than sufficient assets to meet its liabilities, but the assets may not be presently realizable or they may be indispensable for carrying on the business, and therefore the company may be unable to meet its current liabilities.

If any of these circumstances be proved, the Court in its discretion may: (a) make a winding up order at once, or (b) postpone the winding up order for sometime if it is of the opinion that the company shall soon be in a position to meet its current liabilities (Re Brighton Hotel Co.), or (c) refuse to make a winding up order if the majority in value of the creditors oppose the petition for good reason and prove to the satisfaction of the Court that in view of the total assets and liabilities of the company it must continue to trade (R.W. Sharman Ltd.).

6. Just and equitable. A company may also be ordered to be wound up, if the Court is of opinion that it is just and equitable that the company should be wound up. The Court enjoys very wide discretionary power under this clause. What is a ‘just and equitable’ cause depends upon the facts of each
particular case. On the basis of judicial decisions, the following examples may be given where the Court may order winding up under the head ‘just and equitable’:

(i) When the main object of the company has failed or its substrate is gone (H.C. Insurance Society Ltd.), e.g., where the ‘patent’ under which the company proposed to manufacture could not be granted to it, or where the company proposed to acquire some running business but the vendor refused to sell the business to the company.

(ii) When there is a complete deadlock in the management of the company (Akola Electric Supply Company Ltd.) owing to the directors not being on speaking terms (Yenide Tobacco Co.) or being bitterly hostile to each other or for any other reason. This ground is generally applicable to the case of closely held companies in which the directors also happen to be the only shareholders or majority shareholders and therefore reconstitution of the Board of Directors is not feasible. However, mere groupism among the directors does not make a case for winding up the company.

(iii) When the majority of shareholders have adopted an oppressive policy towards the minority, for instance, they have forced an unjust scheme on the minority against its wishes, or the management is carried on in such a way that the minority is disregarded.

(iv) When the company was conceived to carry out an illegal or fraudulent business or when the business of the company becomes illegal, e.g., if the main object of the company is to conduct a lottery.

(v) When the business of the company cannot be carried on except at losses. However, where the majority of shareholders are against it, the Court will not order a company to be wound up merely because it is making a loss (Suburban Hotel Co.).

(vi) When an event prescribed by the Articles as an event on the happening of which the company is to be wound up has happened.

(vii) When it is a mere ‘bubble’ company and it does not carry on any business or does not have any property (London and Country Coal Co.).

Check Your Progress

1. Differentiate between winding up and dissolution of companies.

2. What are the different ways of winding up of companies under the Companies Act?
14.4 THE RIGHT TO INFORMATION ACT, 2005

14.4.1 Right to know and Salient Features

"Right to information means the right to information accessible under this Act which is held by or under the control of any public authority and includes the right to (i) inspection of work, documents, records; (ii) taking notes, extracts or certified copies of documents or records; (iii) taking certified samples of material; (iv) obtaining information in the form of diskettes, floppies, tapes, video cassettes or in any other electronic mode or through printouts where such information is stored in a computer or in any other device.

Salient features of the Act

It has salient features such as clear, time-bound implementation schedules with penal provisions for non-compliance, a minimal exceptions clause, and a well structured appeals system.

14.4.2 Obligation of Public Authority

As per Section 1(h) of the Right to Information Act, 2005, "public authority" means any authority or body or institution of self-government established or constituted—

(a) by or under the Constitution;
(b) by any other law made by Parliament;
(c) by any other law made by State Legislature;
(d) by notification issued or order made by the appropriate Government, and includes any—

(i) body owned, controlled or substantially financed;
(ii) non-Government organisation substantially financed, directly or indirectly by funds provided by the appropriate Government;

As per Section 4 of the Right to Information Act, 2005,

(1) Every public authority shall—

(a) maintain all its records duly catalogued and indexed in a manner and the form which facilitates the right to information under this Act and ensure that all records that are appropriate to be computerised are, within a reasonable time and subject to availability of resources, computerised and connected through a network all over the country on different systems so that access to such records is facilitated;
(b) publish within one hundred and twenty days from the enactment of this Act,—
Company Law and the Right to Information Act, 2005

**NOTES**

(i) the particulars of its organisation, functions and duties;
(ii) the powers and duties of its officers and employees;
(iii) the procedure followed in the decision making process, including channels of supervision and accountability;
(iv) the norms set by it for the discharge of its functions;
(v) the rules, regulations, instructions, manuals and records, held by it or under its control or used by its employees for discharging its functions;
(vi) a statement of the categories of documents that are held by it or under its control;
(vii) the particulars of any arrangement that exists for consultation with, or representation by, the members of the public in relation to the formulation of its policy or implementation thereof;
(viii) a statement of the boards, councils, committees and other bodies consisting of two or more persons constituted as its part or for the purpose of its advice, and as to whether meetings of those boards; councils, committees and other bodies are open to the public, or the minutes of such meetings are accessible for public;
(ix) a directory of its officers and employees;
(x) the monthly remuneration received by each of its officers and employees, including the system of compensation as provided in its regulations; (xi) the budget allocated to each of its agency, indicating the particulars of all plans, proposed expenditures and reports on disbursements made;
(xii) the manner of execution of subsidy programmes, including the amounts allocated and the details of beneficiaries of such programmes;
(xiii) particulars of recipients of concessions, permits or authorisations granted by it;
(xiv) details in respect of the information, available to or held by it, reduced in an electronic form; (xv) the particulars of facilities available to citizens for obtaining information, including the working hours of a library or reading room, if maintained for public use;
(xvi) the names, designations and other particulars of the Public Information Officers;
(xvii) such other information as may be prescribed; and thereafter update these publications every year;
(c) publish all relevant facts while formulating important policies or announcing the decisions which affect public;
(d) provide reasons for its administrative or quasi-judicial decisions to affected persons.

(2) It shall be a constant endeavour of every public authority to take steps in accordance with the requirements of clause (b) of sub-section (1) to provide as much information suo motu to the public at regular intervals through various means of communications, including internet, so that the public have minimum resort to the use of this Act to obtain information.

(3) For the purposes of sub-section (1), every information shall be disseminated widely and in such form and manner which is easily accessible to the public.

(4) All materials shall be disseminated taking into consideration the cost effectiveness, local language and the most effective method of communication in that local area and the information should be easily accessible to the extent possible in electronic format with the Central Public Information Officer or State Public Information Officer, as the case may be, available free of cost or at such cost of the medium or the print cost price as may be prescribed.

Explanation.-For the purposes of sub-sections (3) and (4), “disseminated” means making known or communicated the information to the public through notice boards, newspapers, public announcements, media broadcasts, the internet or any other means, including inspection of offices of any public authority.

14.4.3 Designation of Public Information Officer

Section 5 of the Act deals with the rules on designation of Public Information Officer:

(1) Every public authority shall, within one hundred days of the enactment of this Act, designate as many officers as the Central Public Information Officers or State Public Information Officers, as the case may be, in all administrative units or offices under it as may be necessary to provide information to persons requesting for the information under this Act.

(2) Without prejudice to the provisions of sub-section (1), every public authority shall designate an officer, within one hundred days of the enactment of this Act, at each sub-divisional level or other sub-district level as a Central Assistant Public Information Officer or a State Assistant Public Information Officer, as the case may be, to receive the applications for information or appeals under this Act for forwarding the same forthwith to the Central Public Information Officer or the State Public Information Officer or senior officer specified under sub-section (1) of section 19 or the Central Information Commission or the State Information Commission, as the case may be:

Provided that where an application for information or appeal is given to a Central Assistant Public Information Officer or a State Assistant Public Information Officer, as the case may be, a period of five days shall be
NOTES

14.4.4 Request for Obtaining Information

Section 6 of the RTI Act, 2005 deals with legislation on the request for obtaining information.

(1) A person, who desires to obtain any information under this Act, shall make a request in writing or through electronic means in English or Hindi or in the official language of the area in which the application is being made, accompanying such fee as may be prescribed, to—

(a) the Central Public Information Officer or State Public Information Officer, as the case may be, of the concerned public authority;

(b) the Central Assistant Public Information Officer or State Assistant Public Information Officer, as the case may be, specifying the particulars of the information sought by him or her:

Provided that where such request cannot be made in writing, the Central Public Information Officer or State Public Information Officer, as the case may be, shall render all reasonable assistance to the person making the request orally to reduce the same in writing.

(2) An applicant making request for information shall not be required to give any reason for requesting the information or any other personal details except those that may be necessary for contacting him.

(3) Where an application is made to a public authority requesting for an information,—

(i) which is held by another public authority; or

(ii) the subject matter of which is more closely connected with the functions of another public authority, the public authority, to which such application is made, shall transfer the application or such part of it as may be appropriate to that other public authority and inform the applicant immediately about such transfer:

(3) Every Central Public Information Officer or State Public Information Officer, as the case may be, shall deal with requests from persons seeking information and render reasonable assistance to the persons seeking such information.

(4) The Central Public Information Officer or State Public Information Officer, as the case may be, may seek the assistance of any other officer as he or she considers it necessary for the proper discharge of his or her duties.

(5) Any officer, whose assistance has been sought under sub-section (4), shall render all assistance to the Central Public Information Officer or State Public Information Officer, as the case may be, seeking his or her assistance and for the purposes of any contravention of the provisions of this Act, such other officer shall be treated as a Central Public Information Officer or State Public Information Officer, as the case may be.

290
Self-Instructional Material
Provided that the transfer of an application pursuant to this sub-section shall be made as soon as practicable but in no case later than five days from the date of receipt of the application.

4. Where access to the record or a part thereof is required to be provided under this Act and the person to whom access is to be provided is sensorily disabled, the Central Public Information Officer or State Public Information Officer, as the case may be, shall provide assistance to enable access to the information, including providing such assistance as may be appropriate for the inspection.

5. Where access to information is to be provided in the printed or in any electronic format, the applicant shall, subject to the provisions of sub-section (6), pay such fee as may be prescribed:
   Provided that the fee prescribed under sub-section (1) of section 6 and sub-sections (1) and (5) of section 7 shall be reasonable and no such fee shall be charged from the persons who are of below poverty line as may be determined by the appropriate Government.

6. Notwithstanding anything contained in sub-section (5), the person making request for the information shall be provided the information free of charge where a public authority fails to comply with the time limits specified in sub-section (1). Before taking any decision under sub-section (1), the Central Public Information Officer or State Public Information Officer, as the case may be, shall take into consideration the representation made by a third party under section 11.

7. Where a request has been rejected under sub-section (1), the Central Public Information Officer or State Public Information Officer, as the case may be, shall communicate to the person making the request,—
   (i) the reasons for such rejection;
   (ii) the period within which an appeal against such rejection may be preferred; and
   (iii) the particulars of the appellate authority.

An information shall ordinarily be provided in the form in which it is sought unless it would disproportionately divert the resources of the public authority or be detrimental to the safety or preservation of the record in question.

Check Your Progress

3. Which Section of the RTI Act deals with the rules on designation of Public Information Officer?
4. Which Section of the RTI Act deals with legislation on the request for obtaining information?
14.5 ANSWERS TO CHECK YOUR PROGRESS

QUESTIONS

1. 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 the Register of Companies by the Registrar and the fact is published in the Official Gazette.

2. The Companies Act provides for winding up of a company in any of the these three ways: (i) Compulsory winding up under order of the Court; (ii) Voluntary winding up; and (iii) Voluntary winding up under supervision of the Court.

3. Section 5 of the RTI Act deals with the rules on designation of Public Information Officer.

4. Section 6 of the RTI Act, 2005 deals with legislation on the request for obtaining information.

14.6 SUMMARY

- Certain exceptions have been admitted in the Companies Act in the interest of justice to the ‘rule of supremacy of the majority of shareholders’.
- The will of the majority shall not prevail and an individual shareholder or minority shareholders may bring an action against the company to protect their interests in case the act done is ultra vires the company or illegal.
- Where the act complained of constitutes a fraud on the minority and those responsible for it are in control of the company, the will of the majority shall not prevail.
- Winding up of a company is the process whereby its life is ended and its property administered for the benefits 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.
- In case of ‘compulsory winding up under order of the Court’, as well as in case of ‘voluntary winding up under supervision of the Court’, when the affairs of the company have been completely wound up and the Official Liquidator has made an application to the Court in that behalf, the company is dissolved from the date of the Court’s order.
- In case of ‘voluntary winding up’ the company is deemed to be dissolved from the date of submission of a satisfactory report upon the conduct of
winding up affairs by the Official Liquidator to the Court. The Official Liquidator is required to submit a report to the Court, after scrutinizing the final accounts and other records of winding up, submitted to him by the company’s liquidator:

- **Right to Information** includes the right to (i) inspection of work, documents, records; (ii) taking notes, extracts or certified copies of documents or records; (iii) taking certified samples of material; (iv) obtaining information in the form of diskettes, floppies, tapes, video cassettes or in any other electronic mode or through printouts where such information is stored in a computer or in any other device.

- As per Section 4 of the Right to Information Act, 2005, every public authority is required to maintain all its records duly catalogued and indexed in a manner and the form which facilitates the right to information under this Act and ensure that all records that are appropriate to be computerised are, within a reasonable time and subject to availability of resources, computerised and connected through a network all over the country on different systems so that access to such records is facilitated.

### 14.7 KEY WORDS

- **Winding up** or **liquidation** of a company: It is a process to bring about an end to the life of a company.

- **Right to information**: It means the right to information accessible under the Right to Information Act.

### 14.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

**Short-Answer Questions**

1. List the legal processes available for winding up of companies in India.
2. Identify the circumstances in which a company may be wound up by the Court.

**Long-Answer Questions**

1. Discuss the various exceptions to the Rule of Supremacy of the Majority of Shareholders under the Companies Act.
2. Explain the salient features of the Right to Information Act, 2005.
14.9 FURTHER READINGS
