

# LAWS, ETHICS AND GOVERNANCE

INTERMEDIATE

## STUDY NOTES



**The Institute of Cost Accountants of India**

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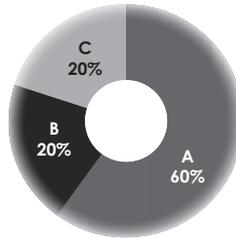
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# Syllabus

## PAPER 6: LAWS, ETHICS AND GOVERNANCE

### Syllabus Structure

A	Industrial and Economic Laws	60%
B	Corporate Laws and Governance	20%
C	Ethics	20%



### ASSESSMENT STRATEGY

There will be written examination paper of three hours.

### OBJECTIVES

To give an exposure to some of the important laws essential and relevant for a business entity. To demonstrate an overview of laws related to Companies. To provide knowledge, comprehension and principles of Corporate Governance. To construct the principles and ethical values of the business and professionals.

### Learning Aims

The syllabus aims to test the student's ability to:

- Explain fundamental aspects of laws relevant for a business entity
- Understand the principles of corporate governance and ability to implement and report compliance
- Create awareness and understanding of the ethical values

### Skill sets required

Level B: Requiring the skill levels of knowledge and comprehension, application and analysis.

**Note: Subjects related to applicable statutes shall be read with amendments made from time to time.**

<b>Section A : Industrial and Economic Laws</b>	<b>60%</b>
1. Laws of Contracts (Advanced level)	
2. Laws relating to Sale of Goods (Advanced level)	
3. Laws relating to Employees: (Bare Act) <ul style="list-style-type: none"> <li>• Factories Act,1948;</li> <li>• Industrial Disputes Act,1947;</li> <li>• Workmen's Compensation Act,1923</li> <li>• Payment of Wages Act, 1936 and Minimum Wages Act,1948</li> <li>• Payment of Bonus Act,1965 and Payment of Gratuity Act,1972</li> <li>• Employees State Insurance (E.S.I) Act, 1948</li> <li>• Provident Fund (P.F.) Act, 1952</li> <li>• The Child Employee (Prohibition and Regulation) Act,1986</li> </ul>	
4. Negotiable Instruments Act,1881 (Advanced Level)	
5. Laws related to Partnership: (Advanced level) <ul style="list-style-type: none"> <li>• Indian Partnership Act,1932</li> <li>• Limited Liability Partnership Act, 2008</li> </ul>	
6. Prevention of Money Laundering Act,2011	
<b>Section B : Corporate Laws and Governance</b>	<b>20%</b>
7. Essentials of Corporate Laws	
8. RTI Act, 2005	
9. Governance	
<b>Section C : Ethics</b>	<b>20%</b>
10.Ethics and Business	
11.Ethical Conflict	

## **SECTION A: LAWS (INDUSTRIAL AND ECONOMIC LAWS) [60 MARKS]**

### **1. Laws of Contracts**

- (a) Essential elements of a contract, offer and acceptance
- (b) Void and voidable agreements
- (c) Consideration
- (d) Legality of object
- (e) Multinational agreement
- (f) e-contracts
- (g) Strategies and constraints to enforce contractual obligations
- (h) Quasi-contracts, contingent contracts, termination or discharge of contracts
- (i) Special contracts : Indemnity and Guarantee; Bailment and Pledge; Laws of Agency

### **2. Laws relating to Sale of Goods**

- (a) Definition
- (b) Transfer of ownership
- (c) Performance of the contract of sale

### **3. Laws relating to Employees: (object, scope and applicability of the following Acts):**

- (a) Factories Act, 1948
- (b) Industrial Disputes Act, 1947
- (c) Workmen's Compensation Act, 1923
- (d) Payment of Wages Act, 1936 and Minimum Wages Act, 1948
- (e) Payment of Bonus Act, 1965 and Payment of Gratuity Act, 1972
- (f) Employees State Insurance (E.S.I) Act, 1950
- (g) Provident Fund (P.F.) Act, 1952
- (h) The Child Employee (Prohibition and Regulation) Act, 1986

### **4. Negotiable Instruments Act, 1881**

- (a) Definition, Acceptance and negotiation
- (b) Rights and liabilities of Parties
- (c) Dishonour of a Negotiable Instrument, Hundis
- (d) Bankers and Customers

### **5. Laws related to Partnership:**

- (a) Indian Partnership Act, 1932
  - (i) Nature of Partnership
  - (ii) Rights and liabilities of Partners
  - (iii) Dissolution of Firms
- (b) Limited Liability Partnership Act, 2008
  - (i) Concept, Formation, Membership, Functioning,
  - (ii) Dissolution

### **6. Prevention of Money Laundering Act ,2011**

- (a) Historical background
- (b) Prevention of Money Laundering Act, 2011
- (c) Concepts, definitions, various transactions, etc
- (d) Obligations of Banks and Financial Institutions
- (e) RBI Guidelines on KYC ( Know Your Customer)

## **SECTION B: CORPORATE LAWS AND GOVERNANCE [20 MARKS]**

### **7. Essentials of Corporate Laws**

- (a) Company – types, formation and related procedures
- (b) Director- roles, responsibilities, qualification, disqualification, appointment/re-appointment, retirement, resignation, removal, remuneration, powers, duties, Director's Identification Number (DIN), Loans to Directors, Office or Place of Profit
- (c) Cost Accountant – Appointment, Role and Responsibilities – with special reference to Certification, Compliance Report and Performance Evaluation of the Organization

### **8. Right to Information Act, 2005**

- (a) Salient features, objective
- (b) Public authorities and their obligations
- (c) Designations of Public Information Officers (PIO) and their duties
- (d) Request for obtaining information

### **9. Governance**

- (a) Basic understanding of Corporate Governance
- (b) Corporate governance practices in India, USA, UK, Japan and Germany
- (c) Tools for ensuring Governance:
  - (i) Cost Audit Methodology and Corporate Governance
  - (ii) Internal Audit for Governance – nature, scope, function, planning process, investigation of fraud, internal audit reports
  - (iii) Statutory Audit for Governance
  - (iv) An introduction to e-governance and XBRL

## **SECTION C : ETHICS [20 MARKS]**

### **10. Ethics and Business**

- (a) Evolution of Business Ethics (with reference to IFAC on Ethics – IEG-8)
- (b) Ethics – meaning, importance, nature and relevance to business, values and attitudes of Professional Accountants
- (c) The “Seven Principles of Public Life” – selflessness, integrity, objectivity, accountability, openness, honesty and leadership

### **11. Ethical Conflict**

- (a) The relationship between ethics and law, difference between ethical codes and contracts
- (b) Unethical behavior - consequences, Conflicts of interest – causes and remedies.
- (c) Ethics of Management Accountant Professionals

**List of Amended Sections under respective Acts**

<b>Name of the Act</b>	<b>Sections</b>	
The Payment of Bonus Act, 1965	• 2(13)	Modified
	• 8	Modified
The Industrial Disputes Act, 1947	• 2(s)	Modified
The Employee's State Insurance Act, 1948	• 2(6A)	Modified
	• 2(9)	Modified
	• 2(12)	Modified
The Payment of Wages Act, 1936	• 1(6)	Modified
The Negotiable Instrument Act, 1881	• 142	Re-numbered
	• 142(2)	Inserted
	• 142(A)	Inserted
The Indian Partnership Act, 1932	• 464 of CA, 2013	Modified
The Limited Liability Partnership Act, 2008	• 5	Modified
	• 15	Modified
The Prevention of Money Laundering Act, 2002	• 2(ra)	Modified
	• 2(sb)	Inserted
	• 2(sc)	Inserted
	• 9	Modified
	• 14	Modified
	• 70	Modified
The Companies Act, 2013	• 2(68)	Modified
	• 2(71)	Modified
	• 9	Modified
	• 11	Omitted
	• 12	Modified
	• 22	Modified
	• 142(12)	Modified
	• 177(4)(iv)	Modified
	• 185(1)(c)	Inserted
	• 185(1)(d)	Inserted
	• 186	Modified
• 188	Modified	
The Right to Information Act, 2005	• 2(h)	Modified
	• 32	Inserted

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## **Section A**

# **Industrial and Economic Laws**

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# Study Note - 1

## LAWS OF CONTRACT



### This Study Note includes

- 1.1 The Indian Contract Act, 1872-Concepts and Definitions
- 1.2 Communication, Acceptance and Revocation of Proposals
- 1.3 Capacity to Contract
- 1.4 Free Consent
- 1.5 Consideration
- 1.6 Void Agreements
- 1.7 Contingent Contracts
- 1.8 The Performance of Contracts
- 1.9 Time and Place for Performance
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- 1.15 Bailment
- 1.16 Pledge
- 1.17 Contracts of Agency

### 1. THE INDIAN CONTRACT ACT, 1872 - INTRODUCTION

The word CONTRACT is common to all of us and virtually no business transactions can take place without any contracts. The Indian Contract Act, 1872, deals with various types of contracts entered into by various people and defines the extremely important aspects of business transactions relating to contracts. In business dealings offers for sale are made and accepted, consideration is agreed, and conditions of sale are specified. Disputes arise when an offer or acceptance is violated, consideration is unpaid, and conditions of transactions are violated. The Indian Contract Act 1872 takes care of all these matters and provides remedies for all such disputes.

Before enactment of The Indian Contract Act, 1872 the courts in India used to apply English Common Laws as suited to Indian conditions, customs and usages. Some difficulties were noticed in using English Common Laws. Accordingly later on the courts started deciding cases based on Hindu personal laws and Muslim personal laws. But the same were still not found fit to address the then business complexities. Accordingly a separate The Indian Contract Act, 1872 was enacted. This Act is based on English Common Law which is to a large extent made up of judicial proceedings. Before 1930, the Act contained provisions relating to contract of sale of goods and partnership. Section 76 to 123 relating to Sale of Goods were deleted from the Indian Contract Act, 1872 and enacted in another act, The Sale of Goods Act, 1930. Similarly section 239-266 relating to partnership were repealed in 1932 and separate act, The Indian Partnership Act, 1932 was passed.

The Indian Contract Act, 1872 is not an exhaustive Act as it does not cover all branches of the law of contract. There are other acts to deal with other types of contract like the Sale of Goods Act for Sales of Goods, Partnership Act for Partnership Contract, Transfer of Property Act for contract relating to Sale of Immovable Property, etc. Again it does not deal with all types of agreements, it deals with only those agreements which are enforceable by law or which give rise to legal consequences. Social

agreements wherein the parties do not intend to create legal obligations to be enforceable by law, like promise to attend marriage ceremony, promise to throw dinner etc are outside the ambit of the Indian Contract Act, 1872.

## 1.1 CONCEPTS AND DEFINITIONS

### 1.1.1 Extent and Commencement

The Indian Contract Act, 1872 extends to the whole of India except the State of Jammu and Kashmir; and it came into force on the first day of September, 1872.

#### Enactments Repealed

The Indian Contract Act, 1872 does not affect nor does expressly repeal any provisions of any Statute, Act or Regulation and also does not expressly repeal any usage or custom of trade, nor any incident of any contract, not inconsistent with the provisions of this Act.

### 1.1.2 Basic Concepts

Section 2 of the Act defines various terms and expressions used in the Act. Before discussing the various provisions of the Act, let us know how various terms used in the Act have been defined in section 2.

#### Section 2

- (a) 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;
- (b) When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal, when accepted, becomes a promise;
- (c) The person making the proposal is called the "promisor", and the person accepting the proposal is called the "promisee";
- (d) 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;
- (e) Every promise and every set of promises, forming the consideration for each other, is an agreement;
- (f) Promises which form the consideration or part of the consideration for each other are called reciprocal promises;
- (g) An agreement not enforceable by law is said to be void;
- (h) An agreement enforceable by law is a contract;
- (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;
- (j) A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable.

#### What is a Contract?

Section 2(h) of the Act defines the term contract as an agreement between two or more parties enforceable by law. This definition of contract is influenced by the definition of contract given by Pollock who define contract as "Every agreement and promise enforceable at law is a contract"

Another definition of Contract given by Salmond is "contract is an agreement creating and defining obligations between the parties."

From the above analysis of the definition of contract, it is clear that contract is based on enforceability



of an agreement. So agreement and its enforceability are two essential component of a contract. If either of these two is missing there is no contract.

### What is agreement?

Agreement has been defined in section 2(e) as “every promise and every set of promises forming consideration for each other”

According to Sec 2 (b), ‘when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted and a proposal when accepted becomes a promise.

Summing together all the three definition we can say an accepted proposal/offer is an agreement.

When we say that an accepted proposal/offer creating legal relationship or enforceable by law is a contract in ordinary sense, it raise another point how a person will accept an offer/proposal. Answer is when he consented to it or in other words there must be consensus ad idem, meeting of mind of both the parties to the contract. The essence of agreement or in turn contract is meeting of mind of the parties. The parties to an agreement must have agreed upon the subject in the same sense and at the same time. Unless there is consensus ad idem, there cannot be any contract.

### Example:

A had two motor car Maruti Alto and Maruti 800; he intends to sell Maruti 800 to B. But B thought he is selling Maruti Alto agrees to his proposal. Since there is no meeting of mind both understood the same transaction differently, there is no consensus ad idem. Accordingly there is no consent and thus there is no contract.

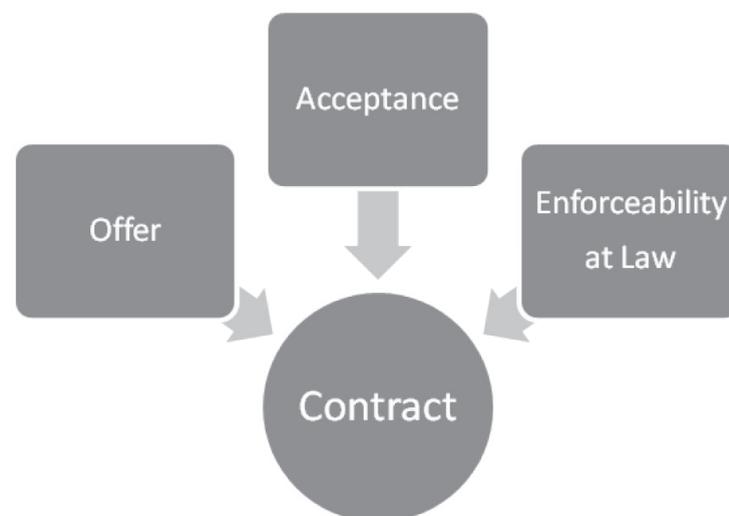
### Will all agreements give rise to a contract?

An agreement to become a contract must give rise to a legal obligation. Agreement can be social obligation or legal obligation.

An agreement giving rise to social obligation is not a contract. That is why it is said that the term agreement is a wide term it includes both social and legal obligations but only those agreements which the parties intend to enforce legally culminates into contract.

An agreement is regarded as a contract when it is enforceable by law.

Legal obligations arise to make an agreement, a contract. It means that an agreement must give rise to legal obligations. There must be an intention to create legal obligation. In case of agreement regulating business relation it is assumed that the parties intended legal consequences. Thus,



### **Agreement = Offer + Acceptance**

### **Contract = Agreement+Enforceability at Law**

*Balfour v Balfour 1919 2KB 571* is a leading case in this matter. In brief the facts of the case are that the defendant (Balfour) and his wife were enjoying their holiday in England. By reason of ill health his wife was advised by Doctors to remain in England for some time. He returned back to Ceylon and agreed to send her maintenance allowance of \$30 per month to meet her medical expenses. He did send the maintenance amount for some time but later on some differences emerged between them which led to their separation and accordingly the maintenance allowance fell in arrears. Wife's action for maintenance was dismissed by the court.

Can you understand the reasons for dismissal of the case? The reasons are very simple, there was no enforceable agreement between the defendant and his wife. The agreement to send maintenance allowance was a social obligation as the parties never intended to give it a legal consequence.

The condition of enforceability by law is reiterated in section 10 of the Indian Contract Act itself which says that "All agreements are contract if they are made by the free consent, consent of the parties competent to contract, for a lawful consideration and with the lawful object and that are not expressly declared to be void".

In nutshell we can say that every contract is an agreement but every agreement is not a contract. An agreement culminates into a contract only the following conditions are satisfied.

- (a) Agreement
- (b) Existence of a consideration
- (c) Parties are competent to contract
- (d) There is free consent
- (e) The object is lawful.
- (f) Intended to create legal obligations

Before discussing the essential features of a valid contract. We first discuss some obligations which are legal but not contractual.

The following obligations are legal obligations but not contractual obligations as they did not arise from contract. Liability has been created by statute and not by contract.

- (a) **Torts or civil wrong:**A tort is described as wrong independent of contract, for which the appropriate remedy is action for damages. According to Winfield Tortious liability arise from the breach of a duty primarily fixed by law; this duty is towards person generally and its breach is redressable by an action for unliquidated damages. Assault, false imprisonment, negligence are some of the examples tort.
- (b) **Quasi contract:**A quasi contract rests upon equitable principle that a person shall not be allowed to enrich himself unjustly at the expense of another person. This will be discussed in detail in separate section.
- (c) **Judgement of court:**Judgement of courts imposes certain obligations on a party or parties to the case. These obligations do not have their source in agreement. They are known as contracts of records also.
- (d) **Recognizance:**A person who has been arrested may be released on the promise to reappear in the court. He may bound himself to pay a certain sum of money in the event of not appearing in the court. This type of obligation is known as recognizance.
- (e) **Status obligations:**Obligations arising due to the relationship of the husband and wife fall under this category.



We shall now discuss the essential element of a valid contract;

### 1.1.3. Essential Elements of a Valid Contract

- (i) **Agreement:** In order to constitute a contract, there must be an agreement in first place. An agreement in turn is composed of two elements-offer and acceptance. Thus there must be at least two parties-one making the offer and another accepting it. The terms of offer must be definite and the acceptance must be absolute and unconditional.
- (ii) **Free Consent:** According to Sec 14, 'Consent is said to be free when it is not caused by coercion, undue influence, fraud, misrepresentation or mistake. If consent is not free, then no valid contract comes into existence. This will be discussed in detail subsequently.
- (iii) **Lawful consideration:** The agreement must be supported by a lawful consideration. Consideration means 'something in return'. 'Something in return' may be an act or abstinence. But it must be real and lawful. This will be discussed in detail subsequently.
- (iv) **Parties are competent:** The parties to an agreement must be capable of entering into a contract. A person is considered competent if he is (a) eighteen years of age (b) of sound mind (c) not disqualified from contracting by any law to which he is subject. Existence of free consent implies the consent of the parties must be free and genuine i.e. not induced by coercion, undue influence, fraud or misrepresentation. This will be discussed in detail subsequently.
- (v) **Legality of object:** There must be legality of object and consideration failing which it will not be a valid contract. This will be discussed in detail subsequently.
- (vi) The parties must intend to create a **legal relationship**. Agreements of social or domestic nature do not contemplate legal relationship, so they are not contracts.

**Example:** A husband promising his wife to buy her a 'necklace' on occasion of her birthday is not a contract.

- (vii) The agreement **not expressly declared void** or illegal by law. This will be discussed in detail subsequently.
- (ix) The terms of agreement must be **certain** and **capable of performance**.

**Example: D** agrees to sell **C** garments. The type, quality, value etc are not discussed. The agreement cannot be enforced as terms are uncertain.

Similarly, if **A** promises **B** to bring rainfall through magic. Such agreement cannot be enforced.

- (x) **Legal formalities:** Where nature of agreement is such that it requires compliance of certain formalities, such requirements should be fulfilled. A contract may require registration in addition of being in writing. However as regards to legal effects, an oral contract has same effect as a contract in writing.

### 1.1.4 Classification of Contract:

Contracts can be classified in terms of their enforceability or form or extent of performance.

#### (A) Based on Enforceability

- (i) **Valid Contract:** An agreement enforceable by law is a valid contract. In other words it satisfies all the requirements of a valid contract as laid down in section 10. If any of the essential requirements is missing it becomes a void contract.
- (ii) **Void agreement:** An agreement not enforceable by law is said to be void. A void agreement has no legal consequences. A void agreement is void from the very beginning; it is null from the very beginning.

**Example:** An agreement with a minor, agreement where both the parties are under a mistake of fact essential to the contract are void agreements.

- (iii) **Voidable contract:** An agreement which is enforceable at the option of one or more parties thereto but not at the option of other or others is a voidable contract.

**Example:**

A threatens to shoot B if he does not sell his goods to him at the price offered by A. B agrees to sell the same. This contract is voidable at the option of B.

- (iv) **Void contract:** A Contract which ceases to be enforceable by law becomes void when it ceases to be so enforceable. Void agreement and void contract are different. Void agreement is void ab-initio but void contract is a valid contract at the beginning but subsequently becomes void when it ceases to be enforceable.

- (v) **Unenforceable contracts:** These are the contracts which cannot be enforced in a court of law because of some technical defects, these contracts becomes fully enforceable if the technical defects are removed. According to Sir William Anson 'an unenforceable contract is one which is good in substance through by reasons of some technical defect; one or both of the parties cannot be sued on it.

**For example a contract may be good, but incapable of enforceable because it is not evidenced by writing as required by statute.** The defect may be curable e.g. the subsequent execution of written agreement may satisfy the requirements of the law and render the contract enforceable.

- (vi) **Illegal agreement:** An illegal agreement is destitute of any legal effect from the very beginning. All illegal agreements are void agreements but all void agreements are not illegal.

According to section 23 an agreement is illegal or unlawful if its object or consideration (a) is forbidden by law or (b) is of such nature that if permitted would defeat the provision of law or (c) is fraudulent or (d) involves or implies injury to the person or property of another or (e) the court regards it as immoral or opposed to public policy.

**Example:**

Sale of smuggled goods is illegal so an agreement to sell smuggled goods is an illegal agreement.

As an illegal agreement is one which is against a law in force in India. It is also void-An agreement to commit robbery, murder, smuggling etc are illegal agreements.

**Distinction between a void agreement and an illegal agreement:**

An illegal agreement is also void. But a void agreement is not an illegal agreement always. An agreement may not be contrary to law when made but may be void subsequently. An agreement the terms of which are uncertain is void but is not illegal at all.

When an agreement is illegal, other agreements which are incidental or collateral to it are also void. The reason underlying this rule is that the court will not enforce any agreement entered into with the object of assisting or promoting illegal transactions.

If main agreement is merely void but not illegal, other agreement which are incidental or collateral to it may be valid.

**Example 1:** X enter into a betting agreement which is wagering in nature for which he borrows ₹ 500 from Y. Even though the main agreement is void but the collateral agreement of borrowing ₹ 500 for this purpose is perfectly valid and its repayment can be enforced.

**Example 2:** X engages Y to kidnap Z for which he borrow ₹ 50,000 from P to pay ₹ 50,000 to Y. The main agreement is illegal so the subsequent agreement which is collateral to it also illegal, so the repayment of ₹ 50,000 borrowed from P can not be enforced if P was aware of the purpose for



which the amount was borrowed. However, if P is not aware of the purpose for which the loan was made it can be argued that the collateral transaction is not invalid.

**(B) Based on method of formation**

**(i) Formal contracts:** This term is usually found in English laws. Validity of these contracts depends upon their form. They are valid even if they lack consideration. These contracts are of two types; Contract under seal and Contract of Records.

Contract under seal are in writing and signed by the parties to them.

Contract of Records includes the court judgments and recognizance; obligations in such cases arise out of judgment and not under the contract.

**(ii) Simple Contract:** All contracts other than formal are called simple contracts or parole contracts.

**(C) Based on extent of performance**

**(i) Executed contracts:** An executed contract is one which has been totally completed by both the parties. A agrees to supply some goods to B and B agreed to pay for the price thereof. A supplied the goods and B paid the price. This is an executed contract as both the parties have fulfilled their contractual obligations.

**(ii) Executory contracts:** It is a contract which is wholly unperformed. If one party has performed his part of obligation but the other party has not yet completed his obligation on the contract, the contract still remains executory contract.

**Example:**

**A agree to sell some goods to B and B agrees to pay after ten days.** A delivered the goods but is yet to pay the price. This is an executor contract as one party has performed his obligations whereas other party is yet to perform its part of obligation.

**(D) Based on Obligation.**

**(i) Unilateral contract:** Under this type of contract there is an obligation only on the part of only one party when the contract is concluded.

**(ii) Bilateral Contract:** Here there is an obligation on both the parties to the contract.

**(iii) Multilateral Agreements/Contract:** Contract or agreement need not be confined to two parties, it may spread over to more than two parties each not only bind itself to other parties but also bind other parties to itself. If three parties are involved in the contract it is known as tri-parties agreement. When more than three parties are involved in an agreement it is called Multilateral Agreement. Most-commonly such Multi-lateral agreements assume international character and are entered into between sovereign Governments.

In common parlance multilateral agreements are the agreement between many parties/nations at one time who wish to regulate the trade between the parties to the agreement without any discrimination. These agreements are intended to facilitate free regime and do away with entry/tariff barriers in a phased manner as a consequence, increase the degree of economic integration between the participants. These trade agreements are considered to be the most effective way of liberalizing trade in an interdependent global economy. These trade agreements aim to reduce such barriers and thus provide all parties with the benefits of increased trade.

**Features of Multi-lateral trade agreements:**

**(i) Reciprocity:** Reciprocal benefits and advantages is a necessary feature of multi-lateral trade agreements, since neither state will be willing to sign the agreement unless it expects to gain as much as it loses.

- (ii) **MFN Treatment:** Most Favored Nation Treatment (MFN) clause, which provides against the possibility that one of the parties to the current agreement will later offer lower tariffs to another country. Agreements often include clauses providing for "national treatment of non-tariff restrictions," meaning that both states promise not to duplicate the properties of tariffs with non-tariff restrictions such as discriminatory regulations, selective excise taxes, quotas, and special licensing requirements. These agreements are sometimes easier to reach than separate bilateral agreements, since the gains to efficient producers from worldwide tariff reductions are large enough to warrant substantial concessions. The most important modern multilateral trade agreement was the GATT, which reduced world tariff levels and greatly expanded world trade.

Since more than two parties/ nations are involved in these agreements so they are very complicated to negotiate, but are very powerful once all parties sign the agreement. In the case of multi-lateral trade agreements the primary benefit is that all nations get equal treatment and provide level playing field especially for poorer nations that are less competitive by nature.

**(E) On the basis of mode of creation:**

- (i) **Express contract:** According to section 9, in so far as the proposal or acceptance of any promise is made in words, the promise is said to be express. Therefore the contracts entered into between the parties by words spoken or written are known as express contracts.

**Example:**

A send a letter to B offering to sell his car to him for ₹ 50,000. B by written letter conveyed his acceptance of the offer. This is an express contract.

- (ii) **Implied or inferred contract:** As per section 9, in so far such proposal or acceptance is made otherwise than in words, the promise is said to be implied. Thus the contracts which are made by an act or conduct of the parties and not by words are termed as implied contract.

**Example:**

When a person enter DMRC Metro station there is an implied offer and acceptance thereof between DMRC and the commuter once he enter the platform. This is a case of implied or inferred contract.

- (iii) **E-contract:** This is a kind of contract formed in the course of E-commerce by interaction of two or more person competent to contract using electronic means, such as e-mail. This involves interaction of an individual with an electronic agent, such as computer program or interaction of at least two electronic agents that are programmed in such a way to generate contract. This contract are conceptually akin to the traditional paper contract and requires all the essential requirements of a valid contract like free consent, capacity of the parties, consideration and legality of objects and consideration.

Advancement in telecommunication technology, information technology, computer technology and development of software has not only brought out changes in the life styles and living standards of the people but also changed the entire business scenario. Increase in the cost of business operations and squeeze in profit margin led to use of Electronic system as a new mode of business activities. Now rapid/instant communication across the world is no more restricted due to the constraints of geography and time. Information is transmitted and received widely and more rapidly than ever before with minimum cost and at the convenience of the parties. E-contracts have now become one of the tools of business process engineering conferring a lot of cost advantages to the contracting parties.

This form of contracting has its own advantages and disadvantages. On the one hand they reduce costs, saves time, fasten customer response and improve service quality by reducing paper work, thus increasing automation, improve the productivity and competitiveness of



participating businesses by providing instant access to Global market and easily reachable to millions of customers spread over across the Globe, on the other hand make the parties to the contract vulnerable to cyber frauds if proper safeguard/security checks are not inbuilt in the software. And this is where the E-commerce or e-contracts offer the flexibility to business environment in terms of place, time, space, distance, and payment. This e-commerce or E-commerce is associated with the buying and selling of information, products and services via computer networks not necessitating physical one to one interaction of the buyer and seller. It is a means of transacting business electronically, usually, over the Internet. It is the tool that leads to 'enterprise integration'. With the growth of e-commerce, there is a rapid advancement in the use of e-contracts.

## 1.2. COMMUNICATION, ACCEPTANCE AND REVOCATION OF PROPOSALS

### INTRODUCTION

A proposal is defined as, 'when one person signifies to another his willingness to do or 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.' [Sec 2(a)]

The term proposal used in the Indian Contract Act is like the term "offer" used in English laws. The person making proposal or offer is called the promisor or offeror and the person to whom offer is made is called the offeree and the person accepting the offer is called the promisee or acceptor. An offer may be made either by words or by conduct. An offer, which is made by words, is called 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 example of implied offer is "Delhi Metro Rail running Metro Rail on different routes to carry passengers at the scheduled tariff rates. This is a case of implied offer by DMRC and once a person board in the DMRC train he is said to have accepted the offer by his act/conduct."

#### **Similarly an offer is different from an invitation to offer.**

In the case of invitation to offer the person sending out invitation does not make an offer but only invites the other parties to make an offer. An advertisement for sale of goods by auction, quotations, catalogues of prices or display of goods at show room with price tag etc is invitation of offer rather than offer.

The main difference between an offer and an invitation to offer is that in the case of former there should be expression of willingness to do or to abstain from doing with a view to obtaining the assent of the other party, while in the later one, the party without expressing his final willingness, proposes certain terms on which he is willing to negotiate, he does not make an offer, he only invites the other party to make an offer on those terms. As already stated above in the preceeding para the display of goods in a shop window is not an offer to sell but simply an invitation to treat. The person who responds to the invitation to offer makes the offer which may or may not be accepted by the person inviting the offer. Invitation to offer also occurs for instance when tenders are invited, Advertisement for tender is merely an invitation to offer. The tender constitutes the offer which can be accepted or rejected. Simply putting goods up for auction, catalogue of goods, a prospectus of a company, invitation for jobs, invitation for public subscription etc are merely invitation to treat and not an offer.

In *Pharmaceuticals Society of Great Britain V Boots Cash Chemists Ltd 1952 2 QB 795* it was held that display of goods in a shop is not an offer to sell but simply an invitation to offer. Similarly in *Grainger and Sons V Gough 1896 AC 325 HL* it was held that "Transmission of a price list does not amount to an offer to supply an unlimited quantity of the wine de scribed at the price named."

In *Harris v Nickerson 1873 LR 8 QB 226* an auctioneer advertised for the public auction of certain goods at a certain time. The appellatant went there at the fixed time but he found that the auction had been postponed. The auctioneer was held not liable for damages for the expenses and inconvenience caused to the appellatant as advertisement for sale of goods by auction was mere an invitation to offer.

In *Harvey V Facey, 1893 AC 552* the plaintiff telegraphed to the defendant "will you sell us Bumper Hall Pen. Telegraph lowest cash price." The defendant replied "lowest price of Bumper Hall penn is \$900" The plaintiff then replied "We agree to buy Bumper Hall Pen for \$900 asked by you. Please send us your title deeds in order that we may get early possession" On refusal to sell the Bumper Hall Penn the Plaintiff sued the defendant. The privy council held that the first telegraph contained two questions namely (i) the willingness of the defendant to sell the goods/property and (ii) the lowest price. The defendant replied the second question only. The last telegraph was an offer to buy, which was rejected. Hence, the mere statement of lowest price at which the vendor would sell contains no implied contract to sell at that price to the person making the enquiry.

In *Spencer v Harding 1870 LR 5 CP 561* it was held that an advertisement inviting tenders and quotations is also an invitation to offer and not an offer.

From the above decided cases we can say that an offer is different from an invitation to offer.

**Offer can be specific or general.** An offer is said to be **specific** when it is addressed to a definite person or persons. Such offer can be accepted only by the person or persons to whom it is made. A **general** offer on the other hand is addressed to public in large and may be accepted by anybody fulfilling the terms and conditions.

The celebrated case of *Carlil v Carbolic Smoke Ball Co 1813 1 QB 256* is an authority on general offer which is produced as under for better understanding:

A Patent Medicine company advertised that it would give reward of \$100 to anyone who contacted influenza after using smoke ball of the company for a certain period according to the printed direction. Mrs Carlill purchased the advertised smoke ball and contacted influenza inspite of using the same according to the prescribed direction. She claimed the reward of \$100. The company resisted the claim on the ground that the advertisement was only an invitation to offer. They argued further that no offer was made to her and that in any case she had not communicated her acceptance assuming the advertisement was an offer. She filed a suit for recovery of the reward. It was held that the advertisement in such type of cases amounts to general offer which could be accepted by any body. She could recover the reward as she had accepted the offer by complying the terms of the offer.

It may be noted that the general offer creates for the offeror a liability in favour of any person who happens to fulfil the conditions of the offer. It is not at all necessary for the offeree to be known to the offeror at the time of offer. When the offer is made, he may be a stranger as you noticed in the case of *Carlil v Carbolic Smoke Ball case*, but by complying with the conditions of the offer, he is deemed to have accepted the offer.

### 1.2.1 Legal Rules for a Valid Offer:

- i) Offer must be made with an intention to create legal obligations; an offer must give rise to legal relationship; if it does not create legal obligations it is not a valid offer.

**Example:**

X invited his friend Y on a dinner party which the latter accepted. This is not a valid offer as the parties never intended to create legal obligations upon each other. Failure of Y attending the party does not give the other party X any legal right against him.

- ii) Offer can be expressed or implied: Already discussed elsewhere in the chapter, an offer which is made in words written or spoken is called an express offer and an offer which is made by an act or conduct of the offerer is called an implied offer. As per section 9 " in so far as the proposal or acceptance of any promise is made in words, the promise is said to be express.

**Example:** A writes a letter to B to purchase 100 tons of certain goods at a certain price. B accepted A's letter by writing a letter. Here both offer and the contract are express offer. This is termed express offer and express contract. In *Room Kumar V Mohan Thedani (2003) 6 SCC 595* it was held " when persons express their agreements in writing it is for the express purpose of getting rid of any



indefiniteness and to put their ideas in such a shape that there can be no misunderstanding which often occurs when reliance is placed upon oral statement”.

Section 9 further states that “ in so far as such proposal or acceptance is made otherwise than in words the promise is said to be implied. Thus the offer which are formed by conduct of the parties and not by words are termed implied offer. When DTC Bus /Metro Rail Rain Delhi, Metro/Tram in kolkatta, are examples of implied offer.

Some other examples amplifying the difference between express offer and implied offer are as under;

A real estate company proposes by letter to sell the flat to X at a certain price. This is an offer by the acts(by letter). This is an express offer.

If a company a company propose to sell a flat to X at a given price over a telephone call. This is an expressed offer by act(oral words)

A leading soft drink company has put up self auto dispensing machines in all leading PVR / Shopping Malls. This is an example of implied offer.

Buses plying on the roads under Public transport systems in various cities is an example of implied offer.

**Example:**

In *Harbajanlal V Harbajanlal AIR 1925 ALL 539*, there was a general offer. Anyone who find trace of a boy and bring him home will be rewarded ₹ 500/. The plaintiff saw the boy near a Railway station, overheard the news of his missing and reward offered, traced him and brought him to his parents. Held he was entitled to reward as promised.

- iii) The terms of offer must be definite and must not be vague .All the terms and conditions of the offer must be definite and certain at the time of making offer. Therefore an agreement to agree in future is not a valid offer due to uncertainty of terms.

**Example:**

X purchase a horse from B with a promise to purchase another one also if the first one proves to the lucky to him. The second offer is not valid due to uncertainty or vagueness of the terms and condition of offer.

- iv) Silence cannot be prescribed as a mode of acceptance. An offeree cannot put silence as a mode of acceptance as, if nothing is heard from the other party by a given time the offer will be deemed to have been accepted.

**Example:**

In *Felt house V Bindley 142 All ER 1037*, a person made an offer to his nephew to purchase a particular horse and wrote, 'If I do not hear anything I shall assume the horse is mine'. Nephew did not replied but told the auctioneer not to auction the horse as the same is reserved for his uncle. The Auctioneer sold horse.Uncle sues the Auctioneer. Held, there was no contract between the uncle and nephew.

As per section 3 of the Act, communication of proposals, the acceptance of proposals, and the revocation of proposals and acceptances, respectively, are deemed to be made by any act or omission of the party proposing, accepting or revoking, by which he intends to communicate such proposal, acceptance or revocation, or which has the effect of communicating it.

- v) If no time is fixed by the offeror within which the offer is to be accepted, the offer does not remain open for an indefinite period. Where no time is specified, then the offer is to be accepted within a reasonable time. What is a reasonable time is a question of fact and would depend upon the circumstances of each case.

- vi)** Two identical cross offer does not result into a contract: When two persons make identical offer in gross ignorance of offer of other party, there is no contract due to lack of acceptance on the part of either party.

**Example:**

X sends a letter to Y offering to sell his car to him for ₹ 50,000, Y also send a letter to X offering to pay him ₹ 50,000 for his car. There is no valid contract between X and Y.

- (vii)** Offer may be general or specific: This we have discussed in preceding paragraphs.

**Example 1:**

In *Carlil v Carbolic Smoke Ball co ltd 1893 1 qb256*, the defended inserted an advertisement in the newspaper that any one getting influenza after taking the medicine for three weeks according to the printed direction would get \$100. The company also deposited \$1000 with a bank. Mrs Carlil purchased the ball used it for three weeks but contacted influenza. She sued the company for the promised reward. It was held that the plaintiff was entitled to reward from the defendant.

- viii)** Offer must be expression of willingness to do something or abstain from doing something; it can be willing to do some positive thing or willingness to abstain from doing something in which it is called negative.

**Example:**

X offers to sell his car to Y. This is a positive offer expressing opinion to do something. If proposal is like this, X offer to not to sue Y. This is an expression to not to do something thing. This is a negative offer. So offer can be both positive as well negative expressions.

- ix)** Offer is different from invitation of offer: This we have already discussed in the preceding paragraphs.

**Examples of Invitation of offer are as under:**

Display of goods in shop is not an offer to sell but simply an invitation to offer, in *Pharmaceutical Society of Great Britan v Boots Cash Chemist(Southern) ltd 1952 2 QB 795*

A Question of prices is not an offer, but an invitation to offer [*Grain and Sons V Gough, (1986) AC325 (HL)*]

An advertisement for auction is a mere invitation to offer [*Haris V Nikerson 1873 LR 8 QB 226*]

An advertisement inviting tenders and quotations is also an invitation [*Spencer v Harding 91870)LR 2 CP 56*]

- x)** Communication of special terms and conditions: Special terms and conditions attached to an offer must also be communicated to make the acceptor bound by them. The courts have laid down the following rules in this regards.

(a) There must be reasonable notice of the special terms and conditions.

(b) The notice of communication must be contemporaneous with the contract.

(c) Unreasonable or illegal terms are excluded from the contract.

(d) An exemption or exclusion clause or a similar provision in a contract should be construed as not applying to a situation created by a fundamental breach of contract because in a standard form of contract exemption clauses are generally laid down in extravagantly wide terms.

The special terms and conditions should be written either on the front side of the document which embodies the contract or there should be some indication on the front side that some terms and



conditions are written on the back of the document. In *Henderson V Stevenson (1875) 32 LT 709* case it was held that here must be reasonable notice to the offeree of the printed terms and conditions. Where this requirement is fulfilled it would be no defence to say that the plaintiff was illiterate or otherwise unable to read.

Similarly the terms must be communicated before or at the time of the contract. A subsequent notice will not bind other party unless his assent thereto is obtained. In the case of *Oily v Marborough court Ltd 1949 1 KB 532* a couple hired a room in a hotel and paid the money in advance. When they went in the room they found a notice on the walls that the hotel authorities would not be responsible for articles lost or stolen unless handed to the managers for safe custody. It was held that they were not bound by the notice.

### 1.2.2. Acceptance of Offer

Once an offer has been made, it has to be accepted to make a valid contract.

Section 2(b) defines acceptance as “When the person to whom an offer is made signifies his assent thereto the proposal is said to be accepted, A proposal when accepted becomes a promise.”

An offer can be accepted by only the person or persons for whom the offer is intended. An offer made to a particular person can only be accepted by him alone, on the other hand an offer made to a class of persons can be accepted by any member of that class of persons. An offer made to the world at large can be accepted by any person whatsoever. In *Boulton V James 1857 ER 232* X sold his business to Y without disclosing this to his esteemed customers. Z a regular and esteemed customer of X was not aware of the development and send an order in writing by the name of X to deliver some goods to him. Y received the order in the name of X and executed the order. Held Z is not bound to accept the goods and his offer was to X and not to Y. It should have been accepted by X alone and not by Y.

#### What are essential elements of a valid acceptance?

##### (a) Acceptance must be absolute and unqualified; it must conform to the offer.

As per section 7 in order to convert a proposal into a promise, the acceptance must—

1. Be absolute and unqualified; if the parties are not *ad idem* on all matters concerning the offer and acceptance, there is no contract.

An invitation with variation is no acceptance, it is simply a counter proposal, which must be accepted by the original proposer before any contract is made. A counter offer puts an end to the original offer and cannot be revived by subsequent acceptance unless it is renewed. In *Hyde v Wrench 1840 3 Bear 334* an offer to sell a car for \$1000 was turned down by the plaintiff who offered \$950 for it. This was rejected by the offeror and then the plaintiff agreed to pay \$ 1000. It was held that there would undoubtedly have been a perfect contract, instead of that the plaintiff made an offer of his own to purchase the property for \$950 and rejected the offer previously made by the defendant. He was not afterwards competent to revive the proposal of the defendant, by tendering an acceptance for it. Thus the suit of the plaintiff was dismissed.

2. Be expressed in some usual and reasonable manner, unless the proposal prescribes the manner in which it is to be accepted. If the proposal prescribes a manner in which it is to be accepted, and the acceptance is not made in such a manner, the proposer may, within a reasonable time after the acceptance is communicated to him, insist that his proposal shall be accepted in the prescribed manner, and not otherwise; but if he fails to do so, he accepts the acceptance.

In *Surender Nath v Kedar Nath AIR 1936 Cal 87* the Calcutta High Court held that where an offerer requires that the acceptance should be sent to a particular person in writing, section 7 was not violated when the offeree instead of writing to the particular person, sent his agent in person to communicate the acceptance.

- (b) Specific offer can be accepted by the person to whom it is made, whereas general offer can be accepted by anyone competent to contract and meeting the conditions of offer. It was held in *Boulton V Jones (1857)27 LJ ex 117* case that a specific offer can be accepted only by the person to whom it is made. A general offer can be accepted by any one as held in case of *Carlill v carbolic Smoke ball co, HarbansLal V Harbanslal*, already discussed earlier in this study note.
- (c) Acceptance may be express or implied:As per section 9 in so far as the proposal or acceptance of any promise is made in words, the promise is said to be express. In so far as such proposal or acceptance is made otherwise than in words, the promise is said to be implied. It can be inferred from the conduct of the parties. When a person boards in Metro Rail it is an implied acceptance.
- (d) Acceptance should be of the whole proposal and not in part; Acceptor should accept the whole proposal in total and not in parts. Part acceptance is no acceptance binding upon the proposer.
- (e) Acceptance should be according to the mode prescribed or usual and reasonable mode; acceptor cannot accept the proposal in a manner different from the manner prescribed in the offer. If no such mode is prescribed it should be usual and reasonable mode. Silence cannot be a mode of acceptance.

In *SurernderNath V KedarNath, AIR 1936 cal 87*, the Calcutta High court held that where an offeror requires that the acceptance should be sent in writing to a particular person, section 7 of the contract act is not violated when the offeree instead of writing to particular person, sent his agent in person to communicate the acceptance.

- (f) Communication of acceptance is must; a mental determination to accept unaccompanied by any external indication will not be sufficient acceptance. To constitute an acceptance such acceptance must be communicated to the offeror or his authorized agent.

**Example:**

A makes an offer to B to supply certain goods at a certain price. B writes the letter of acceptance and puts the letter in the drawer of his table and forgets all about it. Hence putting the letter of acceptance in the drawer does not amount to communication of acceptance without any external manifestation of the intention to accept the offer (*Brogden v Metropolitan Railway co, 1877 AC 666*).

A mere mental assent is not a sufficient acceptance of an offer. To constitute an acceptance such assent must be communicated to the offeror or his authorised agent.

- (g) Acceptance must be given before its lapse; Acceptance must be given before the offer lapses by expiry of time fixed or by expiry of reasonable time if no time is so fixed or before it is withdrawn or revoked by the offeror.

In *Ramasgate Victoria Hotel co V Montefoire (1866)LR 1 Exch 109* it was held that a person who applied for shares in a company in June was not bound by any allotment made in November.

### 1.2.3 Communication of Offer and Acceptance

#### Communication when complete (Sec 4)

Communication means bringing it to the notice of the other party. Communication is very essential element of a contract. The rules relating to communication are contained in section 4 of the Act. As per section 4 the communication of a proposal is complete when it comes to the knowledge of the person to whom it is made.

The communication of acceptance is complete as against the proposer, when it is put in a course of transmission to him, so as to be out of the power of the acceptor;as against the acceptor, when it comes to the knowledge of the proposer.

**Example 1:**

A proposes by letter to sell his car to B at a certain price, the communication of proposal is complete as against A when B receives the letter.



B accepts A's proposal by letter sent by post. The communication of the acceptance is complete as against A, when the letter is posted, as against B when the letter is received by A.

### Example 2:

A proposes by letter to sell his house to B, The letter is posted on 20<sup>th</sup> May which is received by B on 24<sup>th</sup> May, B accepted the proposal and posted the acceptance letter on 25<sup>th</sup> May which reached A on 28<sup>th</sup> May.

In the instant case the communication of offer is complete on 24<sup>th</sup> May when it came to the knowledge of B.

Communication of acceptance is complete as against A on 25<sup>th</sup> May when it is posted by B the acceptor and as against B when it is received by A on 28<sup>th</sup> May.

### Example 3:

A proposes by letter to sell his Car to B for ₹ 60,000, The letter is posted on 28<sup>th</sup> July which is received by B on 2<sup>nd</sup> August, B accepted the proposal and posted the acceptance letter on 5<sup>th</sup> August which reached A on 8<sup>th</sup> August.

In the instant case the communication of offer is complete on 5<sup>th</sup> August when it came to the knowledge of B.

Communication of acceptance is complete as against A on 2<sup>nd</sup> August when it is posted by B the acceptor and as against B when it is received by A on 8<sup>th</sup> August.

When we say communication of offer or acceptance is complete as against the contracting parties, we mean, the concerned party against whom it is complete, is bound by it.

Thus, according to the section when a letter of acceptance is posted by the acceptor, the proposer becomes bound by it the moment the letter of acceptance is posted by the acceptor but the acceptor will become bound by his acceptance only when it comes to the knowledge of the proposer.

From the examples given above you may have noticed some time gap between the time of posting the letter of acceptance and the date of receipt thereof by the proposer. **The time gap between the posting and the delivery of letter of acceptance can be utilized by the acceptor for revoking the acceptance by a speedier communication which will overtake the acceptance.**

**Completion of contract by post:** A complete contract arises when the letter of acceptance is posted. This has been decided in various cases. The first decided case on this issue was *Adams V Lindsell (1818) 106 ER 250*. This rule of *Adams v Lindsell* case was adopted by the courts in various other cases like *Dunlop v Vincent Higgins (1848) HLC381*. Thus when offer is properly accepted by means of a letter or telegram sent through post, the acceptance is complete and binding when it is posted as soon as it is posted even though the letter is lost in post and never reaches the offeror. It is important that the letter of acceptance is properly addressed and stamped. The contract is said to have been made at a place where the letter of acceptance is posted (*Man Lal v Venkatachiapathy 1949 ILR Mad 95*). The Supreme Court of India also approved this view regarding the completion of contract when negotiation are made by post in *Bhagwan Das v Girdharilal & co, 1966 1 SCR656*. This rule is based on commercial expediency.

**Completion of contract by Telephone or telex:** At time many commercial deals are settled through telephone or telex. A question may arise as to how to deal with such situations.

A different principle applies in such cases. In *Bhagwan Das V Girdharilal 1966 1 SCR 656*, the Supreme Court held by 2:1 majority that when a contract is made by telephone, the place where the acceptance is intimated is the place where the contract is made. The contract is complete only when the acceptance is received.

A contract by telephone or telex has the same effect as an oral agreement entered into between the parties when they are face to face. But the offeree must make sure that his acceptance is properly received, heard and understood by the offeror (*Kanhaiyalal v Dineshwara Chandra AIR 1959 MP 234*)

In *Entorse Ltd V Miles Far East Corporation*(1955)QB327, the plaintiff, an English company, made an offer by telex to the defendants, an American Company. The plaintiff's office in London could get into direct and instantaneous communication with the defendant's office in Amsterdam, Holland. The offer was to sell a certain quantity of meat, and the defendant accepted the offer by telex. The question was whether the contract was completed in London or Amesterdam . It was held that " The rule about instantaneous communication between the parties is different from the rule about the post. The contract is complete only when the acceptance is received " Thus it was held that contract was complete in London

Similarly in *ONGC V Modern Construction co, AIR 1998 Guj 46* it was held that in case of acceptance of tender by telegram, the contract becomes concluded where the telegram is dispatched and the place of the contract is where the acceptance of telegram starts its journey.

**Offer and acceptance by e mail:** Unconditional acceptance conveyed through email of offer made through e mail specifying terms and conditions, thereof satisfies the requirement of section 4 and 7 (*Tumex International FZE Ltd v Vedanta Aluminium Ltd (2010) 3 SCC 1*)

#### **1.2.4 Revocation of Proposals and Acceptances (Section 5)**

Revocation means taking back or withdrawal of offer or acceptance.

A proposal may be revoked at any time before the communication of its acceptance is complete as against the proposer, but not afterwards.

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

#### **ILLUSTRATIONS**

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

#### **1.2.5. The Communication of a Revocation is Complete:**

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 who makes it; as against the person to whom it is made, when it comes to his knowledge.

#### **Illustrations**

(a) A proposes, by letter, to sell a house to B at a certain price.

The communication of the proposal is complete when B receives the letter.

(b) B accepts A's proposal by a letter sent by post.

The communication of the acceptance is complete—as against A, when the letter is posted; as against B, when the letter is received by A.

(c) A revokes his proposal by telegram

The revocation is complete as against A when the telegram is dispatched. It is complete as against B when B receives it.

B revokes his acceptance by telegram. B's revocation is complete as against B when the telegram is dispatched, and as against A when it reaches him.

#### **Example:**

A proposes by a letter sent by post to sell his horse to B. B accepts the proposal by a letter sent by post. A may revoke his offer any time before or at the moment when B posts his acceptance letter to A and not afterwards.



An offer can be withdrawn any time before its acceptance. Any subsequent acceptance of offer by the offeree after withdrawal will not result in binding contract. However, the said general principal of contract would be inapplicable where voluntary retirement under a statutory scheme which categorically bars the employees from withdrawing the option once exercised. Terms of the statutory scheme would prevail over the general principal of contract [*New India Assurance Co. Ltd. v Raghuvir Singh Narang*(2010) 5 SCC 335]

### 1.2.6 How Revocation is Made:

#### Section 6 of the Act provides the modes for revocation of an offer or acceptance.

As per section 6 a proposal is revoked—

- (i) By the communication of notice of revocation by the proposer to the other party. The offeror may revoke his proposal any time before the letter of acceptance is posted to him and not afterwards. Similarly acceptance can be revoked any time before the letter of acceptance is received by the offeror.
- (ii) By the lapse of the time prescribed in such proposal for its acceptance, or, if no time is so prescribed, by the lapse of a reasonable time, without communication of the acceptance; What is a reasonable time is a question of fact in each case. In *Ramsgate Victoria Hotel company v Montefore* (1866)LRI 109 an offer to purchase shares made in June was not accepted till November, it was held that the offer had lapsed because of the delay in acceptance within a reasonable time. Where an offerer promises to keep the offer open for a fixed time the promise is mere nudum pactum unless supported by consideration. In the absence of the consideration to keep the offer open the offerer can withdraw his offer any time before acceptance. In case of *Cooke v Oxley* 1790 3 v TR 655 a tobacco merchant offered to sell a quantity of tobacco to the plaintiff at a certain price. The plaintiff asked the tobacco merchant for time in which to decide whether he should buy the goods or not. The time for consideration was granted, but before it expired the tobacco merchant sold the goods to a third party. The plaintiff claimed to be entitled to damages. It was held that the action did not lie as no consideration had passed to bind the seller by his promise to give time and consequently he was entitled to ignore it.

In another case of *Somansundaram Pillai v Provincial Government of Madras*, AIR 34 1974 Mad, the High Court held "A person who makes an offer has the right to withdraw it before acceptance in the absence of a contract to the contrary supported by consideration."

- (iii) By the failure of the acceptor to fulfill a condition precedent to acceptance; In *Pipraich Sugar Mills v Mazdoor Union* (1956)SCR 872 a conditional offer to pay certain amount by the employees lapsed when the condition was not accepted, the condition being immediate withdrawal of strike notice.
- (iv) By the death or insanity of the proposer, if the fact of the death or insanity comes to the knowledge of the acceptor before acceptance. Where an offeree writes his acceptance but dies before posting, the offer lapse and posting of the letter after his death will not create a contract.

### 1.2.7 When does an offer come to an end ?

An offer may come to an end by revocation or lapse, or rejection. Sec 6 deals with revocation of offer which has been discussed already. We shall now discuss rejection of offer.

An offeree may reject an offer. Rejection of offer may be expressed or implied.

*Express rejection:* Express rejection means by words spoken or written. Express rejection is effective only when notice of rejection reaches the offeror.

*Implied rejection:* Rejection of offer is implied by law:

- (a) Where the offeree makes counter offer; or
- (b) Where the offeree gives conditional acceptance.

**Example:**

X offered to sell his car to Y for ₹ 1,50,000, Y replied I am prepared to pay ₹ 120,000 immediately. X is not bound to accept Y 's offer as counter offer of Y has put to an end to original offer of X.

**Example 2:**

X offers to sell his car to Y for ₹ 150,000 on immediate payment and delivery. Y replied prepared to buy at the agreed price but payment to be made after two months after satisfied with the performance of the car. The acceptance of Y is conditional which put an end to the original offer of X.

### 1.3. CAPACITY TO CONTRACT

#### 1.3.1 Who are Competent to Contract? (Section 11)

One of the essentials of a valid contract is the competency of the parties to make contract. Law has laid down certain rules as to who are competent to enter into a valid contract. As per Section 11 every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind, and is not disqualified from contracting by any law to which he is subject.

From the above provisions of the section it means the following types of persons are not competent to contract:

- (a) A person who has not attained the age of majority, i.e. minor.
- (b) A person of unsound mind
- (c) A person who is disqualified from contracting by some law.

#### 1.3.2 Position of Minor

As per section 3 of the Indian Majority Act of 1875, every person in India is a minor if he has not attained the age of 18 years of age. However in case of a minor of whose person or property or both a guardian has been appointed under the Guardian and Wards Act, 1890 or whose property is under the superintendence of any court of wards before he attains 18 years of age is 21 years.

The position of Minor's agreement and effect thereof is as under:

- (i) An agreement with a minor is void ab-initio.
- (ii) The law of estoppels does not apply against a minor. *It means a minor can always his plead his minority despite earlier misrepresenting to be a major.* In other words he cannot be held liable on an agreement on the ground that since earlier he had asserted that he had attained majority.
- (iii) Doctrine of Restitution does not apply against a minor. In India the rules of restitution by minor are similar to those found in English laws. The scope of restitution of contract by minor was examined by the privy council in Mohiri Bibi case when it has held that the restitution of money under section 64 of the Indian Contract Act can not be granted under section 65 because a minor's agreement is not voidable but absolutely void ab-initio. Similarly no relief can be granted under section 65 as this section is applicable where the agreement is discovered to be void or the contract becomes void. Privy council held that section 65 like section 64 starts from the basis of there being an agreement or contract between the competent parties and has no application to cases where there never was and never could have any contract. Accordingly a minor is not liable under section 64-65 as held in Mohiri Bibi case to repay any money or compensate for any benefit that he might have received under a void agreement. In *Raghva Chander v Srinivasa AIR 1917 Mad 630* it was held that a minor is entitled to restitution if he has advanced full money on a mortgage executed in his favour.



- (iv) No Retification on Attaining Majority. Ratification means approval or confirmation. A minor cannot confirm an agreement made by him during minority on attaining majority. If he wants to ratify the agreement, a fresh agreement and fresh consideration for the new agreement is required.
- (v) Contract beneficial to Minor: A minor is entitled to enforce a contract which is of some benefit to him. Minority is a personal privilege and a minor can take advantage of it and bind other parties.
- (vi) Minor as an agent: A minor can be appointed an agent, but he is not personally liable for any of his acts.
- (vii) Minor's liability for necessities. If somebody has supplied a minor or his dependents with necessities, minor's property is liable but a minor cannot be held personally liable
- (viii) A minor cannot be adjudged insolvent as he is incapable of entering into a contract.
- (ix) Where a minor and an adult jointly enter into an agreement with another person the minor is not liable and the contract can be enforced against the major person.

Let us discuss some of these issues relating to minor agreement in some more detail:

**(a) Minor's agreement is absolutely void:**

The privy council in *Mohiri Bibi v Dharm Das Ghosh* have construed section 11 as meaning that no one can enter into a contract who is under age of majority so that under the Indian law, a contract by an infant is absolutely void and as under English law merely voidable, The object of the legislator was to protect the minor not only from the viles of unscrupulous persons who may choose to deal with them but also against their action, however, generous or honorable they may be.

So under Indian law the minor's agreement is absolutely void not merely voidable,

**(b) No Estoppel against a minor:**

Section 115 of the Evidence Act, 1872 defines Estoppel as "when one person has, by his declaration, act or omission, intentionally caused or permitted another person to believe a thing to be true and act upon such belief, neither he nor his representative will be allowed in a suit or proceeding between himself and such other person or his representative to deny the truth of that thing.

In *Brahma Dutt V Dhardas Ghosh* 26 Cal 381 (1898) it was held that section 115 of the Evidence Act has no applicability to an infant. They held, in fact, that the word person in that section means a person having a contractual capacity.

The Lahore High court in *Khan Gul v Iakhasingh* ILR 9Lah 701 (FB) 1928 also held that minor is stopped from pleading his minority and the court reconciled section 11 of the Contract Act with section 115 of the Evidence Act by applying the principles that where a general intention is expressed by the legislator, and also a particular intention, which is incompatible with the general one, the particular intention is considered as exception to the general one.

**(c) Liability for necessities:**

The minor's property is liable for the payment of a reasonable price for necessities supplied to the minor or to anyone whom the minor is bound to support.

What is a necessary article is to be determined from the status and the social position of the minor. The price which the trader will get is reasonable price, not the price "agreed to" by the minor. Only the minor's property is liable. The minor is not personally liable.

**Examples:**

A trader supplies a minor with rice needed for his consumption. He can recover the price from the minor's property.

Inman, an infant undergraduate in Cambridge bought eleven fancy waistcoats from Nash. He was at the time adequately provided with clothing. Held, the waistcoats were not necessary and the price could not be recovered. *Nash vs. Inman*.

When a minor is engaged in trade, contracts entered into by him for trading purposes are not for necessities and are not binding on him.

It has been held that reasonable expenses incurred for the following purposes are necessities – marriage of the minor; marriage of his sister; cost of defending a minor in civil and criminal proceedings; funeral ceremonies of the wife, husband or children of the minor; sradh ceremonies of the ancestors of the minor.

The case of necessities supplied to a minor is covered by section 68 of the contract act which provides as follows: “if a person incapable of entering into a contract, or anyone whom he is legally bound to support, is supplied by another person with necessities suited to his condition of life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person.”

So far as necessities are concerned, the minor’s liability does not arise out of contract. Fletcher Moulton J. in *Nash vs. Inman* observed as follows: “the basis of the action is hardly contract. Its real foundation is an obligation which the law imposes on the infant to make a fair payment in respect of needs satisfied.”

Privy council in *Mohiri Bibee v Dharm Das Ghosh* case observed that “ it is clear from the Act that a minor is not to be liable even for necessities and that no demand in respect thereof is enforceable by law against him, though a statutory claim is created against his property. Thus a minor is not liable even for necessities. The supplier can claim reimbursement out of property of such incapable person.

As regards necessities means goods suitable to the condition in life of the minor and to his actual requirement at the time of sale and delivery.

- I. Goods: Physical goods are necessary not only for bare existence and also for reasonable comforts and luxuries to which the minor concerned is habituated.
- II. Services rendered: A minor requires certain services, for Example a nurse for an infant, a teacher for him, the marriage expenses of a minor, etc.
- III. Loans: If required the minor can incur loans for his necessities.

**(d) No ratification:**

A subsequent ratification on attaining the age of majority by a minor of the transactions which was originally null and void does not validate the contract and on that, no suit can be maintained. In *Gobind Ram V Piran Dutta AIR 1935 lah 561* the court refused to enforce an agreement entered into by a minor after attaining the age of majority, whereby he bounds himself to repay the advances which had been made to him during the period of his minority by a money lender.

In another case of *Suraj Narain V Sukla Ahir 51 All 164 FB 1929* a minor borrowed a sum of money by executing a promissory note and after attaining the age of majority executed second bond in respect of the first bond. It was held the suit was not maintainable as the bond was without any consideration.

**(e) Liability for tort:**

A tort means a civil wrong other than a breach of contract and is redressible by an action for unliquidated damages. A minor is generally liable in tort but he cannot be made liable for what was a tort in a breach of contract. In *Johnson v Pye 1665 1 Sid 258* it was decided that although an infant may be liable in tort generally, he is not liable for a tort directly connected with a contract which as a minor he would be entitled to avoid.

**(f) Position of Minor’s Guardian:**

An agreement entered into by the guardian of a minor on his behalf stands on a different footing from a agreement entered into by the minor himself. An agreement with a minor is void but an



agreement by his guardian on his behalf is valid provided the obligations undertaken are within the powers of the guardian. The powers of a guardian are determined by the personnel law of the minor and by the Guardian and Wards Act. An agreement made by the guardian is binding on the minor if it is for the benefit of the minor or is for legal necessity.

**(g) Minor as a share holder:**

A minor cannot apply for public subscription of a company's share and hence cannot become a member or shareholder. If his name by mistake has been recorded as a member of a company he can rescind the transaction and get his name removed from the register of members. But where a minor was made member of a company after attaining the age of majority and he received and accepted dividends, he will be stopped from denying that he is a member [*Fazalbhoy V the Credit Bank of India 39 Bomb 39*]

**1.3.3 What is a Sound Mind for the Purposes of Contracting? (Section 12)**

A person is said to be of sound mind for the purposes 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 effect upon his interests.

A person who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind.

A person who is usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind.

**Illustrations:**

- (a) A patient in a lunatic asylum, who is at intervals of sound mind, may contract during those intervals.
- (b) A sane man, who is delirious from fever or who is so drunk that he cannot understand the terms of a contract or form a rational judgment as to its effect on his interests, cannot contract whilst such delirium or drunkenness lasts.

Going by the spirit of the section it is clear that a person is of sound mind if he fulfills the following two conditions.

- (i) He/she is capable of understanding the contract.
- (ii) He/she is capable of forming a rational judgment about the effects of such contract on his interest.

A person not satisfying any of these two conditions is not treated as a person of sound mind.

**1.3.4 Other Disqualified Persons:**

The persons who are disqualified from entering into contract due to certain other reasons may be from legal status, political status or corporate status. Some of such categories of persons are given below:

- (a) Alien Enemy:** An agreement with an Alien Enemy is void. But agreement with an Alien friend is perfectly valid and enforceable. When the Government of an Alien is at war with the Government of India, the alien is called Alien enemy who cannot enter into any contract with any Indian citizen without the permission of Government of India as the same is against the public policy. Contract entered into with an alien before war is put into suspension during the duration of war.
- (b) Foreign Sovereign and Ambassadors:** Foreign sovereigns and their representatives enjoy certain privileges and immunities in every country. They cannot enter into contract except through their agents residing in India. They can sue the Indian citizen but an Indian citizen cannot sue them.
- (c) Convicts:** A convict cannot enter into a contract while he is undergoing imprisonment.

- (d) **Insolvents:** An insolvent person is one who is unable to discharge his liabilities and therefore has applied for being adjudged insolvent or such proceedings have been initiated by any of his creditors. An insolvent person cannot enter into any contract relating to his property.
- (e) **Company or Statutory bodies:** A contract entered into by a corporate body or statutory body will be valid only to the extent it is within its Memorandum of Association.

## 1.4. FREE CONSENT

### INTRODUCTION

According to section 10 consensus ad idem or identify of mind is an essential requirement of a valid contract. One of the essential elements of a valid contract is that there should be free consent of the concerned parties to the contract. **'Two or more persons are said to consent when they agree upon the same thing in the same sense.'** [See 13]. If the parties have not agreed upon the same thing in the same sense there is no real consent and hence no contract is formed.

If the parties have not agreed upon the same thing in the same sense there is no real consent and hence no contract is formed. According to Pollock and Mulla the expression "the same things" means "the whole content of the agreement, whether it consists, wholly or in part or Delivery of material objects or payment or other executed acts of promises" For formation of a contract parties must agree upon the same things in the same sense, there must be real consent. If there is no real consent the contract does not come into existence. When there is no consent at all, Salmond describes it as 'Error in Consensus' However, in certain cases there is real consent but once the parties has given his consent, not out of his free will but due to factors in the absence of which he might not have given his consent, consent so given is said to be not free.

#### Example:

A has two horses Chetak and Baaz, he intended to sell Baaz to B. B thinking that A intends to sell Chetak, gave his consent for purchase of Chetak. Here in the instant case there is no consent and there is no meeting of mind. A intended to sell Baaz whereas B thought it to be Chetak gave his consent for Chetak.

As seen from the above example if the parties have not agreed upon the same thing in the same sense there is no real consent and hence no contract is formed. According to Pollock and Mulla, the expression "the same thing" means the whole content of the agreement whether it consists, wholly or in part, or delivery of material objects, or payment or other executed acts or promises.

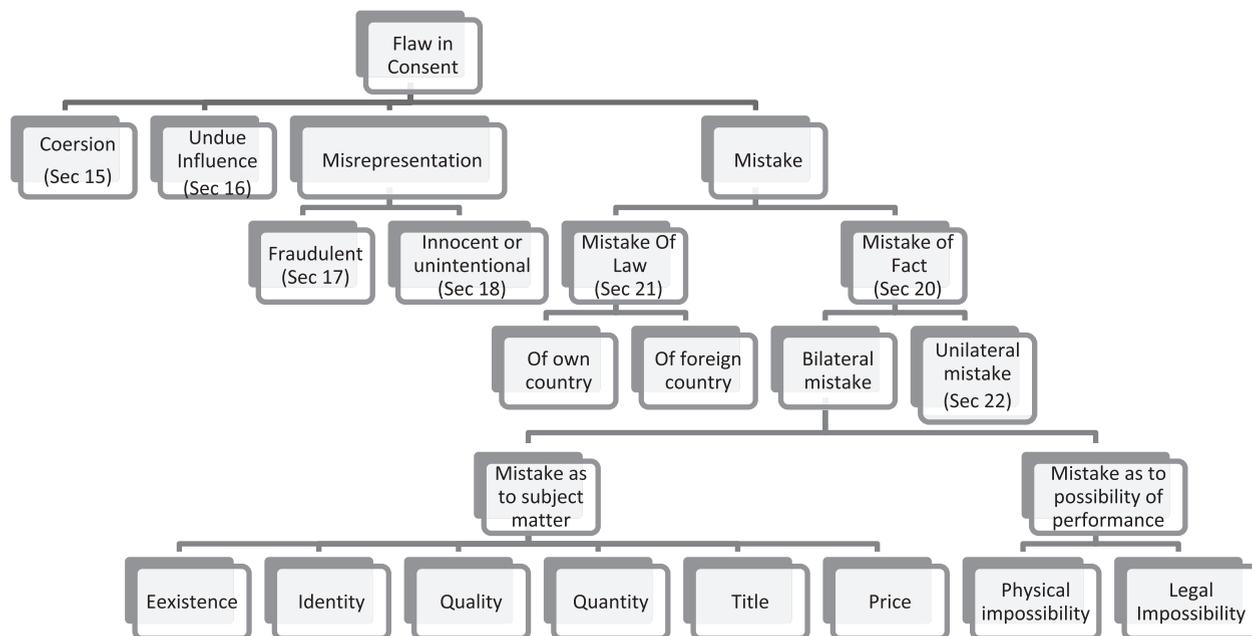
In order to give rise to a valid contract there should not only be consent but the consent should also be free. A consent is said to be free if it is not caused by coercion, undue influence, fraud or misrepresentation, or mistake.

If the consent is tainted by any of these the consent will not be treated free and the contract will not be a valid contract.

As per section 14 of the Contract act consent is said to be free when it is not caused by—

- (1) Coercion (Sec 15), or
- (2) Undue influence (Sec 16), or
- (3) Fraud (Sec 17), or
- (4) Misrepresentation (Sec 18), or
- (5) Mistake, subject to provisions of Sec 20, 21 and 22.

Consent is said to be so caused when it would not have been given but for the existence of such coercion, undue influence, fraud, misrepresentation or mistake.



### 1.4.1. Coercion [Sec 15]

The term coercion has been defined in section 15 of the Act as “Coercion” is the committing or threatening to commit, any act forbidden by the Indian Penal Code (45 of 1860), or the unlawful detaining, or threatening to detain, any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement.

**Explanation:** It is immaterial whether the Indian Penal Code (45 of 1860) is or is not in force in the place where the coercion is employed.

#### Illustrations

A, on board an English ship on the high seas, causes B to enter into an agreement by an act amounting to criminal intimidation under the Indian Penal Code (45 of 1860). A afterwards sues B for breach of contract at Calcutta. A has employed coercion, although his act is not an offence by the law of England, and although section 506 of the Indian Penal Code (45 of 1860) was not in force at the time when, or at the place where the act was done.

From the above definition of coercion given in section 15, consent is said to be caused by coercion when it is obtained by any one of the following;

- (i) committing or threatening to commit any act forbidden by Indian Penal Code;
- (ii) unlawful detaining or threatening to detain the property of another person.

Coercion may come from a person party to the contract or even third person not connected with the contract directly.

#### Example 1:

A threatens to kidnap B, minor son of C, if C did not sell his house to A at the price offered by A. C signed the document selling his house to A at the offer price of A. Here the consent had been obtained by coercion from A one of the party to contract. Consent will not be treated free and the contract will be treated avoidable at the option of C.

**Example 2:**

A threaten to kidnap B, a minor son of C, if C did not sell his property to D for the price agreed by D. C gave his consent and agreed to sell his property to D at the offer price of D. Here also the consent is not free though the threat has not come directly from the party to the contract. The consent is tainted by coercion; accordingly the contract is avoidable at the option of C.

**Unlawful detaining also amount to coercion:** If a person unlawfully detains or give a threat to detain any property to the prejudice of any person whatever with the intention of causing any person to enter into an agreement amount to coercion.

In *Muthia v Karrupan (1927) 50 Mad 786* an agent refused to handover the books of a business after the expiry of his term unless the principal gave him the release from all liability in respect of agency. The principal agreed, it was held that the release deed was not enforceable as consent was obtained by coercion.

**Effect of coercion:**

According to section 19 when the consent is caused by coercion, fraud, misrepresentation, the agreement is avoidable at the option of the party whose consent was so caused. The aggrieved party may opt to rescind the contract. If the aggrieved party seeks to rescind the contract he must restore the benefit so obtained under the contract from other party.

**Example:**

A threatens to kill C, father of B, if he did not sell his flat to him. He also gave him ₹ 50,000 as bayana (advance token money). B gave his consent and made property paper in favor of A. This is voidable at the option of B. If B opts to rescind the contract he must return ₹ 50,000 taken as advance from A as token money for this contract.

**It should be noted that threat to commit suicide also amounts to coercion.**

Some special cases which are prone to be construed cases of coercion are discussed as under;

1. Prosecution: A mere threat to prosecute a man or file suit against him does not constitute a coercion. In the case of *Andhra Sugar Lts V State of AP AIR 1968 SC 599* it was held that compulsion of law is not a coercion, fraud, misrepresentation, mistake or even undue-influence.
2. High prices and high interest Rates: Charging high interest rate, high price etc is not a coercion as the same is not prohibited under the Indian Penal code.
3. A threat to commit suicide: Consent to an agreement may at times be obtained by threatening to commit suicide. The Madras High court has held that threat to commit suicide amounts to coercion. In *Amraju v Seshamma 1917 41 Mad 33* it was argued by Oldfield J one of the judge of the Bench which decided this case, that section 15 of the Contract Act must be construed strictly and that an act which is not punishable under the Indian Penal Code cannot be said to be forbidden by it. Suicide is not punishable by the Indian Penal Code, only the attempt to suicide is punishable.

**1.4.2 Undue Influence [See 16]**

Undue influence is another way of causing forced consent of the other party. It is said to be a subtle species of fraud whereby mastery is obtained over the mind of the victim, by insidious approaches and seductive artifices.

In *Smith v Kay(1859)7 HLC 750* Lord Kingdown pointed out that the principle of undue influence applies to every case where influence is acquired and abused confidence is reposed and betrayed.

**Section 16 of the Indian Contract Act defines undue influence as under:**

- (i) A contract is said to be induced by "undue influence" where the relations subsisting between the



parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.

- (ii) In particular and without prejudice to the generality of the forgoing principle, a person is deemed to be in a position to dominate the will of another—
  - (a) Where he holds a real or apparent authority over the other, or where he stands in a fiduciary relation to the other; or
  - (b) Where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness, or mental or bodily distress.
- (iii) Where a person, who is in a position to dominate the will of another, enters into a contract with him, and the transaction appears, on the face of it or on the evidence adduced, to be unconscionable, the burden of proving that such contract was not induced by undue influence shall lie upon the person in a position to dominate the will of the other.

**Nothing in this sub-section shall affect the provisions of section 111 of the Indian Evidence Act, 1872 (1 of 1872).** There is presumption of undue influence in the following relationships:

- (i) Parent and child
- (ii) Guardian and ward
- (iii) Doctor and patient
- (iv) Solicitor and client
- (v) Trustee and beneficiary
- (vi) Religious advisor and disciple
- (vii) Fiancé and fiancée

There is however no presumption of undue influence in case of relationship of— (i) landlord and tenant (ii) debtor and creditor (iii) husband and wife. The wife has to be *pardanashin* for such presumption. In these relationships undue influence has to be proved.

#### Illustrations

- (a) A, having advanced money to his son, B, during his minority, upon B's coming of age obtains, by misuse of parental influence, a bond from B for a greater amount than the sum due in respect of the advance. A employs undue influence.
- (b) A, a man enfeebled by disease or age, is induced, by B's influence over him as his medical attendant, to agree to pay B an unreasonable sum for his professional services. B employs undue influence.
- (c) A, being in debt to B, the moneylender of his village, contracts a fresh loan on terms which appear to be unconscionable. It lies on B to prove that the contract was not induced by undue influence.
- (d) A applies to a banker for a loan at a time when there is stringency in the money market. The banker declines to make the loan except at an unusually high rate of interest. A accepts the loan on these terms. This is a transaction in the ordinary course of business, and the contract is not induced by undue influence.

Going through the definition of undue influence in section 16 we find that two elements are found in undue influence:

- (i) The relationship subsisting between the parties is such that one is in a position to dominate the will of other and
- (ii) He uses that position to obtain an unfair advantage over the other.

The person intending to avoid the contract on the ground of undue influence must prove both the above two elements.

In *Smt Chinnamma v Devanga Sangha (1973) A Mys 338* it was held that it is not necessary that the person in position of domination must benefit himself. A benefit to a third party may be sufficient. In this case undue influence by office bearers of a society benefiting the society was held to be sufficient ground to avoid the contract.

**Effect of undue influence:** Section 19 A provides that when the consent is caused by undue influence, the agreement is avoidable at the option of the party whose consent was so caused. The aggrieved party may opt to rescind the contract. If the aggrieved party seeks to rescind the contract he must restore the benefit so obtained under the contract from other party, upon such terms and conditions as to the court may seem just. The following illustrations are appended to the section.

- (a) A's son has forged B's name to a promissory note. B, under threat of prosecuting A's son, obtains a bond from A for the amount of the forged note. If B sues on this bond, the Court may set the bond aside.
- (b) A, a moneylender, advances ₹ 100 to B, an agriculturist, and, by undue influence, induces B to execute a bond for ₹ 200 with interest at 6 per cent per month. The Court may set the bond aside; ordering B to repay ₹ 100 with such interest as may seem just.

The court has discretion to direct the aggrieved party for giving back the benefit whether in whole or in part or set aside the contract without any direction for refund of benefit.

In a case for avoiding a contract on the ground of undue influence the plaintiff has to prove that :

- (i) the other party was in a position to dominate the will and that;
- (ii) he actually used his influence to obtain the plaintiff's consent to the contract. It will be then for the defendant to show that the plaintiff freely consented.

The presumption is raised at least in the following cases:

**(a) Unconscionable bargains**

Unconscionable transactions means a transaction which is so much to the advantage of one party and disadvantage to the other that it "shocks the conscience and which is irrecoverable with what is right or reasonable. This sub-section does not lay down any rule of law but lays down a rule of evidence. It throws the burden of proving that no undue influence was applied on party, being in a dominant position in case of unconscionable transactions.

Thus to shift the burden of proof both the facts must be established. This is so not merely in money lending transactions but in others forms of unconscionable bargains also.

If the transaction appears to be unconscionable bargain then the locus lies upon the other party to prove that the consent of other party was obtained freely. In *Bellachi v Pakeeran(2009) 12 SCC 95* it was held that the relationship between the parties so as to enable one of them to dominate the will of another is a *sin qua non* for constitution of undue influence. The party alleging the same must prove the same subject to just exceptions.

**(b) Contracts with pardanashin women**

A pardanashin women is one who, according to the customs of her community lives in complete seclusion. A contract with a Pardanashin women is presumed to be influenced by undue influence. The burden of proof shall always rest upon the person who seeks to sustain transaction entered into with a pardanashin lady to establish that the said document was executed by her after clearly understanding the nature of the transaction. It should be established that it was not only her physical act but also her mental act. The burden can be discharged not only by proving that the document was explained to her and that she understood it, but also by other evidence direct and circumstantial [*Kharbhujia Kuer v Jangbhadhur Rai AIR 1963 sc 1203*]



### 1.4.3. Fraud [See 17]

Fraud is an intentional misrepresentation of a material fact which induces the other party to enter into a contract. This happens when one person makes misrepresentation of material facts known to him to be untrue or made with reckless indifference as to whether it is true or false with the intention of causing other party to enter into a contract relying upon the same.

In the words of Lord Herschell in the case of *Derry v Peek*(1889)14 Ac 337 fraud is a false statement made knowingly or without belief in its truth or recklessly whether it is true or false.

As per section 17 of the Contract Act:

“Fraud” means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:

- (i) The suggestion, as a fact, of that which is not true by one who does not believe it to be true;
- (ii) The active concealment of a fact by one having knowledge or belief of the fact;
- (iii) A promise made without any intention of performing it;
- (iv) Any other act fitted to deceive;
- (v) Any such act or omission as the law specially declares to be fraudulent.

**Explanation:** Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or unless his silence is, in itself, equivalent to speech.

#### Illustrations

- (a) A sells, by auction, to B, a horse which A knows to be unsound. A says nothing to B about the horse's unsoundness. This is not fraud in A.
- (b) B says to A - "If you do not deny it, I shall assume that the horse is sound". A says nothing. Here, A's silence is equivalent to speech.
- (c) A and B, being traders, enter upon a contract. A has private information of a change in prices which would affect B's willingness to proceed with the contract. A is not bound to inform B.

**As evident from the above statutory definition of the term fraud, the following are essential elements of a fraud.**

- (a) The act must have been committed by a party to the contract or with his connivance or by his agent. The fraud committed by a stranger to contract does not vitiate the contract.
- (b) The act constituting fraud must have been committed with the intention to deceive the other party.
- (c) The act must have induced the other party to enter into a contract.
- (d) The other party must have acted upon the statement and have suffered damages or loss.
- (e) The act constituting fraud must be either of the following:
  - (i) A suggestion as to a fact by one of that which is not true who does not believe it to be true.
  - (ii) Active concealment of facts one having knowledge or belief of fact.
  - (iii) A promise made without intention of performing it.
  - (iv) Any other act fitted to deceive.
  - (v) Any other act or omission as the law specially declares to be fraud.

### Does silence amount to fraud?

At times one of the party to a contract makes studied silence to some of the facts relating to the subject matter of contract. The matter on which silence is maintained by party may be material fact. Does this amount to passive fraud under the Indian Contract Act or not depends upon various factors.

Explanation to section 17 of the Indian Contract Act provides that mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud unless the circumstances of case are such that having regard to them it is the duty of the person keeping silence to speak or unless silence itself is equivalent to speech.

#### Example:

A sells by auction a horse which A knows to be of unsound health. A says nothing to B about health condition of the horse. This is not fraud. This is based on the doctrine of Caveat Emptor, which enjoins upon the buyer to beware of.

In *Ward v Hobbs (1878) 4 AC 13*, the defendant sold to the plaintiff some pigs with all faults. At the time of sale the pigs were suffering from swine fever but the defendant did not disclose this fact to the plaintiff. Due to disease subsequently some of the pigs died and the plaintiff brought a case of damages against the defendant. The house of lords held that the defendant was not liable. Again this decision is based on the famous doctrine of **CAVEAT EMPTOR**.

#### Example 1:

As per rules of XYZ University, candidates must have put in at least 80% attendance during the academic year in order appear in the annual examination X knowing that he fell short of required attendance, filled up examination form and appeared in final examination. X cannot be said to have committed fraud and the university cannot cancel his examination. This view was held by the Supreme Court in another case of *Shri Krishnan v Kurukshetra University (1976) 1 SCC 311*.

#### Example 2:

A says to B, 'If you do not deny it, I shall assume that the horse that you are selling me is sound'. If B says nothing, his silent is equivalent to speech and this amounts to fraud.

Thus we can say that there is exception to the rule that mere silence does not amount to silence. These two exceptions are provided in explanation to section 17 as under which we have already discussed above.

- (i) When there is a duty to speak.
- (ii) Where silence is equivalent to speech.

However, in the following two types of cases, silence amounts to fraud, as held by the courts in various cases:

- (a) Where there is change in circumstances: A representation may be true when made but with the passage of time or changed circumstances it may become false. Accordingly this must be communicated to other party otherwise it amount to fraud.

*With v O Flenagan (1930) Ch 575 CA*, the defendant while negotiating the sale of his medical practice, represented to the plaintiff that his practice was worth \$2000 year. The representation was true when the negotiation took place five months ago. Later when the plaintiff brought the practice it fell to \$5 a week owing to illness of the defendant. It was held that the representation must be regarded as continuing until the contract was signed and it was the duty of the defendant to communicate the change in circumstances to the plaintiff. The contract was held to be avoidable at the option of plaintiff as the defendant failed to disclose material fact relating to fall in his medical practice..



(b) When there is half-truth. In *Gluckscin v Barves (1900) AC 240* Lord McNaughtan observed that "Everybody knows that sometimes half-truth is no better than a downright falsehood" Thus even when a person is not bound to disclose a fact he may be held guilty of fraud if he volunteers to disclose a state of fact partly. This is so when the undisclosed part renders the disclosed part false.

In *Shankar Lal V Bimla Devi, AIR 1959 MP 8*, it was held that when a person speaks of another as his son he hold him out as his legitimate, natural or adopted son. It cannot possibly include an illegitimate son. Therefore the representation was fraudulent when a Hindu father represented his illegitimate son as his son.

**Effect of Fraud:** According to section 19 when consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so caused.

A party to a contract, whose consent was caused by fraud or misrepresentation, may, if he thinks fit, insist that the contract shall be performed, and that he shall be put in the position in which he would have been, if the representations made had been true.

**Example 1:**

A intending to deceive B, false represent that 500 mounds of indigo are made annually at A's factory and thereby induces B to buy the factory. This tantamount to false and B is entitled to rescind the contract.

**Example 2:**

A fraudulently informs that A's estate is free from encumbrance, B thereupon buys the estate. The estate is subject to amortize. B may either avoid the contract or may insist of its being carried out, and the mortgage debt be redeemed.

However there is one exception to the rule of voidability of contract at the option of aggrieved party. If such consent was caused by misrepresentation, or by silence, fraudulent within the meaning of section 19 the contract, nevertheless, is not voidable, if the party whose consent was so caused had the means to discovering the truth with ordinary diligence.

**Example 1:**

A intending to deceive B, falsely represents that 500 mounds of indigo are made annually at A's factory and thereby induces B to buy the factory. B visited the factory and took a copy of annual accounts of A which show that actual production was only 50 pounds per annum. After seeing the accounts of A, B still purchased the factory. This contract is not voidable at the option of B as he had means to discover truth and despite that he purchased the factory, so there is no fraud in this case.

**Example 2:**

A fraudulently informs that A's estate is free from encumbrance, B visited the nearby bank where A was having his account and notice that A's estate is hypothetic ted to the bank. Despite knowing this fact B purchased the estate of A. The estate is subject to amortize. B cannot avoid the Contract as no fraud has been committed with him. He has means to discover the truth and after discovering the truth he did buy the mortgaged property.

**1.4.4 Misrepresentation**

A statement of fact which one party makes in the course of negotiation with a view to inducing the other party to enter into a contract is known as misrepresentation. It must relate to some fact which is material to the contract. It may be expressed by words spoken or written or implied from the acts and conduct of the parties.

A representation when wrongly made either innocently or intentionally is a misrepresentation. When it is made innocently or unintentionally it is misrepresentation and when made intentionally or willfully it is fraud.

Misrepresentation has been defined in **section 18** of the Act as under:

“Misrepresentation” means and includes—

- (1) The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;
- (2) Any breach of duty which, without an intent to deceive, gains an advantage to the person committing it, or any one claiming under him, by misleading another to his prejudice or to the prejudice of anyone claiming under him ;
- (3) Causing, however innocently, a party to an agreement to make a mistake as to the substance of the thing which is the subject of the agreement.

From the above definition of the term Misrepresentation, the following three types of misrepresentations are noticed:

- (a) **Unwarranted statements:** When a person positively asserts, makes an absolute and explicit statement of facts, that fact is true, though he has no reliable source to form this opinion, but he believe it to be true. This is one type of misrepresentation.

**Example:**

X told Y that Z would be Director of XYZ Ltd. X did not have this information either from Z or XYZ Ltd. but from another source P which was not true. This information was later on found to be false. It was held that X was not warranted to make such positive assertion that Z would be Director of XYZ Ltd., so Y was entitled to avoid the contract to take share of XYZ Ltd. The High Court held that an assertion cannot be said to warranted for his purpose when it is based on hearsay. [(*Mohanlal v Gungagi cotton Mills co.*,(1900) 4 CWN 369]

- (b) **Breach of duty:** Any breach of duty which brings advantages to the person committing it by misleading the other to his prejudice is a misrepresentation.

**Example 1:**

A while negotiating sale of goodwill of his school told B that there are 3000 students. This statement was true when made. But when the bargain struck it fell to 2000 and was in the knowledge of A. However, A did not tell B that the number of students have fallen to 2000. It was held to be a breach of duty on the part of A. B can void the contract (*Inclledon v Watson*(1862)

**Example 2:**

A intending to sell his business told B that the value of business based on latest market price valuation is \$500 MSD, while the negotiation was on due to not getting a prospective order the share price of the company took a sharp dip and the market valuation came to \$410 MSD. A knowing this did not inform B that the market value of the company has fallen. Here there is a breach of duty on the part of A. The contract is avoidable at the option of B.

**Effect of Misrepresentation:**

As per section 19 when consent to an agreement is caused by misrepresentation, the agreement is a contract avoidable at the option of the party whose consent was so caused. A party to a contract, whose consent was caused by misrepresentation, may, if he thinks fit, insist that the contract shall be performed, and that he shall be put in the position in which he would have been, if the representations made had been true.

**Exception:** If such consent was caused by misrepresentation or by silence, fraudulent within the meaning of section 17, the contract, nevertheless, is not voidable, if the party whose consent was so caused had the means of discovering the truth with ordinary diligence.

**Example:**

A intending to induce B to purchase his factory represent that 500 mounds of indigo are made annually at A's factory( A believe it to be true) and thereby induces B to buy the factory. B visited the factory and took a copy of annual accounts A which show that actual production was only 50 pounds per annum. After seeing the accounts of A, B still purchased the factory. This contract is not avoidable at the option of B as he had means to discover truth and despite that he purchased the factory .

**1.4.5 Mistake**

Mistake means an erroneous belief about something. It has not been defined in the Indian Contract Act.

Mistake can be -

- (A) Mistake of law, or
- (B) Mistake of fact

**(A) Mistake of law: may be (i) mistake of law of the country(ii) mistake of law of a foreign country**

- (i) **Mistake of law of the country:**When a party enters into a contract, without the knowledge of law in the country, the contract is affected by such mistake but it is not void. A contract is not voidable because it was caused by a mistake as to any law in force in India. The reason here is that ignorance of law is not an excuse at all. However if a party is *induced* to enter into a contract by the mistake of law then such a contract may be avoided.

**Example:**

A and B make a contract grounded on the erroneous belief that a particular debt is barred by the Indian Law of Limitation; the contract is not voidable.

- (ii) **Mistake of law of foreign country:** Such a mistake is treated as mistake of fact and agreement in such case is void.

**(B) Mistake of fact: may be(I)a bilateral mistake, or(II)unilateral mistake****(I) Bilateral mistake**

Where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void.

**Explanation:** An erroneous opinion as to the value of the thing which forms the subject-matter of the agreement is not to be deemed a mistake as to a matter of fact.

- (a) A agrees to sell to B a specific cargo of goods supposed to be on its way from England to Bombay. It turns out that, before the day of the bargain, the ship conveying the cargo had been cast away and the goods lost. Neither party was aware of the facts. The agreement is void.
- (b) A agrees to buy from B a certain horse. It turns out that the horse was dead at the time of the bargain, though neither party was aware of the fact. The agreement is void.
- (c) A, being entitled to an estate for the life of B, agrees to sell it to C. B was dead at the time of the agreement, but both parties were ignorant of the fact. The agreement is void.

In order to render a contract void due to bilateral mistake the following two conditions must be met.

- (a) **Mistake must be mutual:** Both the parties must misunderstand each other and should be at cross purpose.

**Example:**

A agreed to purchase B's motor car which was lying in B's garage. Unknown to both the parties the car as well car garage was blown in a massive fire that gulfed his flat. The contract is void due to bilateral mistake of fact.

- (b) Mistake must relate to a matter of fact essential to the agreement:** What is essential fact of an agreement depends upon the nature of promise in each case.

**Example:**

A man and a women entered into a separation agreement whereby man was to pay monthly maintenance allowance to the women. Both of them mistakenly taken to be legally married. However, their marriage was not legally tenable. Held the agreement was void due to mutual mistake on the point of fact which was material to the existence of the agreement. *[(Galloway v Galloway(1914)30 TLR 531)].*

**The various types of mistakes falling under bilateral mistakes are as under:**

- (i) Mistake as to subject matter covers following cases:**

- (a)** Mistake as to **existence** of subject matter: If both the parties are at mutual mistake as to existence of the subject matter the agreement is void.

**Example 1:**

A agree to buy B's dog for ₹ 5000. Unknown to both the parties it was found that the dog had already died at the time of bargain. The agreement is void due to non existence of subject matter.

**Example 2:**

A agrees to sell a cargo of cherry to B for ₹ 5 lakh which was on way to China. The cherry started deteriorating in quality. Accordingly the cargo captain had already sold the same before the aforesaid agreement between A and B. The contract is void due to non existence of subject matter.

- (b)** Mistake as to **identity** of subject matter: It usually happens when both the parties have different subject matter of contract in their mind. The contract is void due to mistake of identify of subject matter.

**Example 1:**

X has two horses Shergil and Chetak, he intended to sell Chetak to Y. Y intending to buy Shergil though the offer is for Chetak send his acceptance. Since there is bilateral mistake as to identify of subject matter there is no contract. The contract is void.

**Example 2:**

In an auction the auctioneer was selling tow. A bid for lot, thinking it was hemp. The bid was extravagant for tow, but reasonable for hemp. Held there was no contract. *[(Scriven Bros & co V Hidley & Co (1913)3 KB 564.)]*

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

**Example:**

Table napkins were sold at an auction by a description “ with the crest of Charles I and the authentic property of that monarch”, in fact the napkins were Geogrian. Held the agreement was void as there was a mistake as to the quality of the subject matter *[(Nicholson & Venn v Smith Marriott(1947)177 LT 180)]*



- (d) Mistake as to **quantity** of subject matter: Bilateral mistake as to quantity of subject matter would render the contract void.

**Example:**

A silver bar was sold under a mistake as to its weight. There was difference in value between the weights of the bar as it was and as it was supposed to be. Held the agreement was void. [(Cox v prentice (1815)3 MS 344]

- e) Mistake as to **title** of subject matter: The agreement is void due to bilateral mistake as to title of the subject matter.

**Example:**

A person took a lease of a fishery which, unknown to both the parties belongs to A itself. Held, the lease was void [(Cooper v Phibbs (1867)LR2 HL 149]

- (f) Mistake as to **price** of the subject matter: Mutual mistake as to price of the subject matter would render the agreement void.

**ii) Mistake as to possibility of performance of Contract. Impossibility may be:**

- (a) Physical impossibility: A contract is void if it is identified to be non-feasible due to physical factors, like time, distance, height, etc.
- (b) Legal impossibility: A contract is void if it provides that something shall be done which as a matter of law cannot be done.

**(II) Unilateral Mistake as to fact:**

As per section 22 a contract is not voidable merely because it was caused by one of the parties to it being under a mistake as to a matter of fact. A unilateral mistake is not allowed as a defense in avoiding a contract unless the mistakes brought about by another party's fraud or misrepresentation.

**Example 1:**

A intended to sell his flat for ₹ 55 lakh. By mistake he made an offer of ₹ 50 lakh in writing. A cannot avoid the contract on the plea of mistake of fact.

**Example 2:**

A bought rice from B, a sample of which was shown to him. He thought it to be old rice, but it turned out to be from fresh crop of rice. Held A cannot avoid the contract due to his mistake

**Example 3:**

A bought a painting from B thinking it to be made by MF Hussain, it turned out to be the work of a local artist of Mumbai. A cannot avoid the contract.

**Voidability of Agreements Without Free Consent (Section 19)**

When consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so caused.

A party to a contract, whose consent was caused by fraud or misrepresentation, may, if he thinks fit, insist that the contract shall be performed, and that he shall be put in the position in which he would have been, if the representations made had been true.

**Exception:** If such consent was caused by misrepresentation or by silence, fraudulent within the meaning of section 17, the contract, nevertheless, is not voidable, if the party whose consent was so caused had the means of discovering the truth with ordinary diligence.

**Explanation:**

A fraud or misrepresentation which did not cause the consent to a contract of the party on whom such fraud was practiced, or to whom such misrepresentation was made, does not render a contract voidable.

### Illustrations

- (a) A, intending to deceive B, falsely represents that five hundred mounds of indigo are made annually at A's factory, and thereby induces B to buy the factory. The contract is voidable at the option of B.
- (b) A, by a misrepresentation, leads B erroneously to believe that five hundred mounds of indigo are made annually at A's factory. B examines the accounts of the factory, which show that only four hundred mounds of indigo have been made. After this B buys the factory. The contract is not voidable on account of A's misrepresentation.
- (c) A fraudulently informs B that A's estate is free from encumbrance. B thereupon buys the estate. The estate is subject to a mortgage. B may either avoid the contract, or may insist on its being carried out and the mortgage debt redeemed.
- (d) B, having discovered a vein of ore on the estate of A, adopts means to conceal, and does conceal, the existence of the ore from A. Through A's ignorance B is enabled to buy the estate at an undervalue. The contract is voidable at the option of A.
- (e) A is entitled to succeed to an estate at the death of B; B dies; C, having received intelligence of B's death, prevents the intelligence reaching A, and thus induces A to sell him his interest in the estate. The sale is voidable at the option of A.

### Power to Set Aside Contract Induced by Undue Influence (Section 19A)

When consent to an agreement is caused by undue influence, the agreement is a contract voidable at the option of the party whose consent was so caused.

Any such contract may be set aside either absolutely, or, if the party who was entitled to avoid it has received any benefit thereunder, upon such terms and conditions as to the Court may seem just.

- (a) A's son has forged B's name to a promissory note. B, under threat of prosecuting A's son, obtains a bond from A for the amount of the forged note. If B sues on this bond, the Court may set the bond aside.
- (b) A, a moneylender, advances ₹ 100 to B, an agriculturist, and, by undue influence, induces B to execute a bond for ₹ 200 with interest at 6 per cent per month. The Court may set the bond aside; ordering B to repay ₹ 100 with such interest as may seem just.

## 1.5 CONSIDERATION

### Introduction

One of the essential elements of a contract is consideration. Consideration means something in return. When someone promises to do or not to do something for somebody else he also in turn needs some reciprocal gesture from other party in return which in common parlance we mean consideration. It may be either some benefit conferred on one party or some detriment suffered by other. It may be an act or abstinence or promise. For Example, if A agrees to sell goods to B for a price of ₹ 20,000/-, the amount is the consideration for A for parting with the goods similarly the consideration for B to pay ₹ 20,000 is goods sold by A.

Section 25 of the Indian Contract Act provides that " An agreement made without consideration is void" thus consideration is life blood of a valid contract. According to Salmond and Winfield "A promise without consideration is a gift, one made for consideration is a bargain."

Sec.2(d) defines consideration as, '*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 agreement without consideration is not enforceable and therefore is void. The reason why law



enforces only those promises which are made for consideration is that *gratuitous* or voluntary promises are often made rashly and without due deliberation. To prevent the parties seeking legal recourse for dispute arising due to non fulfillment of such rash contractual obligations which lack consideration, it is essential to put consideration as once of the essential element in order to be construed as a binding contract.

### 1.5.1 Legal Rules Regarding Consideration:

- I. **It must move at the desire of the promisor.** Any act or abstinence at the desire of third party is not consideration. If the act is not at the desire of the promisor it will not be a good consideration.

#### Example:

A built at his own expense certain shops at a place on the order of Collector. Y (Shopkeeper) made a promise to A to pay him a commission on the articles sold. A's action to recover commission was rejected because A's act was not the result of Y's promise but of the Collectors' order (*Durgaprasad v Baldev 1880 # All 221*).

- II. It may move from the promisee or any other person. Even a stranger under the Indian Law may furnish consideration. In English law as held in *Tweddle v Atkinson (1861) 123 ER762 (QB)* it is necessary that the consideration move from the promisee. But in India consideration may move from any party. So the English law that stranger to consideration cannot sue is not applicable in India.
- III. Consideration must be something of value. Consideration must be something of some value in the eyes of law. In *Chidambara v PS Ranga, AIR 1965 SC 193 SubbaRao K.* laid down that consideration shall be something which not only the parties regard but the law also regard as having some value. It must be real and not illusory. If the consideration of some value in the eyes of law the court will not enquire whether it was equivalent to the promise which the party gave in return.
- IV. It may be an act, abstinence or forbearance or a return promise.

An act i.e. doing of something is an affirmation of doing something is a positive consideration and is good enough to support any promise.

#### Example:

A promises B to guarantee payment of price of the goods which B sells on credit to C. Here selling of goods by B to C is a good consideration for A's promise.

The act must not be one which one is under a legal duty to perform.

#### Example:

A, a constable promises to trace the stolen goods of B. If B promise to give him ₹ 500. This is not a consideration as A is duty bound to trace his stolen property

Abstaining or refraining from doing something is a negative consideration but good enough to support a promise.

#### Example 1:

A promise not to file suit against B if he (B) pays him ₹ 5000. This abstinence of A is consideration for B' payment of ₹ 5000 to him and is a good consideration.

#### Example 2:

A promises not to refer the dispute to arbitration if B settles the due amicably. A's promise not to refer to the dispute to arbitration is a good consideration for B's settlement of his outstanding dues.

A return promise can be a good consideration.

**Example:**

A agree to sell his horse to B for ₹ 5000. Here A's promise of selling horse is a consideration for B's paying him ₹ 5000 and B's promise of paying him ₹ 5000 is a good consideration for A's promise of selling him his horse.

- V. It may be past, present or future which the promisor is already not bound to do.

**Past consideration:** When consideration for the present promise was given in the past, it is said to be a past consideration.

In *Sindha Shri Ganpat V Abraham 1896 30 ILR Bom 755*, the plaintiff rendered some services to the defendant at the desire of the defendant during defendant's minority and continued those services after the majority. The defendant after attaining majority promised to pay an annuity to the plaintiff for the services. The agreement was held to be enforceable. This is case of past consideration.

**Example:**

A rendered some service in past to B at his desire. B now promises to pay him for the services rendered by him. The services rendered by A are a past consideration and promise of B to pay him is a present consideration.

**Present consideration:** When consideration is given simultaneously with promise, at the time of promise, it is said to be a present consideration.

**Example:**

X sells his car to Y for ₹ 50,000. Y pays the amount and X deliver the car to Y. This is a case of present consideration.

**Future or executor consideration:** When consideration from one party to another is to pass sometime in future it is said to be future consideration.

In an executor consideration, the liability is outstanding on both the side. It is in fact a promise for a promise. One promise is brought by the other. The contract is concluded as soon as the promise are exchanged. The contract becomes a binding on the exchange of a valid promise, one being the consideration for the other. If A agree to sell his car to B and both delivery and price to be tendered after one month from now, this becomes an executory or future consideration. In the case of *Ramachandra v Kala Raju 1877 2vBomb 362 A*, vakil accepted a va kalatnama from the defendant to act for him in a certain suit. After some time the defendant executed an agreement in favor of the vakil giving him some reward if the suit is decided in favor of the defendant. It was held that there was no fresh consideration from the plaintiff when he obtained the fresh agreement. It was held that the plaintiff was not entitled to any reward as he was duty bound to defend the case in favor of the defendant.

**Example:**

A promises to deliver his car to Y after one week and Y promise to pay the price after ten days. Here the consideration is future consideration.

- VI. It must not be unlawful.

The consideration or object of an agreement is lawful, unless—

It is forbidden by law; or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another; or the Court regards it as immoral, or opposed to public policy. This is discussed in detail under 'Legality of Object and Consideration'.

**Example:**

A agrees to sell his house to B for ₹ 10,000. Here B's promise to pay the sum of ₹ 10,000 is the consideration for A's promise to sell the house, and A's promise to sell the house is the consideration for B's promise to pay the ₹ 10,000. These are lawful considerations.

- VII. Consideration need not be adequate: As we have already discussed above that consideration is something in return. That something in return being offered need not be adequate only condition to be satisfied is that it must be something having some real value. So long as consideration exists, the courts are not bound to go into its adequacy or otherwise. The issue of adequacy or otherwise arises when it is alleged that the consent of one of the party to the contract was not free, only in such cases the courts may look into the adequacy or inadequacy of consideration.

**Example 1:**

X purchased old used car from Y for ₹ 10,000. It would be difficult for the courts to decide whether the amount paid for the old car was sufficient or not. At the same it would be difficult for the court to decide whether the car was worth the amount paid for it.

**Example 2:**

A promised to pay certain bills if B would hand over a guarantee to him. B handed over the guarantee but it turned out to be unenforceable. Held as A received what he had asked for there was consideration for his promise, although the guarantee was smaller value than he had supposed. (*Haigh V Brooks(1839)A&E 209*)

- VIII. It must not be illusory: As already discussed above, consideration need not be adequate but it must be real and of some value in the eyes of law. A few cases where the consideration is not real are as under:

**Example 1:**

A promise to put back life in C through magic if his wife pays him ₹ 500. Here the consideration from A is not real. So the agreement is void.

**Example 2:**

A owes ₹ 1000 to B. He promises to pay ₹ 100 to C, the servant of B who in turn promises to discharge A from the debt. This is legally impossible because C cannot give valid discharge of the debt due to B, his master. [*Harvey v Gibbons (1675)2 Lev 161*]

- IX. It must not be opposed to public policy: The consideration should not only be real but also not be opposed to public policy. Where the consideration flowing from one of the party to the agreement is unlawful the court will not allow any action on such agreements. Agreements which are opposed to public policy will be discussed subsequently
- X. Pre-existing obligations: Consideration must be something more than what the promisee is already bound to do by contract or by law. But doing or agreeing to do more than one's legal or official duty will serve as a consideration. However, it may be noted that pre-existing contract with a promisor can be no consideration for promise.

**1.5.2 Types of Consideration**

Consideration may be present, past or future.

- (i) Past consideration is something wholly done or suffered before making the agreement.
- (ii) Present consideration is basically an act, which has been done in response to a positive promise. It is also called executed consideration.
- (iii) Executory or future consideration is when consideration is to move at a future date.

These we have already discussed.

### Unlawful Consideration

The Agreements are void, if Considerations and objects are unlawful in part.

If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object, is unlawful, the agreement is void.

#### Example

A promises to superintend, on behalf of B, a legal manufacture of indigo, and an illegal traffic in other articles. B promises to pay o A salary of ₹ 10,000 a year. The agreement is void, the object of A's promise and the consideration for B's promise, being in part unlawful.

### 1.5.3 No Consideration (Section 25)

The general rule is *ex-nudopacto non oritur action* i.e. an agreement made without consideration is void. For example if A promises to pay B ₹ 1000 without any obligation from B. This is a void agreement for want of consideration. However, the Act itself provides exceptions to this rule in section 25 itself. As per section 25, an agreement made without consideration is not void in the following circumstances:

- i. **Agreement without consideration void, unless it is in writing and registered:** If an agreement is expressed in writing and registered under the law for the time being in force for the registration of documents, and is made on account of natural love and affection between parties standing in a near relation to each other, it is valid despite being void of consideration. The expression the parties standing in near relation to each other means the parties are related to each other by blood relations. Nearness of relations does not always mean natural love and affection.

In the case of *Bhiwa V Shivaram 1899 1 Bom LR 495* A sued B his brother for a share of certain lands. The case was initially dismissed on the ground that the property was not ancestral. B later on by registered agreement agreed to give 1/2 of the property to A. The court held that the defendant B had such a natural love and affection for his brother and in order to reconcile was willing to give him half of the property. Hence the agreement was held to be enforceable.

#### Example:

In *Rajlukhy Dabee V Bhootnath Mookerjee (1900)4 Cal WN 488* the defendant promised to pay his wife a fixed sum of money every month for her separate residence and maintenance. The agreement was duly registered and made mention of some domestic quarrels between the parties. The court held that the case is not covered under exception rules as there was no natural love and affection between the parties.

- ii. **Or is a promise to compensate for something done:** If it is a promise to compensate, wholly or in part, a person who has already voluntarily done something for the promisor, or something which the promisor was legally compellable to do, it is a good agreement despite no consideration from other party.

#### Example 1:

A found B's purse and returned the same to B. B promised to pay him ₹ 500. The act of A is voluntary act. This is covered under exception rule and B's promise to pay ₹ 500 is enforceable.

#### Example 2:

A supported B's minor son for years. B in turn promised to compensate A's expenses in doing so. This is a valid contract.

**In order to claim exemption under section 25 on this account the following conditions must be satisfied:**

- (a) The act must have been done voluntarily and not at the request of any party.



- (b) Act must have been done for the promisor who must be in existence at the time when the act was done.
- (c) The act must have been done for the promissory who must be competent to contract at the time when the act was done.
- (d) The intention of the promisor should be to compensate the promisee: In *Abdulla Khan V Purhottam 1948 AIR Bom 265* a person who was highly indebted transferred some immovable property to his son in consideration of the son having sent him money from time to time, not intending to take a loan. The transaction was not held to be covered under this exception as the real intention was not to compensate the son but to defraud the creditors.
- (e) The services rendered must be legal. In *Alice V William 1905 27 ALL 266* it was held that the promise to pay the past cohabitation with a woman whose husband is alive is adulterous.

iii. **Or is a promise to pay a debt barred by limitation law:** If it is a promise, made in writing and signed by the person to be charged therewith, or by his agent generally or specially authorized in that behalf, to pay wholly or in part a debt of which the creditor might have enforced payment but for the law for the limitation of suits.

**Example:**

A owes ₹ 5000 to B. The debt has now become time barred. A now promise to pay him ₹ 1000 in discharge of the debt which has become time barred. This agreement is enforceable.

In order to claim exemption under section 25(3) the following conditions should be satisfied:

- (a) The debt of the creditor must be enforceable but for limitation period.
- (b) There must be a promise to pay the debt and not merely an acknowledgement of debt.
- (c) The promise must be in writing and signed by the debtor or his agent.
- (d) The promise must be given by the person to be charged therewith and not by anybody else.

In any of these cases, such an agreement is a contract.

**Explanation 1:** Nothing in this section shall affect the validity, as between the donor and donee, of any gift actually made.

**Explanation 2:** An agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate; but the inadequacy of the consideration may be taken into account by the Court in determining the question whether the consent of the promisor was freely given.

**Example:**

- (a) A promises, for no consideration, to give to B ₹ 1,000. This is a void agreement.
- (b) A, for natural love and affection, promises to give his son, B, ₹ 1,000. A puts his promise to B into writing and registers it. This is a contract.
- (c) A finds B's purse and gives it to him. B promises to give A ₹ 500. This is a contract.
- (d) A supports B's infant son. B promises to pay A's expenses in so doing. This is a contract.
- (e) A owes B ₹ 1,000, but the debt is barred by the Limitation Act. A signs a written promises to pay B ₹ 500 on account of the debt. This is a contract.
- (f) A agrees to sell a horse worth ₹ 1,000 for ₹ 10. A's consent to the agreement was freely given. The agreement is a contract notwithstanding the inadequacy of the consideration.
- (g) A agrees to sell a horse worth ₹ 1,000 for ₹ 10. A denies that his consent to the agreement was freely given. The inadequacy of the consideration is a fact which the court should take into account in considering whether or not A's consent was freely given.

- (iv) **Gift actually made:** Explanation 1 to section 25 provides that absence of consideration does not affect the validity of any gift between donor and donee if actually made.
- (v) **Creation of agency:** Section 185 of the Act provides that no consideration is required to create Agency.
- (vi) **Charitable subscription:** No consideration is required where promise is for some charitable purpose.

#### 1.5.4 Stranger to Contract (Privity of Contract)

The doctrine of privity of contract means that a contract is between the parties only and no third person can sue upon it. It means that a stranger to contract cannot sue upon it. The Supreme Court of India recognized this rule in *MC Chacko v State Bank of Travancore* (1969) 2vSCC 343. It is settled law that a person not a party to a contract cannot subject to certain well recognized exceptions, enforce the terms of the contract. Under the English Common law only a person who is party to a contract can sue upon it. In India the common law doctrine of privity of contract is applicable. In the course of time, the courts have introduced a number of exceptions to rule of privity of contract.

The Indian Contract Act, 1872 is silent about the right of a stranger to contract to sue or not to sue but the Privy Council extended the Principle of English Common law to India in its decision in *Jamna Das V Ram Avtar Pandey* (1911) 30 I A 7 PC which was affirmed by the Honorable Supreme Court of India in the case of *MC Chako v State Bank of Travancore* AIR 1970 SC 504.

**Accordingly in the following circumstances a stranger to contract can sue .**

- (A) **Beneficiaries under trust or charge:** Where a charge is created by a contract, a beneficiary can enforce the rights which the trust has created even though he is not a party to the contract.

In the case of *Khawaja Mohammad Khan v Hussain Begum* an agreement was entered into between boy's father and girl's father that the former would pay to the girl a certain sum of money in perpetuity in consideration of the girl's marriage with the boy. At the time of marriage both were minor and some property was also charged for the purpose of raising the money. After 19 years some difference emerged between the boy and girl, the girl left her husband and filed sue against her father in law for payment of arrears of annuity. It was held that the lady has every right to proceed against her father in law in the instant case even though she is stranger to the contract.

- (B) **Marriage settlement, partition or other family arrangements:** In case of family arrangement if some provision is made for the benefit of some member of the family he or she may enforce implementation of such provisions even though he or she is not party to such contract or arrangements so made. Section 15 of the Specific Relief Act, 1963 provides where the contract is a settlement on marriage or a compensation of doubtful rights between the members of the same family, any person beneficially entitled hereunder may obtain specific relief. The rights of such person are adversely affected even though he or she is not party to such contract and he can enforce the rights so created.

In the case of *Rose Fernandez v Joseph Gonsalve* AIR 1925 Bomb 97 a girl's father agreed to marry her with the defendant It was held that the girl after attaining the age of majority was entitled to sue the defendant for damages for the breach of promise of marriage. Similarly in another case of *Shupu Ammal V Subhramanyam IRL, 1910 33 Mad 238* on partition of a HUF two brothers agreed to invest ₹ 300 each for the maintenance of their mother. The mother was held entitled to sue to enforce the agreement though she was not a party to the contract.

#### **Example:**

M, a mother of S, a son agreed to pay a sum to S in the event B the eldest son of M did not pay the due share of the property left by her husband H.

This arrangement was done to buy peace in the family consequent upon property dispute after death of husband. This agreement is perfectly valid arrangement. *[(Commissioner of Wealth Tax v Vijayawada AIR 1979 SC 982]*



- (C) Acknowledgement or estoppel.** If a person is required under the terms of contract to pay a certain sum of money to third party and he acknowledges the same to that person, he becomes bound to pay money to that third party even though he is not party to the main contract.

In *Devraj Urs V Rama Krishnaiah AIR 1952 Mysr 109* a person sold a house and left the sale proceeds in the hands of the buyer for payment to the creditor. The buyer made only part payment to the creditor by promising to pay the balance soon. It was held that the creditor was entitled to sue the buyer for recovery of the balance even though there is no privity of contract between them.

**Example:**

A received some money from B to be paid to C. A admit this receipt to C. C can recover this amount from A who shall be regarded as an agent of A.

- (D) Agency:** An agent or undisclosed principal has right to sue a third party even though he is not a party to the contract.

**Example:**

If A had made a contract with B, C may intervene and take A's place if he can show that A was acting throughout as his agent even though B has entered into contract in ignorance of this fact. This is on the premises that an undisclosed agent has the right to sue a third party. But this right as provided in section 232 is subject to the rights and obligations subsisting between the agent and the third party.

- (E) Assignee in case of insurance policy:** The assignee of an insurance policy is entitled to sue on the contract made between the insured and insurer.

**Rights and liabilities of a Stranger;**

With the exception of above cases, a contract cannot confer rights upon a person who is not a party to it. Also a contract can not impose a liability upon a person who is not a party to it.

**Example 1:**

A and B enter into an agreement to pay a certain sum of money to their children C and D upon their marriage. The marriage took place. A dies. C sued to recover the money from the executor's of A. Held he can not sue. [*Tweddle v Atkinson. 1861 1 B & S 393*]

**Example 2:**

A sold some goods to B with a condition that the goods will not be sold at a price below a certain price. B sold the goods to C who was aware of the condition. C in turn resold the goods to below the price stipulated by A as the minimum price. It has held A can not enforce the condition against C on the ground of lack of privity of contract between A and C. [*Mc Gruther V Pitcher 1904 2 Ch 306*]

**Example 3:**

The Managing Director of a theater gave instructions that no tickets were to be sold to S. Knowing this S asked a friend to buy a ticket for him. With this ticket S went to the theater but was refused admission. He filed a suit for damages for breach of contract. Held no cause of action because there was no privity of contract between the plaintiff and the defendant [*S Said v Butt 1920 KB 497*]

### 1.5.5 Legality of Object and Consideration

In order to make a valid contract in addition to various other conditions like free consent, competency of parties and existence of consideration other important requirement is legality of objects and considerations. For the validity of a contract the object as well consideration must be lawful.

Section 23 declares that the object and consideration of an agreement is not lawful in certain cases. What considerations and objects are lawful and what are not lawful are provided in section 23 of the Act.

As per **section 23** the consideration or object of an agreement is lawful, unless: it is forbidden by law; or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another or; the Court regards it as immoral, or opposed to public policy. In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

### Illustrations

- (a) A agrees to sell his house to B for ₹ 10,000. Here B' s promise to pay the sum of ₹ 10,000 is the consideration for A' s promise to sell the house, and A' s promise to sell the house is the consideration for B' s promise to pay the ₹ 10,000. These are lawful considerations.
- (b) A promises to pay B ₹ 1,000 at the end of six months, if C, who owes that sum to B, fails to pay it. B promises to grant time to C accordingly. Here the promise of each party is the consideration for the promise of the other party and they are lawful considerations.
- (c) A promises, for a certain sum paid to him by B, to make good to B the value of his ship if it is wrecked on a certain voyage. Here A' s promise is the consideration for B' s payment and B' s payment is the consideration for A' s promise and these are lawful considerations.
- (d) A promises to maintain B' s child and B promises to pay A ₹ 1,000 monthly for the purpose. Here the promise of each party is the consideration for the promise of the' other party. They are lawful considerations.
- (e) A, B and C enter into an agreement for the division among them of gains acquired, or to be acquired, by them by fraud. The agreement is void, as its object is unlawful.
- (f) A promises to obtain for B an employment in the public service, and B promises to pay ₹ 1,000 to A. The agreement is void, as the consideration for it is unlawful.
- (g) A, being agent for a landed proprietor, agrees for money, without the knowledge of his principal, to obtain for B a lease of land belonging to his principal. The agreement between A and B is void, as it implies a fraud by concealment, by A, on his principal.
- (h) A promises B to drop a prosecution which he has instituted against B for robbery, and B promises to restore the value of the things taken. The agreement is void, as its object is unlawful.
- (i) A' s estate is sold for arrears of revenue under the provisions of an Act of the Legislature, by which the defaulter is prohibited from purchasing, the estate. B, upon an understanding with A, becomes the purchaser, and agrees to convey the estate to A upon receiving from him the price which B has paid. The agreement is void, as it renders the transaction, in effect a purchase by the defaulter, and would so defeat the object of the law.
- (j) A, who is B' s mukhtar, promises to exercise his influence, as such, with B in favour of C, and C promises to pay ₹ 1,000 to A. The agreement is void, because it is immoral.
- (k) A agrees to let her daughter to hire to B for concubinage. The agreement is void, because it is immoral, though the letting may not be punishable under the Indian Penal Code. (45 of 1860.)

From **section 23** it is evident that the consideration or object of an agreement is unlawful:

- (a) If it is forbidden by law: An act is forbidden by law when it is punishable by the criminal law of the country or when it is prohibited by special legislation or regulations made by a competent authority;

### Example 1:

A promise to secure employment in the public service to B and B promise to pay him ₹ 5000. This agreement is void as the consideration is unlawful



- (b) If it is of such a nature that, if permitted would defeat the provision of any law.

**Example:**

S join a company with a monthly salary of ₹ 5000 plus monthly expenses allowance of ₹ 4000. Both employer and S knew that payment of monthly allowance was a way to avoid tax liability. The agreement is unlawful [*Nandlal V Thomas 171 1C 948*].

- (c) If it is fraudulent: An agreement made for fraudulent purpose is void.

**Example:**

A,B,C enter into an agreement to share the amount of bank robbery done or to be done by them in future. This agreement is void as the object is unlawful and fraudulent purpose.

- (d) If it involves or implies injury to the person or property of another person.

- (e) If the court regards it as immoral: An agreement between husband and wife for future separation is immoral hence void.

**Example:**

A married women was given money to divorce her husband and then marry the lender of money is void. [*Baivyajo v Nansa Nagar (1885) Bom 152*]

- (f) Where the court regards it opposed to public policy

**An agreement is unlawful for immorality in the following cases:**

- (a) Where the consideration is an act of sexual immorality.  
(b) Where the object of the agreement is the furtherance of sexual immorality lending money to a prostitute to help her in her trade.

**What types of agreements are opposed to public policy?**

The following types of agreements are opposed to public policy:

- (a) Trading with enemy.  
(b) Agreement to commit crime.  
(c) Agreements which interfere with the administration of justice.  
(d) Agreements in restraint of legal proceedings.  
(e) Trafficking in public offices and titles.  
(f) Agreements tending to create interest opposed to duty.  
(g) Agreements in restraint of parental rights.  
(h) Agreement restricting personal liberty.  
(i) Agreements in restraint of marriage.  
(j) Marriage brokerage agreements.  
(k) Agreements interfering with martial duties.  
(l) Agreements to defraud creditors or revenue authorities.  
(m) Agreements in restraint of trade.

### Effects of Illegal or Unlawful Agreements:

The general rule is that no action is allowed on an illegal agreement. This is based on following two maxims:

- i) ***Ex turpi causa non oritur actio. No action arises from a base cause. The law discourages people from entering into illegal agreements which arise from base causes.***
- ii) ***In pari delicto, potior est condition defendantis.*** In cases of equal guilt, the defendant is in a better position.

#### Example:

X promises to pay Y ₹ 1,000 if Y causes some injury to Z. Y accordingly beats Z. Held, he cannot recover the money from X even if X promised to pay so as the object of the agreement is unlawful.

If an agreement is illegal the law will help neither party to the agreement. The Court is in fact neutral in such cases and as a result of that neutrality, the defendant stands to gain.

The effects of illegality may thus be summed up as follows:

- i) The collateral transactions to an illegal agreement become tainted with illegality and are treated as illegal even though they may be legal by themselves.
- ii) No action is allowed on illegal agreement.
- iii) In cases of equal guilt, the position of defendant is better. The plaintiff (i.e. innocent party) may however sue for money paid or property transferred:
  - a) Where he is not ***in part delicto*** (equally guilty) with defendant.
  - b) Where he does not rely on the illegal transaction [Sajan Singh v Sardara Ali, (1960) A.C 167]
  - c) Where substantial portion of illegal transaction has not been carried out, and he is genuinely repentant. [Bigis v Boustead, (1951) All E.R. 92]

## 1.6 .VOID AGREEMENTS

### Introduction

One of the essential elements of an enforceable agreement i.e. a contract is the lawfulness of the object. Behind any enforceable agreement there is an intention to create legal relationship which implies that there is some transaction. The object of such transaction should be lawful; else agreements shall not be enforceable by law. There are some agreements, which have specifically declared as void in the Act itself. Such agreements are specified in section 23, 24, 25 to 30 and 56 of the Act. These agreements are void even if they satisfy the conditions of a valid contract, as they are not enforceable. According to section 2(g) of the Act, "An agreement not enforceable by law is said to be void".

#### 1.6.1 Agreement in Restraint of Marriage is Void (Section 26)

Section 26 of the Contract Act declares "every agreement in restraint of the marriage of any person, other than a minor, is void".

The agreement is void whether the restraint is general or partial. Therefore an agreement not to marry at all or a certain person, or for a fixed period say next 10 years etc, is void. But there is an exception to this. An agreement restraining marriage of a minor person is perfectly valid.

#### Example 1:

X agrees to transfer his flat in the name of Y if Y promises not to marry at all during his life time. This agreement is void.



### Example 2:

X agree to transfer his flat in the name of Y provided Y promise to give up his idea of marrying X's daughter. This agreement is void.

### Example 3:

X agrees to transfer his flat in the name of Y if Y promises not to marry at all during his life time. This agreement is void.

### Example 4:

X agree to give ₹ 50,000 to Y provided Y promise to not to marry till the life time of X. This agreement is void

## 1.6.2 Agreement in Restraint of Trade Void (Section 27)

As per section 27 "Every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.

An agreement which interferes with the liberty of a person to engage himself in any lawful trade, profession or vocation is called an agreement in restraint of trade.

**Provided** that such limits appear to the Court reasonable, regard being had to the nature of the business.

Such types of agreement are opposed to public policy.

Where an agreement is challenged on the ground of in restraint of trade, the onus is upon the person supporting the contract that the restriction was reasonable and necessary to protect his interest.

**Example:** Out of 40 suppliers of raw cotton bails 35 agreed with Y to supply him and only him all their output. R was free to reject the goods if he found no market for them. This agreement is void being in restraint of trade. [*Shaikh Kalu v Ram Saran Bhagat (1209)8 CWN 388*]

### Exceptions

- I. One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business, therein:

Limits means local limits and the duration of restriction is not too long i.e. duration of the restraint is so long as the buyer or any person deriving title to the goodwill from him carries on the like business and not for life long.

- II. Partners agreement:

- (a) A partner not to carry on any business other than that of the firm while he is a partner of the firm.
- (b) Retiring partner agreeing with his other partners not carry on a business similar to that of the firm within a reasonable period or within a specified local limits.
- (c) Partners on dissolution agreeing not to carry on a business similar to that of the firm within a specified period or within a specified local limit.
- (d) Any partner upon sale of goodwill of a firm, make an agreement with the buyer that such partner shall not carry on similar business within a specified period or within a specified local limits.
- (e) When goodwill of a firm is sold upon dissolution a partner agreeing with the buyer of goodwill that he will not use firms name, represent himself as carrying on firms business or solicit customs of person who were dealing with the firm before dissolution.

Thus liberty to trade is not an asset which a person pledges or keep on bet for money except in special circumstances and within well recognized limitations. Any restriction on freedom of trade unless it is reasonable and justified is against public policy and to that such agreements are void.

**Exception to section 27: Under judicial interpretation.**

**Negative covenants in service contracts;** An agreement of service often contains negative covenants preventing the employees from working elsewhere. The courts have drawn a distinction between restraint applicable during the term of employment and those that apply after its cessation.

A negative covenant that employees would not engage himself in trade or business or would not get himself by any other master for whom he would perform similar or substantially similar duties is not therefore in restraint of trade unless the contract is unconscionable or excessively harsh or unreasonably one-sided (*Niranjan Shankar v Century Spinning Co Ltd, AIR 1967 SC 1098*). But where the restriction extends beyond the period of employment the restriction would be invalid and would be in restraint of trade. (*Brahmaputra Tea Co Ltd v Scarth, 1885 11 Cal 545*)

**1.6.3 Agreements in Restraint of Legal Proceedings are Void (Section 28)**

**As per section 28, every agreement—**

- (a) by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals, or which limits the time within which he may thus enforce his rights; or
- (b) which extinguishes the rights of any party thereto, or discharges any party thereto from any liability, under or in respect of any contract on the expiry of a specified period so as to restrict any party from enforcing his rights, is void to that extent.

**Savings of contract to refer to arbitration dispute that may arise**

**Exception 1—** This section shall not render illegal a contract, by which two or more persons agree that any dispute which may arise between them in respect of any subject or class of subjects shall be referred to arbitration, and that only the amount awarded in such arbitration shall be recoverable in respect of the dispute so referred.

**Suits barred by such contracts:** When such a contract has been made, a suit may be brought for its specific performance, and if a suit, other than for such specific performance, or for the recovery of the amount so awarded, is brought by one party to such contract against any other such party, in respect of any subject which they have so agreed to refer, the existence of such contract shall be a bar to the suit.

**Saving of contract to refer questions that have already arisen**

**Exception 2—** Nor shall this section render illegal any contract in writing, by which two or more persons agree to refer to arbitration any question between them which has already arisen, or affect any provision of any law in force for the time being as to references to arbitration.

**1.6.4 Agreements Void for Uncertainty (Section 29)**

According to section 29 "Agreements, the meaning of which is not certain, or capable of being made certain, are void."

**Example:**

- (a) A agrees to sell to B "a hundred tons of oil". There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.
- (b) A agrees to sell to B one hundred tons of oil of a specified description, known as an article of commerce. There is no uncertainty here to make the agreement void. So this is a perfect valid contract provided other ingredients required for a valid contract are fulfilled.
- (c) A, who is a dealer in coconut oil only, agrees to sell to B "one hundred tons of oil". The nature of A's trade affords an indication of the meaning of the words, and A has entered into a contract for the sale of one hundred tons of coconut oil. This is also a perfectly valid contract provided all other essential ingredients are fulfilled.



- (d) A agrees to sell to B “all the grain in my granary at Ramnagar”; There is no uncertainty here to make the agreement void. This is also a perfectly valid contract provided all other essential ingredients are fulfilled
- (e) A agrees to sell to B “one thousand mounds of rice at a price to be fixed by C”. As the price is capable of being made certain, there is no uncertainty here to make the agreement void. This is also a perfectly valid contract provided all other essential ingredients are fulfilled.
- (f) A agrees to sell to B “my white horse for rupees five hundred or rupees one thousand”. There is nothing to show which of the two prices was to be given. The agreement is void.
- (g) A agree to sell his flat to B for whatever price he deems fit and acceptable him. This is not a valid agreement due to vagueness of the consideration.
- (h) A agree to sell his old car to B at a price determined by 'True value car valuation' agency having expertise in this matter. Here the price is capable of being determined. So there is no uncertainty so the agreement is perfectly valid provided all other essential ingredients are also met.

An agreement to agree in future is void, for there is no certainty whether the parties will be able to agree in future. Thus, there cannot be a contract to contract. In *Kovuru Kalappa V Kumara Krishna AIR 1945 Mad 10* an agreement to pay a certain sum with interest after two years after such deductions as would be agreed upon was held to be void due to uncertainty under section 29.

Similarly in *Guthing v Lyna (1833)213 Ad 232* a horse was brought for a certain sum coupled with a promise to give \$5 more if the horse proved lucky. The agreement was found to be void due to uncertainty of terms.

### 1.6.5 Agreements by Way of Wager are Void (Section 30)

Wagering agreements are mere bet where one person agrees to pay another person a certain sum on happening of something and another person pay him on non happening of that event. Say for X agree to pay ₹ 100 to B if it rains today on the other hand B agree to pay A if it does not rain. This is a wager agreement. Contract Act does not define wager. According to Anson wager is a promise to give money or money's worth upon determination or ascertainment of an uncertain event. The essence of wagering is similar to gambling where one person wins and another person loses.

As per section 30 “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 a person to abide by the result of any game or other uncertain event on which any wager is made.”

**Exception in favour of certain prizes for horse-racing:** 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.

**Section 294A of the Indian Penal Code not affected:** Nothing in this section shall be deemed to legalize any transaction connected with horse-racing, to which the provisions of section 294A of the Indian Penal Code, (45 of 1860) apply.

#### Essentials of a wager agreement:

- (a) Promise to pay money or money worth.
- (b) Uncertain event. The promise to pay must be conditioned on happening or non happening of an uncertain event.
- (c) Each party has equal chance to win or lose. The essence of a wagering agreement is that one party wins and another party loses. It cannot be that one party wins and no one loses or one party loses and no one wins.

- (d) No-control over the event. None of the party to a wager agreement has any control over the event. If one of the party can control the event then the agreement lack the ingredient of a wager agreement and will not be a wagering agreement.

**Example:**

A promise to pay B ₹ 1000 if it rains on Sunday, on the other hand B promise to pay A ₹ 1500 if it is a sunny Sunday. Here, whether it rains or it is a sunny Sunday, neither A nor B has any control over the event. So it is a wagering agreement, and hence void.

- (e) No other interest in the event. None of the party has any interest in the happening or non-happening of the event other than winning or losing the sum in the agreement. If any party has any interest in the happening or non-happening of the event it will not be a wagering agreement.

In the examples given above, A and B have no other interest except winning the bet.

**Agreements held to be not a wagering agreement:**

The following agreements have been held to be not a wagering agreement:

- (a) Crossword competition involving application of skill and knowledge is not a wagering agreement. But if the prize of a crossword competition depends upon the correspondence of the competitors' solution with the previous solution kept with the editor of the newspaper, it is lottery and hence a wagering agreement. [*State of Bombay v RMD Chamarbaugwala AIR (1957)SC699*].

According to Prize competition Act, 1955 prize competitions in games of skill are not wagering provided the amount of prize does not exceed ₹ 1000.

- (b) Games of skill like picture puzzles or athletic competition.
- (c) Subscription or contribution or an agreement to subscribe or contribute towards any prize or sum of money of the value of ₹ 500 or above to be awarded to the winner of horse race.
- (d) Delivery based share market transactions.
- (e) Contract of Insurance. In insurance, the assured has an insurable interest in the subject matter; in wagering agreement there is no such interest.
- (f) Speculative Transactions: A speculative contract is not necessarily a wagering contract, and must be distinguished from agreements by way of wager. This distinction comes into prominence in a class of cases where the contracts are entered into through brokers. The modus operandi of a speculative transaction is that when the defendant enters into a contract of sale, he also enters into a contract of purchase of same quantity before transaction day. This mode of dealing, when the sale and purchase are to and from the same person, has the effect, of course, of cancelling the contracts, leaving only differences to be paid. When they are different persons, it puts the defendant in the position vicariously to perform his contracts. This is, no doubt, a highly speculative mode of transacting business; but the contracts are not wagering contracts, unless it be the intention of both contracting parties at the time of entering into the contracts, neither to call for nor give delivery from or to each other.
- (g) A chit-fund does not come within the scope of wager; [*Narayana Ayyangar v. K.V. Ambalam, (1927) ILR 50 Mad 696 (FB)*].

**Effect of wagering agreements:**

Wagering agreements have been expressly declared void in India. In the state of Maharashtra and Gujarat they have been declared to be illegal also. No suit can be brought to recover anything alleged to have been won on any wagering agreement. Even the amount of money entrusted to any person to manage the wagering game cannot be recovered.

Since wagering agreements are void, transactions collateral to them are not affected. In the state of



Gujarat and Maharashtra the wagering agreements have been declared to be illegal. In rest of India the collateral transaction of a wagering agreement are valid.

### **Exception attached to section 30 in favour of certain prizes for horse racing states-**

*"This section shall not be deemed to render unlawful a subscription or any 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."*

*Section 294A of The Indian Penal Code not affected –*

*"Nothing in this section shall be deemed to legalize any transaction connected with horse Racing, to which the provisions of S.294A of The Indian Penal Code (45 of 1860) apply."*

### **1.6.6 Agreements Contingent on Impossible Event are Void (Section 26)**

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 agreement at the time when it is made.

#### **Illustrations**

- (a) A agrees to pay B ₹ 1,000 if two straight lines should enclose a space. The agreement is void.
- (b) A agrees to pay B ₹ 1,000 if B will marry A's daughter C. C was dead at the time of the agreement. The agreement is void.

### **1.6.7 Agreement to do Impossible Act (Section 56)**

According to section 56 an agreement to do an impossible act is void.

#### **Example 1:**

X promise to find treasure for Y through magic if he pays him ₹ 5,000. This agreement is void due to impossibility of act.

#### **Example 2:**

X promise to put life on Y's dead son if he pays him ₹ 5,100. This agreement is void due to impossibility of Act.

### **1.6.8 Reciprocal promise to do things legal, and also other things illegal (section 57)**

Where persons reciprocally promise, firstly to do certain things which are legal, and, secondly under specified circumstances, to do certain other things which are illegal, the first set of promise is a contract, but the second is a void agreement.

#### **Example:**

A and B agree that A shall sell B a house for ₹ 10,000, but that, if B uses it as a gambling house, he shall pay A ₹ 50,000 for it.

The first set of reciprocal promises, namely, to sell the house and to pay ₹ 10,000 for it, is a contract.

The second set is for an unlawful object, namely, that B may use the house as a gambling house, and is a void agreement.

### **1.6.9 Obligation of person who has Received Advantage Under Void Agreement or Contract that Becomes Void (Section 65)**

**Section 65 of the Act cast upon the person the person receiving any benefit under a void contract which are discussed as under:**

When an agreement is discovered to be void, or when a contract becomes void, any person who has received any advantage under such agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it.

**Example:**

- (a) A pays B ₹ 1,000 in consideration of B's promising to marry C, A's daughter. C is dead at the time of the promise. The agreement is void, but B must repay A ₹ 1,000.
- (b) A contracts with B to deliver to him 250 mounds of rice before the 1st of May. A delivers 130 mounds only before that day, and none after. B retains the 130 mounds after the first day of May. He is bound to pay A for them.
- (c) A, a singer, contracts with B, the manager of a theatre, to sing at his theatre for two nights in every week during the next two months, and B engages to pay her a hundred rupees for each night's performance. On the sixth night, A willfully absents herself from the theatre, and B, in consequence, rescinds the contract. B must pay A for the five nights on which she had sung.
- (d) A contracts to sing for B at a concert for ₹ 1,000, which are paid in advance. A is too ill to sing. A is not bound to make compensation to B for the loss of the profits which B would have made if A had been able to sing, but must refund to B ₹ 1,000 paid in advance.

## 1.7. CONTINGENT CONTRACTS

### Introduction

There are some contracts wherein there is no element of uncertainty in their performance. In other words their performance is not dependent upon a particular event. Such contracts are known as 'absolute contracts'. But there are some contracts, the performance of which depends upon the happening or non happening of an uncertain event, collateral to such contracts. Such contracts are called contingent contracts. Contract of Insurance; guarantee and indemnity are examples of contingent contracts.

#### 1.7.1 Definition (Section 31)

A "contingent contract" is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen.

#### Example 1:

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

#### Example 2:

A agrees to sell a certain piece of land to B, if he succeeds in the litigation concerning his land. This is also a contingent contract.

One of the important characteristic of a contingent contract is that performance of the contract depends upon happening or non happening of an event. The event must be uncertain and must be collateral to the contract. According to Pollock and Mulla the words "some event collateral to such contracts" means that "the event is neither a performance directly promised as part of the contract nor, the whole of the consideration for a promise."

As clear from the above explanation we can say that the following contracts are not contingent contracts:

- (a) A promise to pay ₹ 2,100 someone who trace is missing dog.
- (b) Ram promise to pay Shyam ₹ 5,100 if he marries Radha.

In Example (a) there is no contract unless and until somebody trace the missing dog of A.

Similarly in case (b) the offer becomes binding once Shyam marries Radha and Ram is bound to pay him ₹ 5,100 as promised.



But in a contract where X promises to pay Y ₹ 21,000 if Y's house is damaged in a fire, is contingent contract because the liability of X arises only when Y's house is damaged in a fire and not before. This is an event collateral to the main contract because damage to Y's is not a performance depending upon the act of X nor is he paid any consideration for damage to his house. Damage to Y's house in a fire is an independent event.

### 1.7.2 Characteristics of a Contingent Contract

- (a) Performance depends upon happening or non happening of some future event.
- (b) The event must be uncertain: If the event is bound to happen and the contract has to be performed in any case, the contract will not be a contingent contract.
- (c) The event must be collateral, incidental to the contract.

### 1.7.3 Rules Regarding Contingent Contract are Contained in Section 32 to 36 Which are Discussed as Under:

- (i) As per **section 32** contingent contracts to do or not to do anything if an uncertain future event happens cannot be enforced by law unless and until that event has happened. If the event becomes impossible, such contracts become void.

#### Illustrations

- (a) A makes a contract with B to buy B's horse if A survives C. This contract cannot be enforced by law unless and until C dies in A's lifetime.
  - (b) A makes a contract with B to sell a horse to B at a specified price, if C, to whom the horse has been offered, refuses to buy him. The contract cannot be enforced by law unless and until C refuses to buy the horse.
  - (c) A contracts to pay B a sum of money when B marries C. C dies without being married to B. The contract becomes void.
- (ii) As per **section 33** contingent contracts to do or not to do anything if an uncertain future event does not happen can be enforced when the happening of that event becomes impossible, and not before.

#### Example:

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

- (iii) As per **section 34**, if the future event on which a contract is contingent is the way in which a person will act at an unspecified time, the event shall be considered to become impossible when such person does anything which renders it impossible that he should so act within any definite time, or otherwise than under further contingencies.

#### Example:

A agrees to pay B a sum of money if B marries C.

C marries D. The marriage of B to C must now be considered impossible, although it is possible that D may die and that C may afterwards marry B.

- (iv) As per section 35 contingent contracts to do or not to do anything if a specified uncertain event happens within a fixed time become void if, at the expiration of the time fixed, such event has not happened, or if, before the time fixed, such event becomes impossible.

When contracts may be enforced which are contingent on specified event not happening within fixed time:

Contingent contracts to do or not to do anything if a specified uncertain event does not happen

within a fixed time may be enforced by law when the time fixed has expired and such event has not happened, or, before the time fixed has expired, if it becomes certain that such event will not happen.

**Examples:**

- (a) A promises to pay B a sum of money if a certain ship returns within a year. The contract may be enforced if the ship returns within the year, and becomes void if the ship is burnt within the year.
  - (b) A promises to pay B a sum of money if a certain ship does not return within a year. The contract may be enforced if the ship does not return within the year, or is burnt within the year.
- (v) As per **section 36** 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.

**Examples:**

- (a) A agrees to pay B ₹ 1,000 if two-straight lines should enclose a space. The agreement is void.
- (b) A agrees to pay B ₹ 1,000 if B will marry A's daughter C. C was dead at the time of the agreement. The agreement is void.

**1.7.4 Difference Between Contingent Contract and Wagering Agreement:**

- (i) Wagering agreement consists of reciprocal promise whereas contingent contract may or may not contain reciprocal promises.
- (ii) Contingent agreements are perfectly valid whereas wagering agreements are void
- (iii) In the case of a wagering agreement there is no interest of the parties' in the future uncertain event except winning or losing the amount involved in the wagering. This is not so in the case of a contingent contract.
- (iv) Wagering agreement is a contingent contract whereas contingent contract is not a wagering agreement
- (v) In the contingent contract the future event is collateral whereas in a wagering agreement the future event is the sole determining factor.

**1.8 THE PERFORMANCE OF CONTRACTS**

**Introduction**

Every Contract creates certain obligation on each of the parties involved in it. When both the parties to the Contract fulfill their obligations towards each other, the contract is said to be performed. When both the parties to the contract have performed their obligations, the contract is said to be discharged by performance. When one the party to the contract has fulfilled his part of obligation which has been accepted by other party also it is called performance of the contract. On the contrary when the offer of performance or performance of one party is not accepted by the other party it is termed as attempted performance or tender of performance, which has the same effect as that of an actual performance. The promisor is not responsible for non-performance of the contract nor his rights are affected due to non acceptance of the performance by the promisee. This we will be discussing in subsequent sections.

The provisions of the Contract Act regarding performance of a contract are discussed as under:



### 1.8.1 Obligation of Parties to Contracts (Section 37)

As per section 37 of the contract Act, the parties to a contract must either perform, or offer to perform, their respective promises, unless such performance is dispensed with or excused under the provisions of this Act, or of any other law. The Act further provides that the promises bind the representatives of the promisor even in case of the death of such promisor before performance, unless a contrary intention appears from the contract.

#### Illustrations

- (a) A promises to deliver goods to B on a certain day on payment of ₹ 1,000. A dies before that day. A's representatives are bound to deliver the goods to B, and B is bound to pay ₹ 1,000 to A's representatives.
- (b) A promises to paint a picture for B by a certain day, at a certain price. A dies before the day. The contract cannot be enforced either by A's representatives or by B.

### 1.8.2 Effect of Refusal to Accept Offer of Performance (Section 38)

As stated above performance of a contract include performance but also offer to perform, this is to take care of situation when the promisor offer to perform the contract at the appointed time and place in accordance with the terms of the contract but the promisee does not accept the performance. This is known as attempted performance or tender. This is equal to actual performance and the promisor is relieved of further performance and is entitled to sue the promisee for breach of contract. The consequences of such refusal to accept offer of performance are laid down in section 38 of the Act which provides as under”

As per section 38 “Where a promisor has made an offer of performance to the promisee, and the offer has not been accepted, the promisor is not responsible for non-performance, nor does he thereby lose his rights under the contract.”

Every such offer must fulfill the following conditions: —

- (1) It must be unconditional.

#### Example:

A owes B ₹ 2,500. He offered to pay him ₹ 2,000 provided B give a receipt of ₹ 2,500 and discharge of the debt due by A to B. This is not a valid tender of performance.

- (2) It must be made at a proper time and place, and under such circumstances that the person to whom it is made may have a reasonable opportunity of ascertaining that the person by whom it is made is able and willing there and then to do the whole of what he is bound by his promise to do.
- (3) If the offer is an offer to deliver anything to the promisee, the promisee must have a reasonable opportunity of seeing that the thing offered is the thing which the promisor is bound by his promise to deliver.

An offer to one of several joint promisees has the same legal consequences as an offer to all of them.

#### Example:

A contracts to deliver to B at his warehouse, on the 1<sup>st</sup> March, 100 bales of cotton of a particular quality. In order to make an offer of a performance with the effect stated in this section, A must bring the cotton to B's warehouse, on the appointed day, under such circumstances that B may have a reasonable opportunity of satisfying himself that the thing offered is cotton of the quality contracted for, and that there are 100 bales.

### What are essentials of valid tender?

- (a) It must be unconditional: It becomes unconditional when it is in accordance with the terms and conditions of the contract;

#### Example 1:

A, owes B certain sum of money, he promised to discharge the amount due from him to B if B agrees to sell his flat to him at the price offered by him(A). This is a conditional tender of performance, hence not valid and will not discharge the obligation of A.

#### Example 2:

A tender was made on a condition that a receipt for full discharge of the contract be given. Held the tender was invalid. [(Finch v Miller (1848)5 CB 428)]

- (b) Must be of the whole quantity contracted for or the whole obligation.

Part performance or performance in installment is not a valid tender unless so agreed in the contract.

#### Example:

A owes B ₹ 50,000. He offers to pay the same in five installments of ₹ 10,000 each and paid first installment of ₹ 10,000. The tender is not of whole amount, hence not a valid tender of performance.

- (c) It must be made by the person who is in a position and willing to perform the promise.

- (d) It must be at proper time and place.

When we say proper time and place we mean during business hours and on the stipulated due date neither, before nor after. Similarly it must be made at the usual business place or the place mentioned in the contract.

- (f) It must be made to the proper person: must be made to promisee or his agent.

- (g) In case of joint promisees it must be made to one of them.

- (h) Reasonable opportunity of inspection of goods must be given.

### 1.8.3 Effect of Refusal of Party to Perform Promise Wholly (Section 39)

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.

#### Illustrations

- (a) A, a singer, enters into a contract with B, the manager of a theatre, to sing at his theatre two nights in every week during the next two months, and B engages to pay her ₹ 100 for each night's performance. On the sixth night A willfully absents herself from the theatre. B is at liberty to put an end to the contract.

- (b) A, a singer, enters into a contract with B, the manager of a theatre, to sing at his theatre two nights in every week during the next two months, and B engages to pay her at the rate of ₹ 100 for each night. On the sixth night A willfully absents herself. With the assent of B, A sings on the seventh night. B has signified his acquiescence in the continuance of the contract, and cannot now put an end to it but is entitled to compensation for the damage sustained by him through A's failure to sing on the sixth night.

It may be noted that when a promisee put an end to contract due to non performance on the part of promisor, it is presumed that he has rescinded a voidable contract and shall by virtue of sec 64 be bound to restore to the other party all the benefits that he may have received under the contract. [(Murlidhar Chatterge V International Film co, AIR(1943)PC34)]



#### 1.8.4 Person by Whom Promise is to be Performed (Section 40)

A Contract may be performed by the promisor himself, his duly authorized agent, legal representative and in some cases third person in that the promisor cannot again demand performance of contract.

As per this section, if it appears from the nature of the case that it was the intention of the parties to any contract that any promise contained in it should be performed by the promisor himself, such promise must be performed by the promisor. In such cases the promisor can not entrust this to his agent or employees. This especially in the case of contract of rendering personal services where personal skill or expertise is more important, like a doctor agreeing to carry out surgical operation or an artist agreeing to give some performance. In other cases, the promisor or his representatives may employ a competent person to perform it.

##### Illustrations

- (a) A promises to pay B a sum of money. A may perform this promise, either by personally paying the money to B or by causing it to be paid to B by another; and, if A dies before the time appointed for payment, his representatives must perform the promise, or employ some proper person to do so.
- (b) A promises to paint a picture for B. A must perform this promise personally.
- (c) A celebrated signer of "Sare-gama" music agreed to give a performance on "Republic day celebration" organized by a club of national standing. This contract can be performed by A alone he can not send his employees or agent or friend in his place to give the performance.

#### 1.8.5 Effect of Accepting Performance from Third Person (Section 41)

When a promisee accepts performance of the promise from a third person, he cannot afterwards enforce it against the promisor.

##### Example:

X agree to sell 50 kg of sugar to Y @ ₹ 44 per kg. X delivered the goods as per the terms of the contract but Y being out of station the payment to X was made by Y's father on behalf of Y which was accepted by X. X can not ask further payment from Y.

#### 1.8.6 Devolution of Joint Liabilities (Section 42)

In case two or more person are joint promise then, unless a contrary intention appears by the contract, all such persons, during their joint lives, and after the death of any of them, his representative jointly with the survivor, or survivors, and after the death of the last survivor, the representatives of all jointly, must fulfill the promise.

The promisee has right to demand due performance of the contract from all or any one of the several joint promisee, in such a case the promisee who has performed the contract may ask the other joint promise to contribute equally.

##### Example:

X, Y & Z jointly promised to pay B ₹ 51,000 for B delivering goods for the charity show being organized by them. B delivered the goods as per the contract. He can enforce payment of the promised sum either of these three or jointly from all of them.

##### 1.8.6.1 Anyone of Joint Promisors may be Compelled to Perform (Section 43)

As per section 43, when two or more persons make a joint promise, the promisee may, in the absence of express agreement to the contrary, compel any one or more of such joint promisors to perform the whole of the promise.

**Each promisor may compel contribution:—** Each of two or more joint promisors may compel every other joint promisor to contribute equally with himself to the performance of the promise, unless a contrary intention appears from the contract.

X, Y & Z jointly promised to pay B ₹ 51,000 for B delivering goods for the charity show being organized by XYZ. B delivered the goods as per the contract. B instead of asking XYZ to make payment compelled Y to make the payment. Y paid the sum promised to B. He can demand contribution from X and Z also.

**Sharing of loss by default in contribution:—** If any one of two or more joint promisors makes default in such contribution, the remaining joint promisors must bear the loss arising from such default in equal shares.

**As per explanation to section 43,** a surety is not prevented from recovering from his principal, payments made by the surety on behalf of the principal, or entitle the principal to recover anything from the surety on account of payments made by the principal.

#### Illustrations

- (a) A, B and C jointly promise to pay D ₹ 6,000. D may compel either A or B or C to pay him ₹ 6,000.
- (b) A, B and C jointly promise to pay D the sum of ₹ 3,000. C is compelled to pay the whole. A is insolvent, but his assets are sufficient to pay one-half of his debts, C is entitled to receive 500 rupees from A's estate, and 2,250 rupees from B.
- (c) A, B and C are under a joint promise to pay D ₹ 3,000. C is unable to pay anything, and A is compelled to pay the whole. A is entitled to receive 1,500 rupees from B.
- (d) A, B and C are under a joint promise to pay D ₹ 3,000, A and B being only sureties for C. C fails to pay. A and B are compelled to pay the whole sum. They are entitled to recover it from C.

#### 1.8.6.2 Effect of Release of One Joint Promisor (Section 44)

It may further be noted that where two or more persons have made a joint promise, a release of one of such joint promisors by the promisee does not discharge the other joint promisor or joint promisors; neither does it free the joint promisor so released from responsibility to the other joint promisor or joint promisors. Other joint promise must fulfill their obligation jointly if one the joint promise is released by the promisor due to his death or any other reasons.

#### 1.8.7 Devolution of Joint Rights (Section 45)

Further as per section 45 when a person has made a promise to two or more persons jointly, then, unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and, after the death of any of them, with the representative of such deceased person jointly with the survivor or survivors, and, after the death of the last survivor, with the representatives of all jointly.

#### Illustration

A, in consideration of ₹ 5,000, lent to him by B and C, promises B and C jointly to repay them that sum with interest on a day specified. B dies. The right to claim performance rests with B's representative jointly with C during C's life, and after the death of C with the representatives of B and C jointly.

### 1.9 TIME AND PLACE FOR PERFORMANCE

The time and place of performance of a contract are determined by the terms of agreement between the parties to the contract. In the absence of clear cut provisions in the agreement about the time and place of performance of the contract the following rules under different circumstances as contained in sections 46 to 50 of the Contract Act apply which are summarized as under.

#### (A) Where No Application is to be Made and No Time is Specified (Section 46)

Where, by the contract, a promisor is to perform his promise without application by the promisee, and no time for performance is specified, the engagement must be performed within a reasonable time.

The question "What is a reasonable time" is, in each particular case, a question of fact.



**(B) Where Time is Specified and no Application to be Made (Section 47)**

When a promise is to be performed on a certain day, and the promisor has undertaken to perform it without application by the promisee, the promisor may perform it at any time during the usual hours of business on such day and at the place at which the promise ought to be performed.

**Example:**

X promises to deliver goods at Y's warehouse on the 1st July. On that day X brings the goods to Y's warehouse, but after the usual hour for closing it, and they are not received. X has not performed his promise.

**(C) Application for Performance on Certain Day to be at Proper Time and Place (Section 48)**

When a promise is to be performed on a certain day, and the promisor has not undertaken to perform it without application by the promisee, it is the duty of the promisee to apply for performance at a proper place and within the usual hours of business.

**Explanation:**

The question "What is a proper time and place" is, in each particular case, a question of fact.

**(D) Place for Performance of Promise, Where no Application to be Made and no Place Fixed for Performance (Section 49)**

When a promise is to be performed without application by the promisee, and no place is fixed for the performance of it, it is the duty of the promisor to apply to the promisee to appoint a reasonable place for the performance of the promise, and to perform it at such place.

**Example:**

A undertakes to deliver a thousand mounds of jute to B on a fixed day. A must apply to B to appoint a reasonable place for the purpose of receiving it, and must deliver it to him at such place.

**(E) Performance in Manner or at Time Prescribed or Sanctioned by Promisee (Section 50)**

The performance of any promise may be made in any manner, or at any time which the promisee prescribes or sanctions.

**Illustrations**

- (a) B owes A ₹ 2,000. A desires B to pay the amount to A's account with C, a banker. B, who also banks with C, orders the amount to be transferred from his account to A's credit, and this is done by C. Afterwards, and before A knows of the transfer, C fails. There has been a good payment by B.
- (b) A and B are mutually indebted. A and B settle an account by setting off one item against another, and B pays A the balance found to be due from him upon such settlement. This amounts to a payment by A and B respectively of the sums which they owed to each other.
- (c) A owes B ₹ 2,000. B accepts some of A's goods in deduction of the debt. The delivery of the goods operates as a part payment.

**1.10 PERFORMANCE OF RECIPROCAL PROMISES**

**1.10.1 Promisor not Bound to Perform Unless Reciprocal Promisee Ready and Willing to Perform (Section 51)**

When a contract consists of reciprocal promises to be simultaneously performed, no promisor need perform his promise unless the promisee is ready and willing to perform his reciprocal promise.

### **Illustrations**

- (a) A and B contract that A shall deliver goods to B to be paid for by B on delivery.  
A need not deliver the goods, unless B is ready and willing to pay for the goods on delivery.  
A need not pay for the goods, unless A is ready and willing to deliver them on payment.
- (b) A and B contract that A shall deliver goods to B at a price to be paid by installments, the first installment to be paid on delivery.  
A need not deliver, unless B is ready and willing to pay the first installment on delivery.  
B need not pay the first installment, unless A is ready and willing to deliver the goods on payment of the first installment.

### **1.10.2 Order of Performance of Reciprocal Promises (Section 52)**

Where the order in which reciprocal promises are to be performed is expressly fixed by the contract, they shall be performed in that order; and, where the order is not expressly fixed by the contract, they shall be performed in that order which the nature of the transaction requires.

### **Illustrations**

- (a) A and B contract that A shall build a house for B at a fixed price. A's promise to build the house must be performed before B's promise to pay for it.
- (b) A and B contract that A shall make over his stock-in-trade to B at a fixed price, and B promises to give security for the payment of the money. A's promise need not be performed until the security is given, for the nature of the transaction requires that A should have security before he delivers up his stock

### **1.10.3 Liability of Party Preventing Event on which the Contract is to Take Effect (Section 53)**

When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented; and he is entitled to compensation from the other party for any loss which he may sustain in consequence of the non-performance of the contract.

### **Illustration**

A and B contract that B shall execute certain work for A for a thousand rupees. B is ready and willing to execute the work accordingly, but A prevents him from doing so. The contract is voidable at the option of B; and, if he elects to rescind it, he is entitled to recover from A compensation for any loss which he has incurred by its non-performance.

### **1.10.4 Effect of Default as to that Promise which should be first Performed, in Contract Consisting of Reciprocal Promises (Section 54)**

When a contract consists of reciprocal promises, such that one of them cannot be performed, or that its performance cannot be claimed till the other has been performed, and the promisor of the promise last mentioned fails to perform it, such promisor cannot claim the performance of the reciprocal promise, and must make compensation to the other party to the contract for any loss which such other party may sustain by the non-performance of the contract.

### **Illustrations**

- (a) A hires B's ship to take in and convey, from Calcutta to the Mauritius, a cargo to be provided by A, B receiving a certain freight for its conveyance. A does not provide any cargo for the ship. A cannot claim the performance of B's promise, and must make compensation to B for the loss which B sustains by the non-performance of the contract.
- (b) A contracts with B to execute certain builder's work for a fixed price, B supplying the scaffolding



and timber necessary for the work. B refuses to furnish and scaffolding or timber, and the work cannot be executed. A need not execute the work, and B is bound to make compensation to A for any loss caused to him by the non-performance of the contract.

- (c) A contracts with B to deliver to him, at a specified price, certain merchandise on board a ship which cannot arrive for a month, and B engages to pay for the merchandise within a week from the date of the contract. B does not pay within the week. A's promise to deliver need not be performed, and B must make compensation.
- (d) A promises B to sell him one hundred bales of merchandise, to be delivered next day, and B promises A to pay for them within a month. A does not deliver according to his promise. B's promise to pay need not be performed and A must make compensation.

### 1.10.5 Time is Essence of the Contract (Section 55)

When a party to a contract promises to do a certain thing at or before a specified time, or certain things at or before specified times, and fails to do any such thing at or before the specified time, the contract, or so much of it as has not been performed, becomes voidable at the option of the promisee, if the intention of the parties was that time should be of the essence of the contract.

**Effect of such failure when time is not essential—** when it was not the intention of the parties that time should be of the essence of the contract, the contract does not become voidable by the failure to do such thing at or before the specified time; but the promisee is entitled to compensation from the promisor for any loss occasioned to him by such failure.

**Effect of acceptance of performance at time other than that agreed upon—** If, in case of a contract voidable on account of the promisor's failure to perform his promise at the time agreed, the promisee accepts performance of such promise at any time other than that agreed, the promisee cannot claim compensation for any loss occasioned by the non-performance of the promise at the time agreed, unless, at the time of such acceptance, he gives notice to the promisor of his intention to do so.

### 1.10.6 Agreement to do Impossible Act (Section 56)

An agreement to do an act impossible in itself is void.

**Contract to do act afterwards becoming impossible or unlawful:** 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.

#### **Compensation for loss through Non-Performance of Act known to be Impossible or Unlawful**

Where one person has promised to do something which he knew, or, with reasonable diligence, might have known, and which the promisee did not know to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise.

#### **Illustrations**

- (a) A agrees with B to discover treasure by magic. The agreement is void.
- (b) A and B contract to marry each other. Before the time fixed for the marriage, A goes mad. The contract becomes void.
- (c) A contracts to marry B, being already married to C, and being forbidden by the law to which he is subject to practice polygamy. A must make compensation to B for the loss caused to her by the non-performance of his promise.
- (d) A contracts to take in cargo for B at a foreign port. A's Government afterwards declares war against the country in which the port is situated. The contract becomes void when war is declared.

- (e) A contracts to act at a theatre for six months in consideration of a sum paid in advance by B. On several occasions A is too ill to act. The contract to act on those occasions becomes void.

### **1.10.7 Reciprocal Promises to do Things Legal, and also other Things Illegal (Section 57)**

Where persons reciprocally promise, firstly, to do certain things which are legal, and, secondly, under-specified circumstances, to do certain other things which are illegal, the first set of promises is a contract, but the second is a void agreement.

#### **Illustration**

A and B agree that A shall sell B a house for ₹ 10,000, but that, if B uses it as a gambling house, he shall pay A ₹ 50,000 for it.

The first set of reciprocal promises, namely, to sell the house and to pay ₹ 10,000 for it, is a contract.

The second set is for an unlawful object, namely, that B may use the house as a gambling house, and is a void agreement.

### **Alternative Promise, One Branch Being Illegal (Section 58)**

In the case of an alternative promise, one branch of which is legal and the other illegal, the legal branch alone can be enforced.

#### **Illustration**

A and B agree that A shall pay B ₹ 1,000, for which B shall afterwards deliver to A either rice or smuggled opium.

This is a valid contract to deliver rice, and a void agreement as to the opium.

### **1.10.8 Consequences of Rescission of Voidable Contract (Section 64)**

Where a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is promisor. The party rescinding a voidable contract shall, if he has received any benefit thereunder from another party to such contract, restore such benefit, so far as may be, to the person from whom it was received.

#### **Example:**

X coerced Y to sell his flat worth ₹ 51 lakh for ₹ 20 lakh threatening to expose his illicit affairs. Y agree to sell at the price offered by X and also took an advance token payment of ₹ 50,000. Later on Y decided to avoid the contract on the ground of consent being obtained under coercion. X need pay him the balance money and on the other hand Y is to pay back ₹ 50,000 taken as advance token money from X.

At times one party to the contract is not afforded reasonable facility for due performance of the contract by other party.

As per section 67 If any promisee neglects or refuses to afford the promisor reasonable facilities for the performance of his promise, the promisor is excused by such neglect or refusal as to any non-performance caused thereby.

#### **Example 1:**

A contracts with B to repair B's house. B neglects or refuses to point out to A the places in which his house requires repair.

A is excused for the non-performance of the contract if it is caused by such neglect or refusal.

#### **Example 2:**

A promised to carry out necessary modification in B 's MUV as per the design to be supplied by B. B neither supplied the design nor handed over the MUV to A for performing the assigned contract. A is excused for non-performance due to neglect on the part of B.



## 1.11 APPROPRIATION OF PAYMENTS

### Introduction

Appropriation means application of the payment in accordance with the terms of the contract. The manner of appropriation of payment becomes very important when there are several debts and the debtor has made some payment, then a question arises as to against which debt the instant payment is to be adjusted. In England the law on this subject is laid down in Clayton's case. As per this Rule if a man owes another two debts upon distinct causes, and pays him a sum of money, the payer has right to say to which the account the money so paid is to be appropriated. In India also the said rule is followed subject to some modifications. The rules as to appropriation of payment are contained in section 59 to 61 of the Indian Contract Act which are discussed as under;

#### 1.11.1 Application of Payment where Debt to be Discharged is Indicated (Section 59)

Where a debtor, owing several distinct debts to one person, makes a payment to him, either with express intimation, or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly.

#### Illustrations

- (a) A owes B, among other debts, ₹ 1,000 upon a promissory note which falls due on the first June. He owes B no other debt of that amount. On the first June A pays to B ₹ 1,000. The payment is to be applied to the discharge of the promissory note.
- (b) A owes to B, among other debts, the sum of ₹ 567. B writes to A and demands payment of this sum. A sends to B ₹ 567. This payment is to be applied to the discharge of the debt of which B had demanded payment.

#### 1.11.2 Application of Payment where Debt to be Discharged is not Indicated (Section 60)

Where the debtor has omitted to intimate and there are no other circumstances indicating to which debt the payment is to be applied, the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor, whether its recovery is or is not barred by the law in force for the time being as to the limitation of suits.

#### 1.11.3 Application of Payment where Neither Party Appropriates (Section 61)

Where neither party makes any appropriation the payment shall be applied in discharge of the debts in order of time, whether they are or are not barred by the law in force for the time being as to the limitation of suits. If the debts are of equal standing, the payment shall be applied in discharge of each proportionately.

## 1.12 QUASI CONTRACTS

### Introduction

So far we discussed contractual provisions in respects of the obligations stemming from contractual relations between the parties. As we discussed in the beginning of this study note that there are other obligations which are also enforceable even though not arising from contractual relations like Torts, Statuts, Recognisance, Quasi contract etc. Amongst these such obligations are quasi contracts which we will be discussing in this section of the study note.

**Meaning of Quasi contracts:** Quasi contracts are called Quasi contracts because the obligations associated with such transactions could neither be referred as tortuous nor contractual but still recognised by law as enforceable like other contracts. According to Dr Jenks, quasi contracts is 'a situation in which the law imposes upon one person, on grounds of natural justice, an obligation similar

to that which arises from true contract, although no contract, express or implied has in fact taken place. The basic philosophy underlying quasi contract is that non one shall be allowed unjustly to enrich himself at the expense of another and claim based on a quasi-contract is generally for money. Under certain circumstances a person may receive a benefit to which the law regards another person as better entitled or for which the law consider he should pay for it to the other party even though there is no contractual obligations imposed upon the party. Such relationship are termed as quasi contracts or constructive contracts under the English laws and "certain relations resembling those created by contract" under the Indian Law.

A quasi contract is a fictitious contract created under legal obligations, similar to a valid contract. These contracts are also known as implied-in-law contracts. What makes this different is that the parties involved do not intend to create a contract. A quasi contract is created by the Court. For the same reason, there is no actual offer or acceptance or an agreement between the parties.

The rational of Quasi contractual obligations was explained first of all by Lord Mansfield in *Moses V Macferlan 1706 2 Burr 1005* wherein it was stressed that law and justice should prevent "Undue enrichment". One person should not be enriched at the expense of other person. It was said "---the gist of this kind of action is that the defendant upon the circumstances of the case is obliged by ties of natural justice and equity to refund the money" In another case of *Fibrosa V Fairbain Lawson (1943) AC 32*, Lord Wright said "----it is clear that any system of law is bound to provide remedies for cases of what has been called unjust enrichment or unjust benefits, that is, to prevent a man from retaining the money of, or some benefit derived from, another which it is against conscience that he should accept"

### 1.12.1 Features of a Quasi Contract

The salient features of a quasi contract are as under:

- i) It is imposed by law and does not arise by agreement.
- ii) The duty of a party and not the promise of any party is the basis of such contract.
- iii) The right under it is always a right to money and though not always to a liquidated sum of money.
- iv) The right is available against specific persons and not the whole world.
- v) A suit for breach may be filed in the same way as in case of a complete contract.

### Distinction between Quasi Contracts and Contracts

Basis	Quasi Contracts	Contracts
Essential elements for formation of contracts	The essential elements for formation of contracts are absent.	Essential elements for formation of contracts are present.
Obligation.	Obligation is imposed by law.	Obligation is created by consent of parties

### Similarity between Quasi Contracts and Contracts

The outcome of quasi contract resembles that created by contract. So far as claim for damages are concerned there is a similarity between a quasi contract and contract because in case of breach of a quasi contract, Section 73 provides same remedied as provided in case of breach of contract.

### 1.12.2 Types of Quasi Contracts

Sections 68 to 72 deal with five kinds of quasi contractual obligations. These are discussed below:

#### (A) Claim for Necessaries Supplied to Person Incapable of Contracting, or on his Account (Section 68)

If a person, incapable of entering into a contract, or anyone 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.



### Illustrations

- (a) A supplies B, a lunatic, with necessaries suitable to his condition in life. A is entitled to be reimbursed from B's property.
- (b) A supplies the wife and children of B, a lunatic, with necessaries suitable to their condition in life. A is entitled to be reimbursed from B's property.
- (c) It may be noted that this section covers the cases of necessaries supplied to a minor and other incapable persons and to persons whom the incapable person is bound to maintain by law, for example, his wife and minor children's. The things supplied must come within the category of necessaries, which we have already discussed in preceding chapters. The price to be paid should be a reasonable price, not the price which the incapable person might have agreed. However, the incapable person is not personally liable, only his property is liable in such cases.

### (B) Reimbursement of Person Paying Money Due by Another in Payment of Which he is Interested (Section 69)

Person who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other.

#### Example 1:

B holds land in Bengal, on a lease granted by A, the zamindar. The revenue payable by A to the Government being in arrear, his land is advertised for sale by the Government. Under the revenue law, the consequence of a such sale will be the annulment of B's lease. B, to prevent the sale and the consequent annulment of his own lease, pays to the Government the sum due from A. A is bound to make good to B the amount so paid.

In order to bring it under section 69 and enforce payment the following requirements must be met:

- (a) The payment should be bonafide payment.
- (b) Payment should not be voluntary.
- (c) Payment should be one which other party was legally to pay.

If any of these condition is not met the case will not fall under section 69 of the Act, and the party cannot claim such payment.

#### Example 2:

A a Hindu mother incurred expenses for her daughter's marriage. She is entitled to recover the expenses incurred from the other members of the Hindu Joint Family. [*Vaikuntam V Kallapiram 1900 23 Mad 512*]

#### Example 3:

A's goods were wrongly attached in order to realise arrears of Government revenue due by B. A paid the amount to save the goods from sale by the public authorities. A is entitled to recover the money from B. [*Tulsa Kunwar V Jageshar Prasad 1906 28 ALL 563*]

### (C) Obligation of Person Enjoying Benefit of Non-Gratuitous Act (Section 70)

Where a person lawfully does anything for another person/or delivers anything to him, not intending to do so gratuitously, and such other person enjoys the benefit thereof, the latter is bound to make compensation to the former in respect of, or to restore, the thing so done or delivered.

### Illustrations

- (a) A, a tradesman, leaves goods at B's house by mistake, B treats the goods as his own. He is bound to pay A for them.

- (b) A saves B's property from fire. A is not entitled to compensation from-B, if the circumstances show that he intended to act gratuitously.
- (c) A contractor on the request of an officer of the State of West Bengal, constructed a Katcha road, office, Kitchen etc, for the clerks. The State accepted the works but tried to evade liability because no contract had been concluded according to the formalities of the Government of India Act, Since the State had enjoyed the benefit of the works, the Supreme court decreed the contractor's claim. [*State of West Bengal V BK Mondal & Sons AIR 1962 SC 779*]
- (d) A person supplied spare motor parts and the Pune Corporation accepted the goods. But the corporation said that the contract of sale was not according to the Bombay Municipal Corporation Act. The claim was decreed by the Supreme Court. [*Pillo Dhunjishaw v Muncipal Corporation of the City of Poona AIR 1970 SC 1201*]

In order to bring any case under the ambit of section 70 the following conditions must be satisfied;

- (a) Act have been done lawfully.
- (b) Such act should not be non-gratuitous Act.
- (c) Beneficiary must have enjoyed the benefit.

It has been held that section 70 is not based on contract but embodies the equitable principles of restitution and prevention of unjust enrichment [*I Abraham V KA Cheriyan AIR(1986) ker 60*]

#### **(D) Finder of Goods (Section 71)**

A person who finds goods belonging to another, and takes them into his custody, is subject to the same responsibility as a bailee besides the responsibility of exercising reasonable efforts in finding the real owner.

However, a finder is also bestowed with certain rights as follows:

- (i) Right to retain the goods until the true owner compensates him for the money spent in preserving the goods and finding the owner. The finder, however, cannot sue for compensation. Where the owner has declared specific reward, the finder can sue him for the same.
- (ii) Right to sell: If the owner cannot be found after due search, or he refuses to pay lawful charges of the finder, the finder may sell the goods if:
  - (a) the goods are of perishable nature;
  - (b) lawful charges of the finder amounts to 2/3rd of the value of goods.

**As evident from the section a finder of lost goods can sell the goods so find in the following cases:**

- (a) goods is likely to perish;
- (b) true owner with reasonable diligence could not be found;
- (c) true owner found but refuses to pay lawful charges of the finder of lost goods;
- (d) when lawful charges is about 2/3 of value of thing found.

#### **(E) Liability of Person to Whom Money is Paid, or Thing Delivered by Mistake or Under Coercion (Section 72)**

A person to whom money has been paid, or anything delivered, by mistake or under coercion, must repay or return it.

##### **Illustrations**

- (a) A and B jointly owe ₹ 100 to C. A alone pays the amount to C, and B, not knowing this fact, pays ₹ 100 over again to C. C is bound to repay the amount to B.



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

It may be noted that this section does not make any distinction between mistake of law and mistake of fact [*D.Cawasji & CO, v State AIR (1969)May 23*]

**Example:**

X paid sales tax on his forward transaction of bullion. Subsequently this tax was declared ultra-vires. It was held that K could recover the amount of sales tax so paid as section 72 is wide enough to cover not only mistake of law but mistake of fact also [*Sales Tax officer v Kanhayalal Mukundlalsaraf (1959)SCJ53*]

### 1.12.3 Compensation in the Case of Quasi Contracts

As the obligations created in a Quasi contracts are not based on the contractual stipulations a question may arise as to is there any remedy available for breach of such obligations which have been imposed by the Doctrine of Equity and not by the Contract between the parties. Under section 73(3) " When an obligation resembling those created by contract has not been discharged person injured by the failure to discharge it is entitled to receive the same compensation from the party in default as if such person had contracted to discharge it and had contract to discharge it and had broken the contract".

Explanation in estimating the loss or damages arising from a breach of contract, the means which existed of remedying the inconvenience caused by the non performance of the contract must be taken into account.

From the above provisions of section 73(3) of the Contract Act it is clear that so far the obligations which are termed Quasi Contracts, they have the same remedies available as is available to other contractual obligations under the Contract Act. This will be discussed when we discuss remedies for breach of contractual obligations.

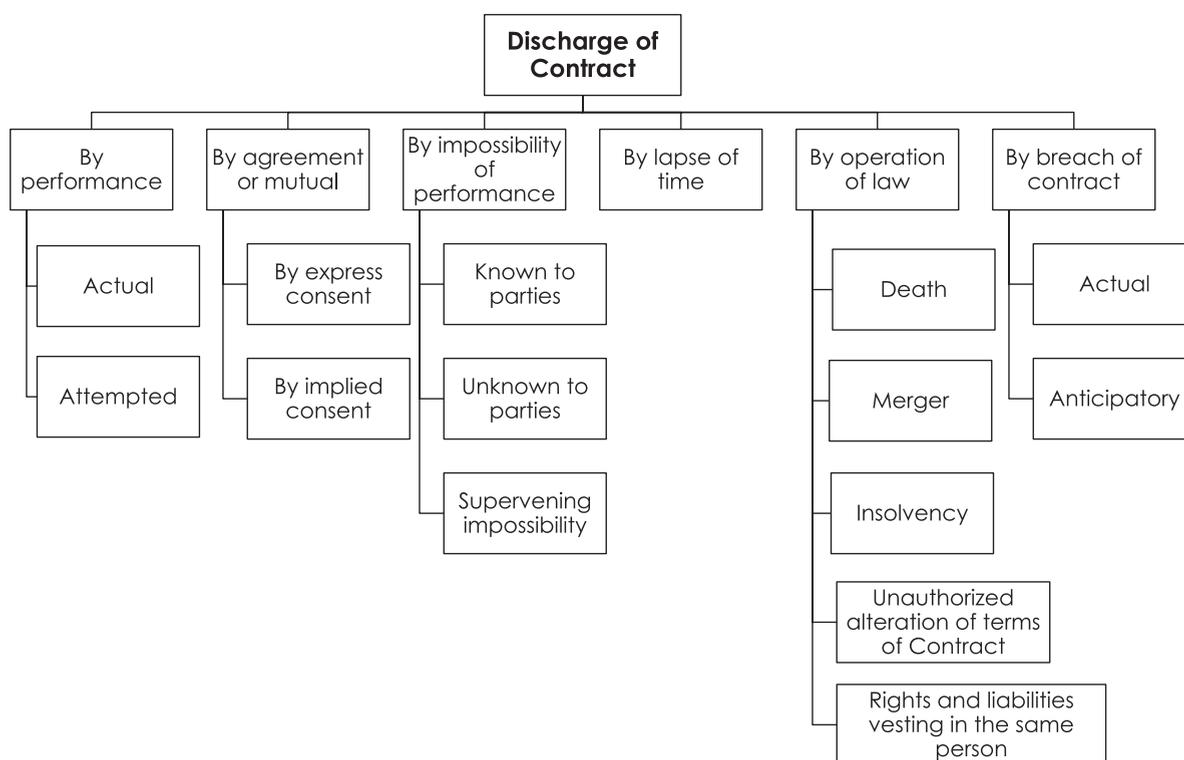
## 1.13 DISCHARGE OF CONTRACTS

### Introduction

Once a contract has been duly formed the next milestones to be achieved is fulfilment of the contractual obligations of both the parties as contemplated in the contract. When the object is fulfilled the liabilities of both the parties comes to an end

Discharge of Contract implies termination of contractual relationship among parties. When we say a contract is discharged it means it ceases to operate and rights and obligation under it comes to an end. A contract may be discharged by any of the following ways;--

- (i) by performance,
- (ii) by mutual consent,
- (iii) by subsequent impossibility of performance,
- (iv) by lapse of time,
- (v) by operation of law,
- (vi) by breach of contract.



### 1.13.1 Modes of Discharge

- I. Discharge by performance is the most usual form of discharge of a contract. A contract is said to be performed when the parties fulfill their respective obligations.

When both the parties to the contract have discharged their respective contractual obligations as contemplated in the contract the contract stand discharged. Performance can be actual performance or tender of performance. In both the cases the contract stand discharged. Rules regarding performance of contract have already been discussed earlier under “ Performance of contract”. When one of the party to the contract offer to perform its parts of obligation but other party refuse to accept the performance it is called attempted performance or tender of performance. Under both the circumstances the contract stand discharged. Section 37-61 deals with rule regarding performance of a contract which is already discussed.

- II. A contract may be discharged by a further agreement among parties which may be expressed or implied.

By agreement of all the parties a contract may be cancelled or its terms altered or get substituted by a new agreement for it. Whenever any of these things happens, the old contract is terminated. If the parties to the contract agree to substitute a new contract for it, or to rescind or alter it, the original contract need not be performed . Section 62-63 provides for discharge of contract by mutual understanding or agreements, which are discussed below:

**Section 62 provide another mode of discharge of a contract through mutual agreement between the parties . The provisions of section 62 are as under.**

#### **Contracts Which Need not be Performed, Effect of Novation, Rescission and Alteration of Contract (Section 62)**

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



## Illustrations

- (a) A owes money to B under a contract. It is agreed between A, B and C that B shall thenceforth accept C as his debtor, instead of A. The old debt of A to B is at an end, a new debt from C to B has been contracted.
- (b) A owes B ₹ 10,000. A enters into an agreement with B, and gives B a mortgage of his (A's) estate for ₹ 5,000 in place of the debt of ₹ 10,000. This is a new contract and extinguishes the old.
- (c) A owes B ₹ 1,000 under a contract, B owes C ₹ 1,000. B orders A to credit C with ₹ 1,000 in his books, but C does not assent to the arrangement. B still owes C ₹ 1,000, and no new contract has been entered into.

Section 62 contemplates three modes of discharge of contract by agreements, namely,

- (i) novation,
- (ii) alteration and
- (iii) rescission.

According to Sec 62, "If the parties to a contract agree to substitute or alter it, the original contract need not be performed."

- i. **Novation:** Novation means substitution of a new contract for the existing contract. If the parties to a contract agree to substitute a new contract for it, the original contract is discharged. **The consideration for the new contract is discharge of the old contract.** The new contract may be either between the same parties or between new parties. The new contract may be either between the same parties or between new parties. Novation cannot be compulsory. It can only take place with mutual consent of all parties. The new contract must be enforceable.

Any novation of contract is to be done on the same terms as are required for entering into a valid and concluded contract. No change in a contract can be made unilaterally. In *DDA vs. Joint Action Committee Allottee of SFS Flats*, (2008)2 SCC 672, it was held that novation of contract cannot be done unilaterally, and the new terms must be brought to the knowledge of the offeree and his acceptance thereto must be obtained. **Parties must be ad idem as to the new terms and conditions for a valid novation of contract.** Moreover, when a contract been worked out, a fresh liability cannot be thrust upon a contracting party. In present case, Delhi Development Authority was not allowed to charge extra sums beyond the scope of the original terms contained in the offer document and the allotment letter of the self-financing scheme, without obtaining consent of the allottees.

## Illustrations

- (a) X owes money to Y under a contract. It is agreed between X, Y and Z that Y shall thenceforth accept Y as his debtor, instead of X. The old debt of X to Y comes to an end, and a new debt from Z to Y has been contracted.
- (b) X owes Y ₹ 15,000, X enters into an arrangement with Y, and gives Y mortgage of his (X's) estate for ₹ 10,000 in place of the debt of ₹ 15,000. This is a new contract and extinguishes the old one.
- (c) P owes Q ₹ 5,000 under a contract. Q owes ₹ 2,000. Q orders no credit R with ₹ 5,000 in his books but R does not assent to the arrangement. Q still owes ₹ 3,000, and no new contract has been entered into.

In illustration (b) the parties to the contract remain the same but a new contract comes into existence with altered terms in place of the old contract. Novation between the same parties is valid when the original parties agree to it. In illustration (a) there is novation by change in the parties to the contract. In such a case obligation may be imposed on a new party. Therefore, in such cases all the three parties must give their consent. The same principles apply in case of admission and retirement of partners.

- ii. **Alteration:** if the parties to a contract agree to alter it, the original contract need not be performed. In this case parties remain the same, only terms of contract are altered. Alteration means change in one or more terms of the contract. To come under Section 62 the alteration must be done by mutual consent of the parties. If a material alteration is done without the consent of the other party the contract becomes void. An alteration is material if it alters the legal effect of contract. An alteration of the amount, the rate of interest, the time of payment, the time of delivery are material in nature while correction of clerical error are non-material.
- iii. **Rescission:** if the parties to a contract agree to rescind it, the original contract need not be performed. Rescission results in cancellation of the contract. In case of rescission the parties to a contract, before its performance, mutually agree that it shall no longer bind them. Thus in case of rescission the existing contract is concealed by mutual consent and new contract does not come into existence.

**Another mode of discharge of a contract by mutual agreement or consent of the parties is remission or dispensing with the performance as per section 63.**

Promisee may dispense with or may remit performance of the promise. Section 63 reads: "every promise may dispense with or may remit, wholly or in part, the performance of the promise made to him, or may extend the time for such performance, or may accept instead of it any satisfaction which he thinks fit."

- i. **Waiver:** Dispensing with performance or giving up a right under the contract is known as waiver.

**Example:**

A promises to paint a picture for B. B afterwards forbids him to do. A is no longer bound to perform the promise.

- ii. **Remission:** Acceptance of lesser promise than what is due under the contract is called remission.

**Example:**

A owes B ₹ 5,000. A pays to B, and B accepts in satisfaction of the whole debt ₹ 2,000 paid at the time and place at which the ₹ 5,000 were payable. The whole debt is discharged.

In *Kapoor chand V Mrs Nawab Khan AIR 1963 SC 250* a creditor accepted ₹ 20 lakhs in full satisfaction of his claim of ₹ 27 lakhs. It was held that the creditor was not entitled to sue for the balance. The case was completely covered by section 63. However, as held in *Amarnath V Bharat Heavy Electicals Ltd* the position would be different if the promisee accepts some performance under protest and the contract is not discharged.

- iii. Agreement to extend time. Every promise may extend the time of performance of contract. No consideration is necessary for such an agreement as more is required for the total or partial remission of the performance. In *Keshavlal v Lal Bhari Mills Ltd 1959 SCR 213* the Supreme court held that the buyer can not unilaterally extend time of his own accord and for his own benefit. Consent of the other party is also necessary.

Accepting any other satisfaction instead of performance. Promisee may accept any satisfaction which he thinks fit and this would discharge the promisor. Accepting some other satisfaction instead of actual performance is called 'Accord and Satisfaction' under English law. Accord is the agreement by which the obligation is discharged and satisfaction is the consideration which makes the agreement operative.

**Example:**

A owes B, under a contract, a sum of money, the amount of which has not been ascertained.



A without ascertaining the amount gives to B, and B, in satisfaction thereof, accepts the sum of ₹ 2,000. This is a discharge of the whole debt, whatever may be its amount.

III. A contract to perform an impossible act is void *ab-initio*. A contract is discharged if subsequent performance becomes impossible due to factors beyond the control of the parties. Supervening impossibility occurs in the following circumstances:-

- (a) When the subject matter of contract is destroyed.
- (b) When the state of things which form basis of contract changes.
- (c) When the performance depends on personal skill, incapacity of that party renders the contract discharged.
- (d) Change of law may render the performance impossible.
- (e) Outbreak of war may make a party alien enemy. Contract with alien enemy is unlawful and such contracts are suspended during duration of war. It should however be noted that 'impossibility of performance' as a rule cannot be an excuse for non- performance unless performance becomes absolutely impossible.

IV. As per Law of Limitation, a contract should be performed within a specified time period, called period of limitation. If not performed within 'period of limitation' and no action is taken by the promisee, the contract is terminated.

**Example 1:** X agreed sell goods worth ₹ 21,000 to Y without any stipulation as to credit, Y did not paid the amount for three years. On expiry of three years from the date of the contract the debt becomes time barred under the Limitation Act and contract stand discharged.

**Example 2:** X agreed sell goods worth ₹ 21,000 to Y with stipulation of 3 months credit credit, Y did not paid the amount even after expiry of three months, from the expiry of credit period of 3 months. On expiry of three years from the expiry of credit period the debt becomes time barred under the Limitation Act and contract stand discharged.

V. A contract may be discharged due to operation of law by death of a party, merger, and insolvency of a party, unauthorized alteration in terms of contract, rights and liabilities getting vested in the same person.

- (i) Death: In contract involving personal skills or ability, death terminates the contract. In other cases the rights and liabilities pass on to the legal representatives of the deceased party.

**Example:**

X, a celebrated Artist agree to draw a life size portrait of Y on his next birth day. However, before arrival of Y's birth day X dies in a road accident. The contract is discharged by operation of law due to death of X.

- (ii) Insolvency: Upon insolvency, the right and liabilities of the insolvent are, with certain exceptions, transferred to an officer of the court, known as the official Assignee in Kolkata and other presidency town and as Official receivers in other cases.

- (iii) Merger: When a superior rights and an inferior right coincide and meet in one and the same person, the inferior right vanishes into the superior right. This is known as merger.

**Example:**

A man holding property under a lease, buys the property. His rights as a lessee vanishes. They are merged into the rights of ownership which he has now acquired.

- (iv) Unauthorised alternation in the terms of the contract;- Any material unauthorised alteration in the contract by any party to the contract renders the contract discharged and makes it void.

**Example:** X agree to sell his flat to Y for ₹ 5,00,000, however X while preparing the conveyance document mentioned the amount ₹ 5,50,000 instead of ₹ 5,00,000 without knowledge of Y. The contract stand discharged and Y is not entitled to honor the contract.

- VI.** Breach of contractual obligation on the part of either party lead to discharge of the contract. If a party to a contract breaks his obligation under the contract, he is said to have committed breach. Breach of contract maybe actual or anticipatory. Actual breach may occur when performance is due or during performance. Breach on the part of either of the parties may take place at the time when the performance is due or during the performance of the contractual obligation. This type of breach is called actual breach. Anticipatory breach of contract occurs when a party refuses to perform before the time of performance. Anticipatory breach may be by express renouncement by the party or by doing some act so that the performance of the act becomes impossible.

An anticipatory breach does not necessarily means discharge of the contract unless the aggrieved party choose to do so. Aggrieved party has right to treat the contract discharged so as to absolve himself from his or her part of contractual obligations or take a legal action for breach of the contract or wait till the time of actual due date of performance of the contract.

### 1.13.2 The Consequences of Breach of Contract

Remedies for breach of contractual obligation;

Non-performance of contractual obligation on the part of either party entitles other party to foreclose the contract on its part and proceed further in number of ways. The aggrieved party in addition to requesting or persuading the other party to honor the contractual obligations may due the other party for specific performance, damages or sue for other remedies available under the Indian Contract Act beside seeking redressed from Consumer Association, Consumer Forum etc. Section 74-75 of the Indian contract Act provides for the compensation or damages for breach of the contractual obligations. Under the Specific Relief Act, 1963 also the aggrieved party has remedies available in the form of (i) decree for specific performance (ii) suit on quantum meruit and (iii) Injunction. When there is a contractual breach the other party can treat the contract as rescinded and thus relieve itself from all contractual obligations. For example, when X agree to give a stage performance on Y's wedding anniversary for which he will be paid ₹ 51,000. Failure of X to give the performance, entitles Y to treat the contract rescinded and not to pay the amount agreed to be paid. He is entitled to seek other remedies available under the Indian Contract Act. The remedies available under section 73-74 of the Contract Act are discussed hereunder:

#### 1.13.2.1 The Consequences of Breach of Contract, Compensation for Loss or Damage Caused by Breach of Contract (Section 73)

As per section 73 when a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.

Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach.

#### **Compensation for failure to discharge obligation resembling those created by contract:**

When an obligation resembling those created by contract has been incurred and has not been discharged, any person injured by the failure to discharge it is entitled to receive the same compensation from the party in default, as if such person had contracted to discharge it and had broken his contract.

**Explanation:** In estimating the loss or damage arising from a breach of contract, the means which existed of remedying the inconvenience caused by the non-performance of the contract must be taken into account.



## Illustrations

- (a) A contracts to sell and deliver 50 mounds of saltpetre to B, at a certain price to be paid on delivery. A breaks his promise. B is entitled to receive from A, by way of compensation, the sum, if any, by which the contract price falls short of the price for which B might have obtained 50 mounds of saltpetre of like quality at the time when the saltpetre ought to have been delivered.
- (b) A hires B's ship to go to Bombay, and there take on board on the first of January a cargo which A is to provide, and (bring it to Calcutta, the freight to be paid when earned). B's ship does not go to Bombay, but A has opportunities of procuring suitable conveyance for the cargo upon terms as advantageous as those on which he had chartered the ship. A avails himself of those opportunities, but is put to trouble and expense in doing so. A is entitled to receive compensation from B in respect of such trouble and expense.
- (c) A contracts to buy of B, at a stated price, 50 mounds of rice, no time being fixed for delivery. A afterwards informs B that he will not accept the rice if tendered to him. B is entitled to receive from A, by way of compensation, the amount, if any, by which the contract price exceeds that which B can obtain for the rice at the time when A informs B that he will not accept it.
- (d) A contracts to buy B's ship for ₹ 60,000, but breaks his promise. A must pay to B, by way of compensation, the excess, if any, of the contract price over the price which B can obtain for the ship at the time of the breach of promise.
- (e) A, the owner of a boat, contracts with B to take a cargo of jute to Mirzapur, for sale at that place, starting on a specified day. The boat, owing to some avoidable cause, does not start at the time appointed, whereby the arrival of the cargo at Mirzapur is delayed beyond the time when it would have arrived if the boat had sailed according to the contract. After that date, and before the arrival of the cargo, the price of jute falls. The measure of the compensation payable to B by A is the difference between the price which B could have obtained for the cargo at Mirzapur at the time when it would have arrived if forwarded in due course, and its market price at the time when it actually arrived.
- (f) A contracts to repair B's house in a certain manner, and receives payment in advance. A repairs the house, but not according to contract. B is entitled to recover from A the cost of making the repairs conforming to the contract.
- (g) A contracts to let his ship to B for a year, from the 1st January, for a certain price. Freight rises, and, on the 1st January, the hire obtainable for the ship is higher than the contract price. A breaks his promise. He must pay to B, by way of compensation, a sum equal to the difference between the contract price and the price for which B could hire a similar ship for a year on and from the 1st January.
- (h) A contracts to supply B with a certain quantity of iron at a fixed price, being a higher price than that for which A could procure and deliver the iron. B wrongfully refuses to receive the iron. B must pay to A, by way of compensation, the difference between the contract price of the iron and the sum for which A could have obtained and delivered it.
- (i) A delivers to B, a common carrier, a machine to be conveyed, without delay, to A's mill, informing B that his mill is stopped for want of the machine. B unreasonably delays the delivery of the machine and A, in consequence, loses a profitable contract with the Government. A is entitled to receive from B, by way of compensation, the average amount of profit which would have been made by the working of the mill during the time that delivery of it was delayed, but not the loss sustained through the loss of the Government contract.
- (j) A, having contracted with B to supply B with 1,000 tons of iron at ₹ 100 a ton, to be delivered at a stated time, contracts with C for the purchase of 1,000 tons of iron at ₹ 80 a ton, telling C that he does so for the purpose of performing his contract with B. C fails to perform his contract with A, who cannot procure other iron, and B, in consequence, rescinds the contract. C must pay to A ₹ 20,000, being the profit which A would have made by the performance of his contract with B.

- (k) A contracts with B to make and deliver to B, by a fixed day, for a specified price, a certain piece of machinery. A does not deliver the piece of machinery at the time specified, and in consequence of this, B is obliged to procure another at a higher price than that which he was to have paid to A, and is prevented from performing a contract which B had made with a third person at the time of his contract with A (but which had not been then communicated to A), and is compelled to make compensation for breach of that contract. A must pay to B, by way of compensation, the difference between the contract price of the piece of machinery and the sum paid by B for another, but not the sum paid by B to the third person by way of compensation.
- (l) A, a builder, contracts to erect and finish a house by the 1st day of January, in order that B may give possession of it at that time to C, to whom B has contracted to let it. A is informed of the contract between B and C. A builds the house so badly that, before the 1st January, it falls down and has to be rebuilt by B, who, in consequence, loses the rent which he was to have received from C, and is obliged to make compensation to C for the breach of his contract. A must make compensation to B for the cost of rebuilding the house, for the rent lost, and for the compensation made to C.
- (m) A sells certain merchandise to B, warranting it to be of a particular quality, and B, in reliance upon this warranty, sells it to C with a similar warranty. The goods prove to be not according to the warranty, and B becomes liable to pay C a sum of money by way of compensation. B is entitled to be reimbursed this sum by A.
- (n) A contracts to pay a sum of money to B on a day specified. A does not pay the money on that day; B in consequence of not receiving the money on that day is unable to pay his debts, and is totally ruined. A is not liable to make good to B anything except the principal sum he contracted to pay, together with interest up to the day of payment.
- (o) A contracts to deliver 50 mounds of saltpetre to B on the 1st day of January, at a certain price. B afterwards, before the 1st day of January, contracts to sell the saltpetre to C at a price higher than the market price of the 1st January. A breaks his promise. In estimating the compensation payable by A or to B, the market price of the 1st January, and not the profit which would have arisen to B from the sale to C, is to be taken into account.
- (p) A contracts to sell and deliver 500 bales of cotton to B on a fixed day. A knows nothing of B's mode of conducting his business. A breaks his promise, and B, having no cotton, is obliged to close his mill. A is not responsible to B for the loss caused to B by the closing of the mill.
- (q) A contracts to sell and deliver to B, on the 1st day of January, certain cloth which B intends to manufacture into caps of a particular kind, for which there is no demand, except at that season. The cloth is not delivered till after the appointed time, and too late to be used that year in making caps. B is entitled to receive from A, by way of compensation, the difference between the contract price of the cloth and its market price at the time of delivery, but not the profits which he expected to obtain by making caps, nor the expenses which he has been put to in making preparation for the manufacture.
- (r) A, a ship-owner, contracts with B to convey him from Calcutta to Sydney in A's ship sailing on the 1st day of January, and B pays to A, by way of deposit, one-half of his passage money. The ship does not sail on the 1st day January, and B, after being, in consequence, detained in Calcutta for some time, and thereby put to some expense, proceeds to Sydney in another vessel, and, in consequence, arriving too late in Sydney, loses a sum of money. A is liable to repay to B his deposit, with interest, and the expense to which he is put by his detention in Calcutta, and the excess, if any, of the passage money paid for the second ship over that agreed upon for the first, but not the sum of money which B lost by arriving in Sydney too late.

### **1.13.2.2 Compensation for Breach of Contract where Penalty Stipulated for (Section 74)**

When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party



complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.

**Explanation:** A stipulation for increased interest from the date of default may be a stipulation by way of penalty.

**Exception:** When any person enters into any bail-bond, recognizance or other instrument of the same nature, or, under the provisions of any law, or under the orders of the Central Government or of any State Government, gives any bond for the performance of any public duty or act in which the public are interested, he shall be liable, upon breach of the condition of any such instrument, to pay the whole sum mentioned therein.

**Explanation:** A person who enters into a contract with the Government does not necessarily thereby undertake any public duty, or promise to do an act in which the public are interested.

### Illustrations

- (a) A contracts with B to pay B ₹ 1,000, if he fails to pay B ₹ 500 on a given day. A fails to pay B ₹ 500 on that day. B is entitled to recover from A such compensation, not exceeding ₹ 1,000, as the Court considers reasonable.
- (b) A contracts with B that if A practises as a surgeon within Kolkata, he will pay B ₹ 5,000. A practices as a surgeon in Kolkata. B is entitled to such compensation, not exceeding ₹ 5,000, as the Court considers reasonable.
- (c) A gives a recognizance binding him in a penalty of ₹ 500 to appear in Court on a certain day. He forfeits his recognizance. He is liable to pay the whole penalty.
- (d) A gives B a bond for the repayment of ₹ 1,000 with interest at 12 per cent at the end of six months, with a stipulation that, in case of default, interest shall be payable at the rate of 75 per cent from the date of default. This is a stipulation by way of penalty, and B is only entitled to recover from A such compensation as the Court considers reasonable.
- (e) A, who owes money to B, a money-lender, undertakes to repay him by delivering to him 10 mounds of grain on a certain date, and stipulates that, in the event of his not delivering the stipulated amount by the stipulated date, he shall be liable to deliver 20 mounds. This is a stipulation by way of penalty, and B is only entitled to reasonable compensation in case of breach.
- (f) A undertakes to repay B a loan of ₹ 1,000 by five equal monthly installments, with a stipulation that, in default of payment of any installment, the whole shall become due. This stipulation is not by way of penalty, and the contract may be enforced according to its terms.
- (g) A borrows ₹ 100 from B and gives him a bond for ₹ 200 payable by five yearly installments of ₹ 40, with a stipulation that, in default of payment of any installment, the whole shall become due. This is a stipulation by way of penalty.

From section 73 and 74 and various decided cases, the principles for assessment of damages may be summarised as under:

1. General or Ordinary damages: The aggrieved party is entitled to receive compensation for any loss or damage caused to him which naturally arose in the usual course of business from such breach or which the parties knew when they made the contract to be likely to result from the breach of it, such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach. [*Murlidhar Chiranjilal V Harish Chander AIR 1962 SC 366.*]

A agreed to supply canvas from Kanpur to Calcutta for which labor and transportation charges were to be borne by the buyer. The seller did not supply the canvas. It was held that the contract was to be performed at Kanpur so the measure of damages will be difference between contract price and market price at Kanpur. In the instant case the buyer could not prove the market price of similar canvas at Kanpur on the date of breach, he was not awarded any damages.

2. The aggrieved party is to be placed, as far as money can do it, in as good a position as if the contract had been performed.
3. The aggrieved party must take reasonable steps to mitigate the loss consequent on the breach. He cannot claim any part of the damage which is due to his neglect to take such steps.
4. The loss to be ascertained is the loss at the date of the breach of contract.
5. Damages are compensatory and not penal. Damages are given by way of compensation for the loss by the plaintiff and not for the purpose of punishing the defendants for the breach.
6. Ordinarily damages for mental pain and suffering caused by the breach are not allowed except in case of (i) unjustified dishonour of a cheque, and (ii) breach of a promise to marry. In case of unjustified dishonour of cheque or breach of a promise to marry, the court award exemplary damages. These damages are given for mental pain or suffering caused to the aggrieved party. Example, in a Scottish case of *Diesen V Samson(1971)SLT 49* a photographer who contracted to take photographs at a wedding, failed to appear at the time of wedding. As a result of his absence the bride had no photograph of her wedding. It was held that she was entitled to claim damages for resulting injury to her feeling.
7. Nominal damages may be awarded when the plaintiff does not suffer any loss. Amount of such damages is only nominal. For example, it may be as nominal as Rupee One, if no damage is actually suffered by the aggrieved party, the party is not entitled to any compensation at all. In *Union of India V Tribhuvan Das AIR 1971 Delhi 120* a person provided to supply sleepers to the Railway .The contract provide for payment of compensation for delay in supply of sleepers i in time. As Railways suffered no loss, Railway's claim for damages was dismissed by the court however nominal damages was awarded by the court.
8. In case of a contract of sale, where the goods are available in the market, it is the difference between the market price on the date of the breach and the contract price which is the measure of damages.
9. In case of service contracts, where the contract of employment was for a fixed period, the normal measure of damages for wrongful dismissal, subject to the rule of mitigation would be the salary for the whole of the unexpired period of service. If the contract of employment is not for a fixed term, damages are awarded for a reasonable period.
10. According to section 74 " when a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for."
11. Compensation can be awarded where contract becomes incapable of specific performance without any fault of the plaintiff.
12. Special damages are those damages which the parties knew when they made the contract, to be likely to result from the breach of it. Special damages are such that if they are not communicated it would not be fair and reasonable to hold the defendant responsible for losses which could not be taken to contemplate as likely to result from his breach of contract.

### **Liquidated damages**

At times contract sometimes contains a clause in which a sum of money is named as the amount payable in case of breach of contract which is called Liquidated damages or sometimes penalty. In English laws the money so specified in the contract is interpreted either as liquidated damages or as



a penalty. It is considered to be liquidated damages when the amount is fixed by the parties based on a reasonable estimate of the probable actual loss which a party will suffer in case of breach of the contract. On the other hand if the amount so fixed is not based on assessment of loss suffered by the parties but is fixed by way of punishment and is a threat it is treated as a penalty. In other words if the actual loss is less and the amount so fixed in the contract is more than it is treated as penalty.

In English law the courts allow the amount so specified in the contract even though the actual loss is more or less than the amount so stipulated in the contract as liquidated damages. Penalty clause is however treated invalid and the courts allow only reasonable compensation by way of damages.

In India there is no distinction between penalty and liquidated damages. As per section 74 if some amount has been fixed as what the damages will be, the courts will never allow more. But the courts may allow less but not more than what is fixed in the contract itself. A decree is to be passed by the court only for the reasonable compensation, not exceeding the sum named by the parties. However there is one exception when any person enters into any bail bond or similar instrument or gives any bond for the performance of any public duty, he shall be liable upon breach to pay the whole sum mentioned in the instrument and it is not necessary to calculate the actual loss.

At times a contract contains stipulation as to increased interest from the date of breach of contract which is considered penalty and is often disallowed by the courts. If simple interest is payable and there is an agreement that the debtor will have to pay compound interest on failure to pay at the specified date, the condition will be treated as penalty.

Remedies Available under the Specific Relief Act, 1963

### **Quantum Meruit (Section 30 of the Specific Relief Act, 1963)**

The term Quantum Meruit means as much as is earned. A person can under certain circumstances, claim payment for work done or goods supplied without any contract or where the original contract has been terminated due to breach by any party or the contract has become void due to any reasons whatsoever. This is called the Doctrine of Quantum Meruit. A suit under quantum meruit can also be filed under the Indian Contract Act for breach of any contractual obligations. The Rules regarding Quantum Meruit are summarized as under:

- (a) When there is breach of a contract the aggrieved party is entitled to claim reasonable compensation for what has been done under the contract.
- (b) As provided in section 65 when a contract is subsequently discovered to be unenforceable due to some reasons, any party who had done something under the contract is entitled to a reasonable compensation.
- (c) In certain cases the law presumes an implied agreement to pay for the services rendered, as provided in section 70, when the work done is without any intention of doing so gratuitously and the other party has enjoyed some benefits under it.
- (d) In case of indivisible contract and a lump sum is provided in the contract for the entire contract. Part performance does not entitle any party to claim any payment under the Doctrine of Quantum Meruit.
- (e) The doctrine of Quantum Meruit is not applicable where there is no evidence of an express or implied promise to pay for work already done.
- (f) A person guilty of breach of contract can not claim payment on the ground of Quantum Meruit

### **Example 1:**

There was an implied agreement between P and a fire brigade for services of the brigade. It was held that a reasonable remuneration was payable by P for the services received by P. *[[Upton Rural District Council v Powell (1942) 1 All ER 220]]*

**Example 2:**

P agreed to decorate D's flat for a sum of ₹ 1,750 certain requirements having been laid down. P did the work but D complained of faulty workmanship. It cost D ₹ 200 to remedy that defect work. It was held that P could recover from D ₹ 1,550 [₹ (1,750 - 200)] [(*Hoenig V Issaces(1952)All ER 176*)]

**Example 3:**

A agreed to repair B's house for ₹ 5000. A did repair B's house but there were some deficiencies which B himself got rectified by spending another ₹ 1000. It was held that A is entitled to ₹ 4000 only from B on the doctrine of Quantum Meruit [(*Dakin(H) & Co v Lee(1916)All 1 KB 566*)]

**Decree for Specific Performance(section 10)**

Specific performance is a discretionary remedy available under Specific Relief Act of 1877 and is allowed in some limited cases by the courts. This remedy is granted by the court in cases where monetary compensation is not an adequate remedy. Where monetary compensation is adequate remedy specific performance is not allowed by the courts.

It is also not allowed in case of contracts of personal nature like contract to marry, contract to give a stage performance. Similarly where close supervision by the courts is not possible specific performance is not ordered by the courts.

**Injunction(section 38-41)**

Injunction means an order of the court to prevent a person from doing something which is promised not to do under the contract. This is generally granted to enforce negative stipulation in the contract where damages is not an adequate relief under the contract. It is generally more common in case of Anticipatory breach of contract.

**Example:**

X a star comedian signed a contract with a leading Production House(X) to work for them and them only for one year on payment of his yearly retainership fee. After successfully working with the Production house for six months, he stopped going to X Production House under contract and start working with other Production house(Y). X production house can seek injunction order from court preventing him working for other Production House(Y) during the currency of the current contract with it.

**Restitution of Benefit**

As already discussed in section 64 of the Act, when a person at whose option a contract is avoidable, and rescind the contract, he must restore the other party any benefit which he may have received from him. For **example** when a contract for sale of an old car is avoided on any ground that the consent thereto was not free, any advance money so received is required to be refunded to the other party.

Similarly as per section 65 when a contract becomes void or is discovered to be void, any person who has received any benefit under such agreements or contract is bound to restore it or to make compensation for it, to the person from whom he received it.

**1.13.3 Party Rightfully Rescinding Contract Entitled to Compensation (Section 75)**

A person who rightfully rescinds a contract is entitled to compensation for any damage which he has sustained through the non-fulfillment of the contract.

**Illustration**

A, a singer, contracts with B, the manager of a theatre, to sing at his theatre for two nights in every week during the next two months, and B engages to pay her 100 rupees for each night's performance. On the sixth night, A willfully absents herself from the theatre, and B, in consequence, rescinds the contract. B is entitled to claim compensation for the damage which he has sustained through the non-fulfillment of the contract.



## 1.14 INDEMNITY AND GUARANTEE

### Introduction

The contract of indemnity and guarantee are the special types of contracts. They are species of general contract, accordingly all the provisions of law of contract are equally applicable to them also.

Indemnity means protection against loss, especially in the form of a promise to pay, or payment for loss of money, goods etc. Basically it is a security against any default or compensation for loss etc. The person who promises to indemnify is known as indemnifier and the person in whose favor such promise is made is known as indemnified.

The special provision relating to contract of Indemnity and Guarantee are embodied in section 124 to 147 of the Act.

#### 1.14.1 “Contract of Indemnity” (Section 124)

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.” There are two parties to a contract of Indemnity. The person who promises the other party to make good the loss is called indemnifier. The position of a indemnifier in a contract of Indemnity is that of a promisor in other contracts. Similarly the person to whom such promise is given or whose loss is promised to be made good is called promisee or Indemnified or Indemnity holder.

It may be noted that the definition of indemnity given in the Indian contract Act is not exhaustive one. It includes (a) express promise to indemnify and (b) cases where the loss is caused by the conduct of the promisor himself or by the conduct of any other person. However, it does not include (a) implied promises to indemnify and (b) cases where loss arises from accidents and events not depending on the conduct of the promisor or any other person.

#### Example 1:

A contracts to indemnify B against the consequences of any proceedings which C may take against B in respect of a certain sum of ₹ 200. This is a contract of indemnity.

#### Example 2:

X and Y went to a TV shop. X neither have enough cash nor any credit card to make the payment Y, common friend of both X and Z (shop keeper) said to the shopkeeper, let X take the TV of his choice, I (Y) will see that you (Shop keeper) are paid. This again is a case of indemnity. Here also Y is the indemnifier and Z the shopkeeper is the indemnified or indemnity holder.

If we analyze the definition of Indemnity given in section 124 of the Indian Contract Act, the following points can be noted:

(a) It is express promise of indemnity and not an implied promise of indemnity (b) the cases where loss is caused by the conduct of the promisor or the conduct of any other person. In other words the loss caused by events or accidents not depending on the conduct of the promisor or any person is not covered under indemnity. The definition of Indemnity given in the Indian Contract Act is not exhaustive enough to take care of host of other cases.

Accordingly it has been held that the courts in India would have to apply the same equitable principles that are applied by the courts in England as if we go by the definition given in the Contract Act. Most of modern day contracts like contract of Insurance will fall out of the ambit of contract of Indemnity which goes against the very spirit of the Act.

Since the courts have been mandated to apply the principle of English law, let us see how the term Indemnity is defined in English law. As per English law Indemnity is “ a promise to save another harmless from loss caused as a result of a transaction entered into at the instance of the promisor”. This definition of the Contract as per English law is wider enough and covers the loss caused by events or accidents

which do not depend on the conduct of any person. Accordingly English law of Indemnity is followed in India due to its practicability and magnanimity.

Accordingly the contract of indemnity may be express or implied. An implied indemnity is inferred from the circumstances of the case or from the relationship of the parties.

**Example:**

A on the instruction of B sold certain cattle belonging to C. C held A liable for it and recovered damages from him for selling it. It was held that A could recover the loss from B as a promise by B to A from any loss would be implied from his conduct in asking A to sell the cattle. [(*Adamson v Jarvis*(1927)4 Bing 66)] It is a case of implied indemnity which can be inferred from the instruction of A to B.

**1.14.2 Rights of Indemnity-Holder when Sued (Section 125)**

The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor—

- (1) all damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies ;
- (2) all costs which he may be compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit;
- (3) all sums which he may have paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the promisor, and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promisor authorised him to compromise the suit.

So far we have discussed the rights of an Indemnity holder: Now the question arise do the indemnifier has any right under the Indian Contract Act? Indian contract Act is silent about it, as mentioned above courts in India are to apply English law. The English law confers the same rights as that of a surety under section 141 of the Contract Act. This will be discussed later in subsequent section.

When does the liability of indemnifier commences? Indian Contract does not address this question. Even judicial pronouncements on this issue are not unanimous. Some High Courts held that unless and until the indemnified has suffered any loss actually there is no liability of indemnifier. Other High Courts have held that the indemnified can compel the indemnifier to make good the loss even before he has actually discharged his liability [(*Osman Jamal & Sons V Gopal* (1919)56 cal 262 G)]

**1.14.3 “Contract of Guarantee”, “Surety”, “Principal Debtor” and “Creditor” (Section 126)**

A “contract of guarantee” is a contract to perform the promise, or discharge the liability, of a third person in case of his default. 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.

It may be noted that the contract of guarantee is a tripartite agreement which contemplates the Principal debtor, the Creditors and the Surety.

Having defined the term Guarantee, let us discuss the essential features of a Guarantee Contract.

**A Contract of Guarantee is characterized by:**

- (a) **Concurrence:** All the three parties must concur without which a contract of Guarantee is not complete.

**Example:**

C enters into a contract with P S without any communication with P, undertakes for a consideration moving from C to indemnify C against any damages that may arise from a breach of P's obligation.



This does not make S a surety for P, for a person cannot become a surety without the consent of the principal debtor.

- (b) **To fulfill all the essentials of a valid contract:** All elements of a valid contract/agreements like capacity, free consent, legal object and lawful consideration equally apply to a contract of Indemnity also.
- (c) **Need not be in writing:** It may be expressed or implied from the conduct of the parties. It may be in writing or oral. But as per English law a contract of guarantee must be in writing and signed by the party to the contract.
- (d) **There must be a primary liability in some person other than surety.** If that liability does not exist, there cannot be a contract of guarantee. But a guarantee given for the debt of a minor is an exception to this rule.

The primary liability in a contract of guarantee is that of the principal debtor, whereas that of a surety is secondary. This arises only when there is a default on the part of the Principal debtor.

#### Example 1:

X took a loan of ₹ 50,000 from Y for which Z stood as a guarantor or surety. Here the primary liability of discharge of the debt is that of X. Y cannot ask Z to pay the loan taken by Y unless and until there is default by Y.

#### Example 2:

A owes a debt of ₹ 50,000 to B. C gave a guarantee to B for payment of the debt after it is barred by the law of limitation. C pays the amount to B. Though C has paid the debt but he cannot recover the amount from A as there is no enforceability liability of A as the debt has become time barred.

After discussing the essential features of a contract of guarantee it is also necessary to discuss the consideration required for a Guarantee; As per section 127 of the Act "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". Consideration received by the principal debtor is sufficient for the surety and it is not necessary that it must necessarily result in some benefit to the surety himself.

#### Illustrations

- (a) B requests A to sell and deliver to him goods on credit. A agrees to do so, provided C will guarantee the payment of the price of the goods. C promises to guarantee the payment in consideration of A's promise to deliver the goods. This is a sufficient consideration for C's promise.
- (b) A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year, and promises that if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.
- (c) A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

#### Is Contract of Guarantee a contract of uberrimaefidei?

Contract of Partnership, Insurance Contract are contract of "uberrimaefidei" They are contract of utmost good faith. In the case of contract of Uberrimae Fidel "fraud" on the part of any party to the contract gives another party to set aside the contract.

**In the case of contract of Guarantee" fraud on the part of the principal debtor is not enough to set aside the contract unless the surety shows that the creditor or his agent knew of the fraud and was party to it.**

#### Example:

A guaranteed the account of B with the bank. Afterwards B drew on this account and paid off an overdraft he had with another bank. Held the fact that bank was suspicious that B was defrauding A

and did not communicate its suspicions to A did not discharge the guarantee. [(National Provincial Bank of England v Glauusk(1913)3KB335]

#### 1.14.4 Distinction between Contract of Indemnity & Contract of Guarantee:

After having understood the meaning of Contract of Indemnity and Contract of Guarantee, a confusion may arise that they may be one and the same thing. Though prima-facia they appear to be the same but in fact they are different from each other in one way or another. In the following table we will summarise the point of difference between contract of guarantee and contract of indemnity.

Sl. No.	Contract of Indemnity	Contract of Guarantee
(i)	There are two parties to a contract, indemnifier and indemnified.	There are three parties to contract, creditor, principal debtor and surety.
(ii)	The liability of the indemnifier is primary and independent.	The liability of the surety is secondary and collateral, the principal debtor being primarily liable.
(iii)	The number of contract is one, between indemnifier and indemnified.	The number of contract is three, (a) between principal debtor and creditor (b) between creditor and surety (c) between surety and principal debtor.
(iv)	The liability of the indemnifier is subject to happening of a contingency.	There is an existing debt the performance of which is guaranteed by the surety.
(v)	The indemnifier need not act only at the request of the indemnified of the indemnified.	The surety should give guarantee only at the request of the principal debtor.
(vi)	The indemnifier cannot proceed against third parties in his own name unless there is an assignment in his favour.	After discharging the debt the surety can proceed against the principal debtor in his own name.

#### 1.14.5 Consideration for Guarantee (Section 127)

Anything done, or any promise made, for the benefit of the principal debtor, maybe a sufficient consideration to the surety for giving the guarantee.

##### Illustrations

- (a) B requests A to sell and deliver to him goods on credit. A agrees to do so, provided C will guarantee the payment of the price of the goods. C promises to guarantee the payment in consideration of A's promise to deliver the goods. This is a sufficient consideration for C's promise.
- (b) A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year, and promises that if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.
- (c) A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

#### 1.14.6 Surety's Liability (Sec 128)

Liability of a surety is provided in section 128 of the Act which says that the liability of the surety is **co-extensive** with that of the principal debtor. However, these may vary as per the terms of the contract between the parties. In other words the surety is liable to the extent the Principal Debtor is liable under the contract.

##### Example:

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

**One cardinal principle also be kept in mind that the liability of a surety cannot be more than that of a**



**Principal Debtor.** It can be less than that of the Principal debtor if so agreed between the parties. But the creditor cannot demand payment from the Surety without first exhausting of his right of payment from the principal debtor. However, in the event of default on the part of the principal debtor he can sue the surety for nonpayment by him without suing the principal debtor.

**Example 1:**

X took a loan of ₹ 60,000 from B to be paid with interest @10% p.a. to be paid within one year. C stood a guarantor for X. What is the extent of liability of C in the instant case?

C is liable to pay principal amount of ₹ 60,000 plus interest @10% for the period the debt remained unpaid in the event of X's failure to pay the debt. B cannot demand the payment from C unless claiming the amount from X. However, he can sue C without suing the principal debtor X

**Example 2:**

X took a loan of ₹ 60,000 from B to be paid with interest @12% pa to be paid within one year. C stood a guarantor for X. However, as per the guarantee agreement surety is liable for principal payment only. What is the extent of liability of C in the instant case? C is liable to pay principal amount of ₹ 60,000 but not interest thereon due to X's default in payment. However, he can sue C without suing the principal debtor X.

A situation may arise when two persons contract with a third person to undertake a certain liability, and also contract with each other that one of them shall be liable only on the default of the other to the third person not being a party to such contract, under such circumstance the liability of each of such two persons to the third person under the first contract is not affected by the existence of the second contract, although such third person may have been aware of its existence.

**Example:**

A and B make a joint and several promissory note to C. A makes it, in fact, as surety for B, and C knows this at the time when the note is made. The fact that A, to the knowledge of C, made the note as surety for B, is no answer to a suit by C against A upon the note.

**1.14.7 Continuing Guarantee (Section 129)**

A guarantee which extends to a series of transactions is called a "continuing guarantee". In the case of continuing guarantee the liability of the surety extends to all the transactions contemplated until the revocation of the Guarantee.

**Illustrations**

- (a) A, in consideration that B will employ C in collecting the rents of B's zamindari, promises B to be responsible, to the amount of ₹ 5,000, for due collection and payment by C of those rents. This is a continuing guarantee.
- (b) A guarantees payment to B, a tea-dealer, to the amount of \$100, for any tea he may from time to time supply to C. B supplies C with tea to above the value of \$ 100, and C pays B for it. Afterwards B supplies C with tea to the value of \$200. C fails to pay. The guarantee given by A was a continuing guarantee, and he is accordingly liable to B to the extent of \$100.
- (c) A guarantees payment to B of the price of five sacks of flour to be delivered by B to C and to be paid for in a month. B delivers five sacks to C. C pays for them. Afterwards B delivers four sacks to C, which C does not pay for. The guarantee given by A was not a continuing guarantee, and accordingly he is not liable for the price of the four sacks.

Whether a guarantee given by a surety is continuing one or not depends upon the language of the guarantee agreement, the subject matter and surrounding circumstances. Only after considering all the factors it can be decided whether the guarantee is continuing one or not.

### **Revocation of Continuing Guarantee (Section 130)**

**Once a continuing guarantee has been given by the surety it can be revoked any time by following ways:**

#### **I. By Notice (Section 130)**

A continuing guarantee may at any time be revoked by the surety, as to future transactions, by notice to the creditor.

##### **Illustrations:**

- (a) A, in consideration of B's discounting, at A's request, bills of exchange for C, guarantees to B, for twelve months, the due payment of all such bills to the extent of ₹ 5,000. B discounts bills for C to the extent of ₹ 2,000. Afterwards, at the end of three months, A revokes the guarantee. This revocation discharges A from all liability to B for any subsequent discount. But A is liable to B for the ₹ 2,000, on default of C.
- (b) A guarantees to B, to the extent of ₹ 10,000, that C shall pay all the bills that B shall draw upon him. B draws upon C. C accepts the bill. A gives notice of revocation. C dishonours the bill at maturity. A is liable upon his guarantee.
- (c) A stood surety for B for any amount which C may lend to B from time to time in the next 24 months upto a maximum of ₹ 20,000. Afterwards at the end of three months A gave a notice to C revoking his guarantee, when C had lent to B ₹ 10,000. This revocation discharges A from any liability to C for any subsequent loans. But A is liable to C for default on B [(*Offord V Davies(1862)*)]12 CBNS 476. This is so because after tendering notice of revocation of guarantee he is not liable for subsequent future transactions but he remains liable for the past transactions.

#### **II. By Surety's Death (Section 131)**

The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions.

However, the liability of the surety for the previous transactions remains same. Death just operate to relieve him of guarantee for future transactions only and not for past one

#### **III. By Other Modes**

Apart from the two modes of revocation of continuing guarantee provided in section 130-131, other ways of revocation of continuing providing under different sections are as under;

- (i) Novation (section 62)
- ii) Variation in terms of contract (section 133)
- (iii) Release of principal debtor (section 134)
- (iv) Compounding with principal debtor (section 135)
- (v) Creditor's act or omission impairing surety's eventual remedy (section 139)
- (vi) Loss of security (section 141)

#### **1.14.8 Liability of two persons, Primarily Liable, not Affected by Arrangement between them that one shall be Surety on Other's Default (Section132)**

Where two persons contract with a third person to undertake a certain liability, and also contract with each other that one of them shall be liable only on the default to the other, the third person not being a party to such contract, the liability of each of such two persons to the third person under the first contract is not affected by the existence of these contract, although such third person may have been aware of its existence.



### Example:

A and B make a joint and several promissory note to C. A makes it, in fact, assuredly for B, and C knows this at the time when the note is made. The fact that A, to the knowledge of C, made the note assuredly for B, is no answer to a suit by C against A upon the note.

### 1.14.9 Rights of a Surety

#### A. Rights against Creditor

- (i) The surety may, before he is called upon to pay the debt, require the creditor to sue the principal debtor. In such case the surety is required to indemnify the creditor for any expenses or loss resulting therefrom.
- (ii) On being sued by the creditor, the surety can rely on any counter claim the principal debtor has against the creditor.
- (iii) Where a guaranteed debt has become due, or default of the principal debtor to perform a guaranteed duty has taken place, the surety, upon payment or performance of all that he is liable for, is invested with all the rights which the creditor had against the principal debtor.
- (iv) Surety's right to benefit of Creditor's Securities (**Section 141**)

A surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of surety ship is entered into, whether the surety knows of the existence of such security or not; and, if the creditor loses, or, without the consent of the surety, parts with such security, the surety is discharged to the extent of the value of the security.

#### Illustrations

- (a) C advances to B, his tenant, ₹ 2,000 on the guarantee of A. C has also a further security for the ₹ 2,000 by a mortgage of B's furniture. C cancels the mortgage. B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture.
- (b) C, a creditor, whose advance to B is secured by a decree, receives also a guarantee for that advance from A. C afterwards takes B's goods in execution under the decree, and then, without the knowledge of A, withdraws the execution. A is discharged.
- (c) A, as surety for B, makes a bond jointly with B to C, to secure a loan from C to B. Afterwards, C obtains from B a further security for the same debt. Subsequently, C gives up the further security. A is not discharged.

#### B. Rights against Principal Debtor

- (i) Right to be relieved of liability before payment has been made. But before he can do so, debt must be ascertained. Once the principal debtors' liability accrues as a fixed sum, the surety can ask him to exonerate him from that liability
- (ii) Implied promise to indemnify surety (Section 145): In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee, but no sums which he has paid wrongfully.

#### Illustrations

- (a) B is indebted to C, and A is surety for the debt. C demands payment from A, and on his refusal sues him for the amount. A defends the suit, having reasonable grounds for doing so, but is compelled to pay the amount of the debt with costs. He can recover from B the amount paid by him for costs, as well as the principal debt.

- (b) C lends B a sum of money, and A, at the request of B, accepts a bill of exchange drawn by B upon A to secure the amount. C, the holder of the bill, demands payment of it from A, and, on A's refusal to pay, sues him upon the bill. A, not having reasonable grounds for so doing, defends the suit, and has to pay the amount of the bill and costs. He can recover from B the amount of the bill, but not the sum paid for costs, as there was no real ground for defending the action.
- (c) A guarantees to C, to the extent of ₹ 2,000, payment for rice to be supplied by C to B. C supplies to B rice to a less amount than ₹ 2,000, but obtains from A payment of the sum of ₹ 2,000 in respect of the rice supplied. A cannot recover from B more than the price of the rice actually supplied.

### C. Right against Co-Sureties (Right of Contribution)

#### (i) Co-Sureties liable to contribute equally (Section 146)

Where two or more persons are co-sureties for the same debt or duty, either jointly or severally, and whether under the same or different contracts, and whether with or without the knowledge of each other, the co sureties, in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt or of that part of it which remains unpaid by the principal debtor.

#### Illustrations

- (a) A, B and C are sureties to D for the sum of ₹ 3,000 lent to E. E makes default in payment. A, B and C are liable, as between themselves, to pay ₹ 1,000 each.
- (b) A, B and C are sureties to D for the sum of ₹ 1,000 lent to E, and there is a contract between A, B and C that A is to be responsible to the extent of one-quarter, B to the extent of one-quarter, and C to the extent of one-half. E makes default in payment. As between the sureties, A is liable to pay ₹ 250, B ₹ 250, and C ₹ 500.

#### (ii) Liability of co-sureties bound in different sums (Section 147)

Co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit.

#### Illustrations

- (a) A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of ₹ 10,000, B in that of ₹ 20,000, C in that of ₹ 40,000, conditioned for D's duly accounting to E. D makes default to the extent of ₹ 30,000. A, B and C are each liable to pay ₹ 10,000.
- (b) A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of ₹ 10,000, B in that of ₹ 20,000, C in that of ₹ 40,000, conditioned for D's duly accounting to E. D makes default to the extent of ₹ 40,000; A is liable to pay ₹ 10,000, and B and C ₹ 15,000 each.
- (c) A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of ₹ 10,000, B in that of ₹ 20,000, C in that of ₹ 40,000, conditioned for D's duly accounting to E. D makes default to the extent of ₹ 70,000. A, B and C have to pay each the full penalty of his bond.
- (iii) A release by creditor of one of the co-sureties, does not discharge the others, nor does it free the co-surety so released, from his responsibility to other sureties.

### 1.14.10 Discharge of a Surety

#### A. By revocation which may be by way of –

- (i) Giving notice (**Section 130**): A specific guarantee cannot be revoked by the surety if the liability has already accrued. But continuing guarantee can be revoked by notice as to future transactions.



### Example:

A in consideration of B's discounting at A's request bills of exchange for C, guarantees to B for twelve months, the due payment of all such bills to the extent of ₹ 50000. B discounts the bill for C to the extent of ₹ 24,000. Afterwards, at the end of the three months, A revokes the guarantee. The revocation discharges A from liability to B for any subsequent discount. But A is liable to B for ₹ 24,000 on default of C.

- (ii) Death of surety (**Section 131**): Surety stands discharged for future transactions unless is contrary is not there in the contract. But deceased surety's estate cannot be liable for any transactions between the creditors and principal debtors after the death of the surety even if the creditor has no notice thereof.
- (iii) Novation i.e. substitution of with a new contract for an old one.

### B. By conduct of creditor –

#### (i) By Variance in terms of contract (Section 133)

Any variance, made without 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.

#### Illustrations

- (a) A becomes surety to C for B's conduct as a manager in C's bank. Afterwards, B and C contract, without A's consent, that B's salary shall be raised, and that he shall become liable for one-fourth of the losses on overdrafts. B allows a customer to overdraw, and the bank loses a sum of money. A is discharged from his surety ship by the variance made without his consent, and is not liable to make good this loss.
- (b) A guarantees C against the misconduct of B in an office to which B is appointed by C, and of which the duties are defined by an Act of the Legislature. By a subsequent Act, the nature of the office is materially altered. Afterwards, B misconducts himself. A is discharged by the change from future liability under his guarantee, though the misconduct of B is in respect of a duty not affected by the later act.
- (c) C agrees to appoint B as his clerk to sell goods at a yearly salary, upon A's becoming surety to C for B's duly accounting for moneys received by him as such clerk. Afterwards, without A's knowledge or consent, C and B agree that B should be paid by a commission on the goods sold by him and not by a fixed salary. A is not liable for subsequent misconduct of B.
- (d) A gives to C a continuing guarantee to the extent of ₹ 3,000 for any oil supplied by C to B on credit. Afterwards B becomes embarrassed, and, without the knowledge of A, B and C contract that C shall continue to supply B with oil for ready money, and that the payments shall be applied to the then existing debts between B and C. A is not liable on his guarantee for any goods supplied after this new arrangement.
- (e) C contracts to lend B ₹ 5,000 on 1st March. A guarantees repayment. C pays the ₹ 5,000 to B on 1st January. A is discharged from his liability, as the contract has been varied, in as much as C might sue B for the money before 1st March.

#### (ii) By release or discharge of principal debtor (Section 134)

The surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.

### Illustrations

- (a) A gives a guarantee to C for goods to be supplied by C to B. C supplies goods to B, and afterwards B becomes embarrassed and contracts with his creditors (including C) to assign to them his property in consideration of their releasing him from their demands. Here B is released from his debt by the contract with C, and A is discharged from his surety ship.
- (b) A contracts with B to grow a crop of indigo on A's land and to deliver it to B at a fixed rate, and C guarantees A's performance of this contract. B diverts a stream of water which is necessary for irrigation of A's land and thereby prevents him from raising the indigo. C is no longer liable on his guarantee.
- (c) A contracts with B for a fixed price to build a house for B within a stipulated time, B supplying the necessary timber. C guarantees A's performance of the contract. B omits to supply the timber. C is discharged from his suretyship.

### (iii) When creditor compounds with, gives time to, or agrees not to sue, principal debtor (Section 135)

A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or not to sue, the principal debtor, discharges the surety, unless the surety assents to such contract.

#### Example:

A the holder of an overdue bill of exchange drawn by B as surety for C and accepted by C, contracts with D to give additional time to C. B is not discharged.

### (iv) Discharge of Surety by Creditor's Act or Omission Impairing Surety's Eventual Remedy (Section 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.

### Illustrations

- (a) B contracts to build a ship for C for a given sum, to be paid by installments as the work reaches certain stages. A becomes surety to C for B's due performance of the contract. C, without the knowledge of A, prepays to B the last two installments. A is discharged by this prepayment.
- (b) C lends money to B on the security of a joint and several promissory note made in C's favour by B, and by A assuredly for B, together with a bill of sale of B's furniture, which gives power to C to sell the furniture, and apply the proceeds in discharge of the note. Subsequently, C sells the furniture, but, owing to his misconduct and willful negligence, only a small price is realised. A is discharged from liability on the note.
- (c) A puts M as apprentice to B, and gives a guarantee to B for M's fidelity. B promises on his part that he will, at least once a month, see that M make up the cash. B omits to see this done as promised, and M embezzles. A is not liable to B on his guarantee.

### C. By invalidation of contract:

- (i) *Guarantee Obtained by Misrepresentation Invalid (Section 142)* — Any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid and thus discharge the surety to that extent.



- (ii) **Guarantee Obtained by Concealment Invalid (Section 143)** —Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid and thus discharge the surety to that extent.

**Illustrations**

- (a) A engages B as a clerk to collect money for him, B fails to account for some of his receipts, and A in consequence calls upon him to furnish security for his duly accounting. C gives his guarantee for B's duly accounting. A does not acquaint C with B's previous conduct. B afterwards makes default. The guarantee is invalid.
- (b) A guarantees to C payment for iron to be supplied by him to B to the amount of 2,000 tons. B and C have privately agreed that B should pay five rupees per ton beyond the market price, such excess to be applied in liquidation of an old debt. This agreement is concealed from A. A is not liable as a surety.
- (iii) **Guarantee on Contract that Creditor shall not Act on it until Co-Surety joins (Section 144)** — 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.

**Example:**

B signed a guarantee given to a bank which on the face of it was intended to be the joint and several guarantee of A, B and C and D, D did not sign and afterwards died. The bank did not agree with A, B and C to dispense with D's signatures. Held A and B will not be liable [National Provincial Bank of England V Brackenbury 1966 22 TLR 727]

- (iv) If there is failure of consideration between creditor and principal debtor.

**Cases When Surety is not Discharged:**

**Surety is not discharged in the following circumstances;**

**(a) When Agreement Made with Third Person to Give Time to Principal Debtor (Section 136)**

Where a contract to give time to the principal debtor is made by the creditor with a third person, and not with the principal debtor, the surety is not discharged.

**Example:**

C, the holder of an overdue bill of exchange drawn by A as surety for B, and accepted by B, contracts with M to give time to B. A is not discharged.

**(b) Creditor's Forbearance to Sue Does (Section 137)**

Mere forbearance on the part of the creditor to sue the principal debtor or to enforce any other remedy against him does not, in the absence of any provision in the guarantee to the contrary, discharge the surety.

**Example:**

B owes to C a debt guaranteed by A. The debt becomes payable. C does not sue B for a year after the debt has become payable. A is not discharged from his suretyship.

**(c) Release of One Co-Surety (Section 138)**

Where there are co-sureties, a release by the creditor of one of them does not discharge the others; neither does it free the surety so released from his responsibility to the other sureties.

## 1.15 BAILMENT

### Introduction

In laymen's term Bailment means to deliver or to hand over. It involves change of possession and not of ownership. It implies a sort of relationship in which the personal property of one person temporarily goes into the possession of another person. The provisions relating to Bailment and Pledge are contained in section 148 to 181 of the Act.

There are three different types of Bailment for which different Acts namely The Railway Act, 1989, The Carrier Act, 1865. The Carriage of Goods by Sea Act, 1925 which deals with these types of special Bailment. However, the Indian Contract Act, 1872 just deals with general principals underlying contract of Bailment.

The term bailment is derived from the French word "bailer": which means to deliver. Etymologically, it means any kind of handling over. In legal sense it involves change of possession of goods from one person to another for some specific purpose.

#### 1.15.1 "Bailment", "Bailor" and "Bailee" (Section 148)

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".

**Explanation :** If a person already in possession of the goods of another contract to hold them as a bailee, he thereby becomes the bailee, and the owner becomes the bailor, of such goods, although they may not have been delivered by way of bailment.

- (i) From the definition it is clear that 'bailment' is concerned only with goods.
- (ii) Another point which brings out the salient features of bailment is that it is delivery of possession to another person .
- (iii) Delivery to another person should be for accomplishment of some purpose; and
- (iv) Goods to be returned to the original owner on accomplishment of the defined purpose. We can understand this with the following examples.

#### Example 1:

X delivered his scooter to Y an authorized Auto-Care dealer for repair and servicing of all types of Auto vehicles for repair and servicing of his scooter. This is a case of bailment as it has all the essential features (i) transfer of delivery to auto centre (ii) purpose to be accomplished is to repair and service the scooter (iii) on accomplishment of the purpose i.e., repair and servicing the scooter is to be delivered back to the owner X on payment of repair and servicing charges. This is a contract of Bailment.

#### Example 2:

A sold some goods to B, B however for some time left the goods with A. This is a case of bailment.

Bailment is not always by a contract between the parties. At times it turnout to be case of bailment without volition of any party. Say finder of lost goods, the finder of goods become a bailee and have the same responsibility to that of a bailee.

#### What are the requisite of a bailment?

As stated above a bailment contract involves the following;

- (a) **Contract:** Bailment is based on the agreement between the parties which may be expressed or implied from the conduct of the parties. But at time it is imposed by law as in the case of finder of



lost goods. Law of equity cast a duty upon the finder of lost goods to take reasonable care of the goods.

**(b) Delivery of possession:** There is temporary transfer of possession between the bailor and bailee.

The delivery of possession may be actual or constructive. Actual delivery may be made by physically handing over the goods bailed to the bailee. Constructive delivery may be made by doing something which has the effect of putting the goods in the possession of the intended bailee or any person authorized to hold them on his behalf.

**Example:**

A lady employed a goldsmith for melting her old jewellery and making a new one out of it. Every evening she received the unfinished jewellery and put it into a box kept at the goldsmith's premises. She kept the key of the box with herself. One night the jewellery was stolen from the box. It was held there was no bailment as the goldsmith had redelivered to the lady the jewellery bailed with him by her [*Kaliperumal v Visalaksmi AIR 1938 Mad 32*]

**(c) Definite purpose:** Delivery of goods from bailor to bailee must be for some purpose. If the goods are delivered to a person by default there is no bailment.

**(d) Return of specific goods.** The same goods must be returned to the bailor after accomplishment of the intended purpose. It is not necessary that the specific goods must be returned in the same form in which they were delivered to the bailee. If a piece of cloth was delivered to the tailor for stitching a shirt, the same cloth must be returned in the form of shirt to the owner rather than the piece of cloth. Similarly when a motor car is delivered to a motor car service centre for repair, the same car must be returned in repaired and serviced condition to the original owner.

As per section 171 of the Indian Contract Act, Bankers, Factors, Wharfingers, Attorneys of a High Court and policy-brokers may, in the absence of a contract to the contrary, retain, as a security for a general balance of account any goods bailed to them; but no other persons have a right to retain, as a security for such balance, goods bailed to them, unless there is an express contract to the effect.

### 1.15.2 Types of Bailment:

Based on the benefits derived by the parties, bailment can be of the following types:

**(a) Bailment for the exclusive benefit of the bailor wherein no charges are paid by the bailor to the bailee.**

**Example:**

X and Y are two good friends. X left for one month's foreign tour and left all the valuables with his friend Y. This is also a bailment for the benefit of bailor only as no charges are to be paid by X to Y for taking care of his valuables.

**(b) For exclusive benefit of the bailee without any compensation to the bailor.**

**Example:**

X lends his Car to Y a personal friend of X for his use without any charges. This is a bailment for the benefit of Y bailee only.

**(c) Mutual benefit of both the parties. In this type of bailment there is a consideration from both the sides.**

**Example:**

X delivered his car to Y a auto centre for repair and maintenance. After repair and maintenance the car is to be delivered back to X on payment of repair and service charges. Here consideration from bailor side is repair and servicing charges to be paid and from bailee side is to do necessary repair and maintenance.

Bailment can also be classified into:

- (a) Gratuitous bailment: It is a bailment where there is no consideration from either side.
- (b) Non Gratuitous bailment or bailment for reward: Here consideration passes between bailor and bailee.

### 1.15.3 Delivery to Bailee how Made (Section 149)

The delivery to the bailee may be made by doing anything which has the effect of putting the goods in the possession of the intended bailee or of any person authorized to hold them on his behalf.

**Consideration for bailment :** The detriment suffered by the bailor, in parting with the possession of the goods, is sufficient consideration to support the contract of bailment.

What are the duties of a bailor in a bailment contract?

Now we discuss the duties of a bailor.

### 1.15.4 Duties of Bailor:

A bailor has the following duties in the bailment contract:

#### (a) To disclose faults in goods bailed (Section 150):

The bailor is bound to disclose to the bailee faults in the goods bailed, of which the bailor is aware, and which materially interfere with the use of them, or expose the bailee to extraordinary risks; and if he does not make such disclosure, he is responsible for damage arising to the bailee directly from such faults.

If the goods are bailed for hire, the bailor is responsible for such damage, whether he was or was not aware of the existence of such faults in the goods bailed.

#### Illustrations:

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

#### (b) To bear extra-ordinary expenses on bailment:

The bailee is expected to take reasonable and ordinary care of the goods bailed to him. But when extraordinary expense is required on the goods bailed the same are to be borne by the bailor.

#### Example:

A lend his car to B for one week. Usual running and maintenance charges are to be borne by B. However, if due to some reasons the engine is to be overhauled, expenses thereon is to be borne by A.

If, 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, the bailor is required to repay to the bailee the necessary expenses incurred by him for the purpose of the bailment.

- (c) **To indemnify bailee for loss in case of premature termination of gratuitous bailment:** In a gratuitous bailment the bailor can terminate the bailment any time, but in that case the loss accruing to the bailee from such premature termination should not exceed the benefit he has derived out of the bailment. If the loss exceeds the benefit derived by the bailee, the bailor has to make good the loss.



### Example:

A lend his old motor car to his friend D for three months gratuitously. D incurred ₹ 50,000 on complete overhauling the car, however after one month A asked D to return the car. A should compensate him if the benefit derived by D for using the car for one month is less than the cost of ₹ 50,000 incurred by him.

As per **section 159** of the Act the lender of a thing for use may at any time require its return, if the loan was gratuitous, even though he lent it for a specified time or purpose. But if, on the face of such loan made for a specified time or purpose, the borrower has acted in such a manner that the return of the thing lent before the time agreed upon would cause him loss exceeding the benefit actually derived by him from the loan, the lender must, if he compels the return, indemnify the borrower for the amount in which the loss so occasioned exceeds the benefit so derived.

- (d) **To receive back the goods:** It is the duty of bailor to take back the goods after the purpose for which the goods were delivered to the bailee is accomplished. Failure to do so within a reasonable time entitles the bailor to demand compensation from him.
- (e) **To indemnify the bailee:** Where the title of the bailor to the goods is defective and the bailee suffers as a consequence the bailor is responsible to the bailee for any loss which the bailee might sustain by reason that the bailor was not entitled to make bailment or receive back the goods or to give directions respecting them.

### 1.15.5 Duties of Bailee:

Both the bailor and bailee have some rights and some duties in the contract of bailment. As we have already discussed the duties of a bailor, now we discuss the duties of a bailee imposed by the contract Act. The duties of a bailee are summarized as under:

#### (a) Duty to take care (Section 151):

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.

The onus is upon the bailee to prove that there has been no failure or negligence on his part to take reasonable care of the goods entrusted to him.

#### Example:

A delivered his car to B for servicing and periodic servicing. However, a Stereo player and car stepny was stolen from the car before returning back the car to A. B neither informed A nor lodged any FIR. B is liable to A as he has not taken reasonable care in the instant case. The onus lies upon B to prove that there was no negligence on his part.

However, the bailee, in the absence of any special contract, is not responsible for the loss, destruction or deterioration of the thing bailed, if he has taken the amount of care of it described in section 151.

#### (b) Not to make unauthorised use of goods bailed (Section 154):

Bailee is not expected to make unauthorised use of the goods bailed to him. If the bailee makes any use of the goods bailed, which is not according to the conditions of the bailment, he is liable to make compensation to the bailor for any damage arising to the goods from or during such use of them.

#### Illustrations

- (a) A lends a horse to B for his own riding only. B allows C, a member of his family, to ride the horse. C rides with care, but the horse accidentally falls and is injured. B is liable to make compensation to A for the injury done to the horse.

(b) A hires a horse in Kolkata from B expressly to march to Benares. A rides with due care, but marches to Cuttack instead. The horse accidentally falls and is injured. A is liable to make compensation to B for the injury to the horse.

(c) A contract of bailment is voidable at the option of the bailor, if the bailee does any act with regard to the goods bailed, inconsistent with the conditions of the bailment.

**Example:**

A lets to B, for hire, a horse for his own riding. B drives the horse in his carriage. This is, at the option of A, a termination of the bailment.

(d) **Not to mix the goods bailed with other goods.** The bailor must take reasonable care to ensure that the goods bailed do not mix with his own goods. If he mixes the bailed goods with his own goods the following rules will apply depending whether the mixing was with or without consent of bailor:

(i) If the bailee, with the consent of the bailor, mixes the goods of the bailor with his own goods, the bailor and the bailee shall have an interest, in proportion to their respective shares, in the mixture thus produced.

(ii) If the bailee, without the consent of the bailor, mixes the goods of the bailor with his own goods, and 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 or division, and any damage arising from the mixture.

**Example 1:**

A bails 100 bales of cotton marked with a particular mark to B. B, without A's consent, mixes the 100 bales with other bales of his own, bearing a different mark; A is entitled to have his 100 bales returned, and B is bound to bear all the expenses incurred in the separation of the bales, and any other incidental damage.

**Example 2:**

A bails a barrel of Cape flour worth ₹ 45 to B. B, without A's consent, mixes the flour with country flour of his own, worth only ₹ 25 a barrel. B must compensate A for the loss of his flour.

(e) **Not to set up an adverse title:** Bailee should hold the goods on behalf of the bailor. If he delivers the goods bailed to other persons, he must prove that such third person has a right over the goods as against the bailor.

(f) **To return any accretion to the bailed goods.** Bailor is bound to return any accretion on the bailed goods to the bailee unless there is a contract to the contrary.

**Example:**

X delivered his cow to Y for his care and custody until he returns from tour. Meanwhile the cow gave birth to a calf. While returning the cow X is bound to return both the cow and calf to X.

(g) **To return the bailed goods timely.** It is duty of bailee to return the goods bailed to him as per the direction of the bailor after accomplishment of the intended purpose without demand from the bailor. If he fails to do so he is responsible to the bailor for any loss despite reasonable care by him.

**Example:**

A delivered his scooter to B for repair and servicing. B did the necessary servicing and repair demanded by the scooter. Despite having requested by A to deliver the scooter to him, he did not deliver the scooter and after one week the scooter was stolen by a thief. B is liable to A because he failed to return the scooter within a reasonable time even after repeated request by A.

As per section 161 of the Act, if, by the default of the bailee, the goods are not returned, delivered or tendered at the proper time, he is responsible to the bailor for any loss, destruction or deterioration of the goods from that time.



### 1.15.6 Rights of Bailor

#### (a) Right to increase or profit from goods bailed out.

As per section 165 of the Act in the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, or according to his directions, any increase or profit which may have accrued from the goods bailed.

#### Example:

A leaves a cow in the custody of B to be taken care of. The cow has a calf, B is bound to deliver the calf as well as the cow to A.

#### (b) Right of enforcement: The bailor has right to enforce by suit all the liabilities or duties of the bailee as his rights.

#### (c) Right to have the goods returned in accordance with direction. When the goods are lent gratuitously the bailor can demand their return whenever he like even though he lent them for specified time or purpose. In case of gratuitous bailment if the bailee has suffered any loss due to premature termination of bailment the bailor is to compensate him.

#### (d) Right to have compensation from wrong doer. As per section 180 if a third person wrongfully deprives the bailee of the use or possession of the goods bailed, or does them any injury, the bailor or the bailee may bring a suit against the third person for such deprivation or injury.

#### Example:

X delivered his Maruti 800 to Auto mart for routine servicing and maintenance check up. However, Y a local bad boy of the area prevented the service centre from servicing the car of X and on the other hand caused some damage to the car also. X is entitled to proceed against Y for his wrong doing.

### 1.15.7 Bailor's Responsibility to Bailee (Section 164)

The bailor is responsible to the bailee for any loss which the bailee may sustain by reason that the bailor was not entitled to make the bailment, or to receive back the goods or to give directions, respecting them.

### 1.15.8 Rights of Bailee

#### (a) As per section 165 of the Act if several joint owners of goods bail them, the bailee may deliver them back to, or according to the directions of, one joint owner without the consent of all, in the absence of any agreement to the contrary. In other words if there is nothing in the contract to have consent of all the joint owners, the bailee can deliver the goods to one of the joint owners without any consent of others.

#### Example:

A,B,C are the joint owner of a CAB, they delivered it to D on one month's hire charges. After one month D can return the same to either of the joint owners A, B or C without taking consent of all of them. However, if the agreement, provides that it has to be returned back to one particular owner, say A, then it must be returned to him only.

#### (b) As per section 166 if the bailor has no title to the goods, and the bailee, in good faith, delivers them back to, or according to the directions of, the bailor, the bailee is not responsible to the owner in respect of such delivery.

#### (c) As per section 167 if a person, other than the bailor, claims goods bailed, he may apply to the Court to stop the delivery of the goods to the bailor, and to decide the title to the goods.

#### Example:

A send his car to an authorized motor car service centre for repair. Before taking back the car

from the service centre after repairs D a local private financier approach the service centre and claims his title over the car.

A can approach the court to stop delivery of the goods to D and decide the title of the goods.

- (d)** As per section 170 of the Act where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the services he has rendered in respect of them. This is bailee's particular lien.

**Illustrations:**

- (i) A delivers a rough diamond to B, a jeweller, to be cut and polished, which is accordingly done. B is entitled to retain the stone till he is paid for the services he has rendered.
- (ii) A gives cloth to B, a tailor, to make into a coat. B promises A to deliver the coat as soon as it is finished, and to give a three-months' credit for the price. B is not entitled to retain the coat until he is paid.

**1.15.9 Rights of a Finder of Lost Goods.**

At times we do come across some lost goods of other which we take in our own custody. We are otherwise not obliged to pick it up. But if we do so, we have some liability toward the goods as the bailee has on the goods bailed. As per section 71 of the Indian Contract Act, a person who finds goods belonging to others and take them on his custody is subject to the same responsibility as the bailee.

The rights of the finder of a lost goods as discussed in Indian Contract Act, 1872, are being reproduced here as follows:

- A) Right of lien (Sec 168):** The finder of goods has a right of lien over the goods for his expenses. The finder of goods has no right to sue the owner for compensation for trouble and expense voluntarily incurred by him to preserve the goods and to find out the owner but he may retain the goods against the owner until he receives such compensation.

**B) Right to finder of goods may sue for specified reward offered (Sec 168):**

The finder of goods has no right to sue the owner for compensation for trouble and expense, voluntarily incurred by him to preserve the goods and to find out the owner; but he may retain the goods against the owner until he receive such compensation; and where the owner has offered a specific reward for the return of goods lost, the finder may sue for such reward, and may retain the goods until he received it.

**C) Right to sell (Sec 169):**

When thing which is commonly the subject of sale is lost, if the owner cannot with reasonable diligence be found, or if he refuses upon demand, to pay the lawful charges of the finder, the finder may sell it:

- (i) when the thing is in danger of perishing or of losing the greater part of its value, or
- (ii) when the lawful charges of the finder, in respect of the thing found, amount to two-thirds of its value.

**1.15.10 Duties of a Finder of Lost Goods:**

- (a) He must take reasonable care of the goods and if in spite of this the goods are destroyed for no negligence on his part he is not liable for it.
- (b) He must not own the goods for his own purpose
- (c) He must not mix up the goods with other goods
- (d) He must try to find out the true owner of the goods. If he fails to do so he is liable as a trespasser.



### 1.15.11 Termination of Bailment:

A contract of bailment is terminated in the following cases:

**(a) On the expiry of the period:** When the bailment is for a specific period. It terminates on its expiry.

**Example:**

A lends his three wheeler Auto to his friend B on three months hire on payment of monthly hire charges. On the expiry of 3 months the bailment contract stand discharged.

**(b) On achievement of the object;** When the bailment is for a specific purpose, it stands terminated on accomplishment of that purpose.

**Example:**

S deliver his motor cycle to T for repair. On completion of repair work by T the bailment stands discharged.

**(c) Destruction of the subject matter goods;** A bailment stand discharged on destruction of the subject matter or when by reasons of change in nature it becomes incapable of use for purpose of the bailment.

**(d) Death of bailee or bailor:** A gratuitous bailment stands discharged by the death of either of the party i.e. bailor or bailee.

**(e)** Gratuitous bailment can be terminated any time subject to conditions laid down in section 159 of the Contract Act

### 1.15.12 Suits by Bailees or Bailors against Wrong-Doers

#### 1. Right to interplead:

If a person, other than the bailor, claims the goods bailed, he may apply to the courts to stop delivery of the goods bailed and to decide the title to the goods (Sec. 167).

#### 2. Suit by bailor or bailee against wrong-doer

If a third party wrongfully deprives the bailee of the use of the goods bailed or does them any injury, the bailee is entitled to use all such remedies as the owner of the goods might have used. Either the bailee or the bailor may file a suit against the third party in such cases (Sec. 180).

#### 3. Apportionment of relief or compensation obtained by such suits

Whatever is obtained by way of relief or compensation in any such suits shall, as between the bailor and the bailee be dealt with according to their respective interests (Sec. 181).

### 1.15.13 Bailee's Particular Lien (Section 170)

'Lien' means right of a person to retain possession of some goods belonging to another until claim of the person in possession is satisfied.

Where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the services he has rendered in respect of them.

#### Illustrations

(a) A delivers a rough diamond to B, a jeweller, to be cut and polished, which is accordingly done. B is entitled to retain the stone till he is paid for the services he has rendered.

(b) A gives cloth to B, a tailor, to make into a coat. B promises A to deliver the coat as soon as it is finished, and to give a three-months' credit for the price. B is not entitled to retain the coat until he is paid.

### 1.15.14 General Lien of Bankers, Factors, Wharfingers, Attorneys and Policy-Brokers (Section 171)

Bankers, factors, wharfingers, attorney of High Court and policy-brokers may, in the absence of a contract to the contrary, retain, as a security for a general balance of account any goods bailed to them; but no other persons have a right to retain, as a security for such balance, goods bailed to them, unless there is an express contract to the effect.

## 1.16 PLEDGE

Pledge or pawn is a special kind of bailment in which goods are delivered as a security for payment of a debt. In other words when bailment of goods is as a security for payment of a debt or performance of a promise, it is called pledge.

### 1.16.1 "Pledge", "Pawnor" and "Pawnee" (Section 172)

The bailment of goods as security for payment of a debt or performance of a promise is called "pledge". The bailor is in this case called the "pawnor". The bailee is called the "pawnee".

#### Example:

A took a personal loan of ₹ 50,000 from B and offered his golden ring as a security for due payment of the loan. Here the bailment of golden ring is a pledge.

#### What can be pledged?

Any moveable goods including document, valuables, Fixed deposit receipt, Saving bank a/c can be pledged. The only condition is the property to be pledged must be delivered which may be actual or constructive.

#### How bailment is different from pledge?

Bailment can be for any purpose but pledge can be for the purpose of security for the performance of a specific purpose.

In case of default by the pawnor to repay the debt, the pawnee may after giving notice to the pawnor can sell the pledged goods. On the other hand the bailee may either retain the goods or sue for his charges.

Pawnee has no right to use the goods pledged for his own use but in case of a bailment the bailee can use the goods if the terms of contract so provide.

### 1.16.2 Rights of a Pawnee:

#### (a) Right to retain the goods.

As per section 173 of the Act the pawnee may retain the goods pledged, not only for payment of the debt or the performance of the promise, but for the interest, of the debt, and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged.

(b) As per section 174 of the Act the pawnee cannot, in the absence of a contract to that effect retain the goods pledged for any debt or promise other than the debt or promise for which they are pledged; but such contract, in the absence of anything to the contrary, can be presumed in regard to subsequent advances made by the pawnor.

(c) As per section 175 the pawnee is entitled to receive from the pawnor extraordinary expenses incurred by him for the preservation of the goods pledged. But for such expenses he has no right to retain the goods he can only sue to recover them.

(d) As per section 176 if the pawnor makes default in payment of the debt, or performance, at the stipulated time, of the promise, in respect of which the goods were pledged, the pawnee may bring a suit against the pawnor upon the debt or promise, and retain the goods pledged as a



collateral security; or he may sell the thing pledged on giving the pawnor reasonable notice of the sale.

If the proceeds of such sale are less than the amount due in respect of the debt or promise, the pawnor is still liable to pay the balance. If the proceeds of the sale are greater than the amount so due, the pawnee shall pay over the surplus to the pawnor.

- (e) Right against true owner, when the pawnee's title is defective: if the title acquired by the pawnor is defective being obtained by fraud or misrepresentation or undue influence, coercion and the contract has not been rescinded, the pawnee acquires a good title to the goods provided he acts in good faith.

### 1.16.3 Rights of Pawnor:

Like pawnee, pawnor also have some rights which are discussed hereunder:

- (a) **Right to redeem the goods/debts:** If a time is stipulated for the payment of the debt, or performance of the promise, for which the pledge is made, and the pawnor makes default in payment of the debt or performance of the promise at the stipulated time, he may redeem the goods pledged at any subsequent time before the actual sale of them; but he must, in that case, pay, in addition, any expenses which have arisen from his default.
- (b) **Preservation and maintenance of the goods.** The pawnor has a right to see that the pledged goods are properly maintained and preserved by the pawnee.
- (c) Rights of an ordinary debtors as provided under various statutes meant for protection of debtor.

### 1.16.4 Pledge by Non-Owners

As per common understanding only the true real owner can pledge the goods but in the following cases even a non owner can create a valid pledge.

- I. **Pledge by mercantile agent (Section 178)** — Where a mercantile agent is, with the consent of the owner, in possession of goods or the documents of title to goods, any pledge made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorised by the owner of the goods to make the same; provided that the pawnee acts in good faith and has not at the time of the pledge notice, that the pawnor has no authority to pledge.  
**Explanation:** In this section, the expressions 'mercantile agent' and 'documents of title' shall have the meanings assigned to them in the Indian Sale of Goods Act, 1930.
- II. **Pledge by person in possession under voidable contract (Section 178A)** — When the pawnor has obtained possession of the goods pledged by him under a contract voidable under section 19 or section 19A, but the contract has not been rescinded at the time of the pledge, the pawnee acquires a good title to the goods, provided he acts in good faith and without notice of the pawnor's defect of title.
- III. **Pledge where pawnor has only a limited interest (Section 179)** — Where a person pledges goods in which he has only a limited interest, the pledge is valid to the extent of that interest.
- IV. Pledge by seller after or buyer before sale can create a valid pledge provided the pawnee acts in good faith and has no notice of previous sale of goods to the buyer or lien of seller on the goods.
- V. Pledge by co-owner in possession thereof with consent of other co-owners may create a valid pledge.

### 1.16.5 Suit by Bailor or Bailee against Wrong-Doer (Section 180)

If a third person wrongfully deprives the bailee of the use or possession of the goods bailed, or does them any injury, the bailee is entitled to use such remedies as the owner might have used in the like case if no bailment had been made; and either the bailor or the bailee may bring a suit against a third person for such deprivation or injury.

### 1.16.6 Apportionment Of Relief Or Compensation Obtained By Such Suits (Section 181)

Whatever is obtained by way of relief or compensation in any such suit shall, as between the bailor and the bailee, be dealt with according to their respective interests.

## 1.17 CONTRACTS OF AGENCY

Now a days it is getting difficult and impossible for all of use to do our work on our own. In the business world, most of the works are executed through agents. Consciously or unconsciously we all play the role of agent and principal in our day to day life. You ask your brother to visit the Electricity office and settle the bill. Your brother acted as an agent and you as a Principal are liable for his act. Similarly if you are working in some organization you act as an agent of the business owner/proprietor. So it is necessary to know the rules regarding agents provided in the Indian Contract Act, 1872.

### 1.17.1 Agent (Section 182)

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 so represented, is called the "principal". The function of agent is to bring his principal in contact with third person.

What are essential characteristics of Agency?

- (a) Terms of agency depends upon the agreement between the principal and agent, but it is not necessary to have any agreement in writing. As between principal and third party any person can become an agent.
- (b) No consideration is required to create agency.
- (c) Intention of the parties: whether a person does intend to act on behalf of another person as an agent is also an important point. Unless and until the person has intention to act as an agent, there cannot be any agency relationship.

### 1.17.2 Rules of Agency

- (i) There is a well known rule whatever a person can do personally he can do so through his agent. This is subject to a well known rule that when the act to be done is personal one in character like marriage, which cannot be done through agent.
- (ii) He who acts through an agent, does it himself subject to certain conditions.. As per section 226 an agent act and contract will have the same legal consequence if the contract had been entered between the contractor and the principal and the act has been done by the principal himself.

#### Example 1:

A being an agent of B receive the money due by C to B. This act of A discharge the debt of C to B.

#### Example 2:

A not knowing that B is an agent of C, the owner of the shop buy goods from B and pay the price thereof to B. C in a suit by A cannot claim a debt to himself from B.

### 1.17.3 Who may Employ Agent (Sec 183)?

As per section 183 of the Act 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. Accordingly a minor or a lunatic person or a drunken person cannot appoint an agent.

### 1.17.4 Who may be an Agent (Sec 184)?

As per section 184 as between the principal and third persons any person may become an agent, but



no person who is not of the age of majority and of sound mind can become an agent, so as to be responsible to his principal according to the provisions in that behalf herein contained. But a minor can be appointed as an agent but he is not responsible to the principal.

### 1.17.5 Consideration not Necessary

No consideration is necessary to create an agency. **(Section 185)**

### 1.17.6 What is the test of Agency?

At times a question is raised whether a person has acted in the capacity of someone or not. This leads us to a question: What is the real test of agency. If the person has a capacity to bind the principal and make him answerable to the third person by bringing the principal into a legal relationship with the third person and thus establish a privity of contract between the parties. If the answer is yes, it is a case of agency-principal relationship, otherwise not.

### 1.17.7 Creation of Agency

- I. **By express agreement:** The usual form of a contract of agency is a power of attorney on a stamped paper.
- II. **By implied agreement:** Such agency arises when the principal through his conduct leads the third party to believe that certain person is his agent. It includes:
  - (i) Agency by estoppel: Where a person by his conduct or by words spoken or written lead another person to believe that the person is his agent, he is precluded from denying that subsequently.
  - (ii) Agency by holding out: Agency by holding out is a branch of the agency by estoppel. A prior positive or affirmative action on the part of the principal is required to establish agency relationship.
  - (iii) Agency by necessity: In certain urgent cases the law confers an authority on a person to act as an agent for the benefit of another person when there is no opportunity to communicate between them. This is called agency by necessity.

#### Example 1:

A and B are two real brothers. A lives in Delhi whereas B lives in Kolkata. B has a flat in Delhi which is let out by him and A takes the rent and deposits in B's account. This is a case of agency between A and B even though it is not in writing.

#### Example 2:

A within the hearing of B tell C that he(A) is agent of B. B did not react to it. C later on supplied goods to A believing that he is agent of B and A also pretended to be agent of B. C can claim payment from B as his silence amounted to that A is his agent.

- III. **By ratification:** When a person acts on behalf of another without his consent, and the other person accepts his acts, the acts are said to be ratified. This places the parties in the same position in which they would have been if acts were done with prior authority.

#### Example 1

A sold B's flat without B's authority and remitted the sum in B's bank a/c. B later on ratified his act. The sale is valid as B' has ratified A's act as if it is authorized by him.

#### Example 2:

A took a insurance policy for B without his authority. Later on B ratified A's act and accepted the policy. The policy will be treated a valid policy if B's had authorized it. [(William v North China Insurance co, 1876(1)CPD757]

### What are essential requirement for a valid ratification?

- (a) The principal must have contractual capacity both at the time of the said act as well at the time of ratification.
- (b) The principal must be in existence at the time of contract.
- (c) The agent must purport to act as an agent for a principal who is in contemplation and is identifiable at the time of contract.
- (d) Ratification must be done with the full knowledge of the facts.
- (e) Ratification must be done within a reasonable time.
- (d) The act of ratification must be lawful and legal.
- (g) There can be ratification or rejection of whole transaction in total but not in part
- (h) Ratification should put the third party into damage.

**Effect of ratification (Section 196)**

Where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown such acts. If he ratifies them, the same effects will follow as if they had been performed by his authority.

**Ratification may be expressed or implied (Section 197)**

Ratification may be expressed or may be implied by the conduct of the person on whose behalf the acts are done.

**Illustrations**

- (a) A, without authority, buys goods for B. Afterwards B sells them to C on his own account; B's conduct implies a ratification of the purchase made for him by A.
- (b) A, without B's authority, lends B's money to C. Afterwards B accepts interests on the money from C. B's conduct implies a ratification of the loan.

**Knowledge requisite for valid ratification (Section 198)**

No valid ratification can be made by a person whose knowledge of the facts of the case is materially defective.

**Effect of ratifying unauthorized act forming part of a transaction (Section 199)**

A person ratifying any unauthorized act done on his behalf ratifies the whole of the transaction of which such act formed a part.

**Ratification of unauthorized act cannot injure third person (Section 200)**

An act done by one person on behalf of another, without such other person's authority, which, if done with authority, would have the effect of subjecting a third person to damages, or of terminating any right or interest of a third person, cannot, by ratification, be made to have such effect.

**Illustrations**

- (a) A, not being authorized thereto by B, demands on behalf of B, the delivery of a chattel, the property of B, from C, who is in possession of it. This demand cannot be ratified by B, so as to make C liable for damages for his refusal to deliver.
- (b) A holds a lease from B, terminable on three months' notice: C, an unauthorized person, gives notice of termination to A. The notice cannot be ratified by B, so as to be binding on A.

**IV. By operation of law :** Sometimes agency arises due to operation of law. Promoters of a company and partners of a firm are agents due to such implication.



### **1.17.8 Agent's Authority may be Express or Implied (Section 186)**

The authority of an agent may be express or implied.

#### **1.17.8.1 Definitions of Express and Implied Authority (Section 187)**

An authority is said to be express when it is given by words, spoken or written. An authority is said to be implied when it is to be inferred from the circumstances of the case; and things spoken or written, or the ordinary course of dealing, may be accounted in circumstances of the case.

#### **Example:**

A owns a shop in Serampore, living himself in Kolkata, and visiting the shop occasionally. The shop is managed by B, and he is in the habit of ordering goods from C in the name of A for the purposes of the shop, and of paying for them out of A's funds with A's knowledge. B has an implied authority from A to order goods from C in the name of A for the purposes of the shop.

#### **1.17.8.2 Extent of Agent's Authority (Section 188)**

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

An agent having an authority to carry on a business has authority to do every lawful thing necessary for the purpose, or usually done in the course, of conducting such business.

#### **Illustrations**

- (a) A is employed by B, residing in London, to recover at Bombay a debt due to B. A may adopt any legal process necessary for the purpose of recovering the debt, and may give a valid discharge for the same.
- (b) A constitutes B as his agent to carry on his business of a shipbuilder. B may purchase timber and other materials, and hire workmen, for the purposes of carrying on the business.

#### **1.17.8.3 Agent's Authority in an Emergency (Section 189)**

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

#### **Illustrations**

- (a) An agent for sale may have goods repaired if it be necessary.
- (b) A consigns provisions to B at Kolkata, with directions to send them immediately to C at Cuttack. B may sell the provisions at Kolkata, if they will not bear the journey to Cuttack without spoiling.

### **1.17.9 Sub-Agents when Agent Cannot Delegate (Section 190)**

An agent cannot lawfully employ another to perform acts which he has expressly or impliedly undertaken to perform personally, unless by the ordinary custom of trade a sub-agent may, or from the nature of the agency, a sub-agent must, be employed.

#### **"SUB-AGENT" (Section 191)**

A "Sub-agent" is a person employed by, and acting under the control of, the original agent in the business of the agency.

#### **Representation of Principal by Sub-Agent Properly Appointed (Section 192)**

Where a sub-agent is properly appointed, the principal is, so far as regards third persons, represented by the sub-agent, and is bound by and responsible for his acts as if he were an agent originally appointed by the principal.

**Agent's responsibility for sub-agents**—The agent is responsible to the principal for the acts of the sub-agent.

**Sub-agent's responsibility** — The sub-agent is responsible for his acts to the agent, but not to the principal, except in case of fraud or willful wrong.

**Agent's Responsibility for Sub-Agent Appointed without Authority (Section 193)**

Where an agent, without having authority to do so, has appointed a person to act as a sub-agent, the agent stands towards such person in the relation of a principal to an agent, and is responsible for his acts both to the principal and to third persons; the principal is not represented by or responsible for the acts of the person so employed, nor is that person responsible to the principal.

**Relation between Principal and Person Duly Appointed by Agent to Act in Business of Agency (Section 194)**

Where an agent, holding an express or implied authority to name another person to act for the principal in the business of the agency, has named another person accordingly, such person is not a sub-agent, but an agent of the principal for such part of the business of the agency as is entrusted to him.

**Illustrations**

- (a) A directs B, his solicitor, to sell his estate by auction, and to employ an auctioneer for the purpose. B names C, an auctioneer, to conduct the sale. C is not a sub-agent, but is A's agent for the conduct of the sale.
- (b) A authorizes B, a merchant in Kolkata, to recover the moneys due to A from C & Co. B instructs D, a solicitor, to take legal proceedings against C & Co. for the recovery of the money. D is not a sub-agent, but is a solicitor for A.

**Agent's Duty in Naming Such Person (Section 195)**

In selecting such agent for his principal, an agent is bound to exercise the same amount of discretion as a man of ordinary prudence would exercise in his own case; and, if he does this, he is not responsible to the principal for the acts or negligence of the agent so selected.

**Illustrations**

- (a) A instructs B, a merchant, to buy a ship for him. B employs a ship surveyor of good reputation to choose a ship for A. The surveyor makes the choice negligently and the ship turns out to be unseaworthy and is lost. B is not, but the surveyor is, responsible to A.
- (b) A consigns goods to B, a merchant, for sale B, in due course, employs an auctioneer in good credit to sell the goods of A, and allows the auctioneer to receive the proceeds of the sale. The auctioneer afterwards becomes insolvent without having accounted for the proceeds. B is not responsible to A for the proceeds.

**1.17.10 Termination of Agency (Section 201)**

An agency is terminated by the principal revoking his authority; or by the agent renouncing the business of the agency; or by the business of the agency being completed; or by either the principal or agent dying or becoming of unsound mind; or by the principal being adjudicated an insolvent under the provisions of any Act for the time being in force for the relief of insolvent debtors.

**I. By Act of Parties**

- (i) Agreement between principal and agent.
- (ii) **Revocation by the principal** : The principal may revoke the authority of the agent any time before the authority has been exercised. When agency is continuous one, notice of termination to agent as well as third parties is essential.

The principal cannot revoke the authority given to his agent after the authority has been partly exercised so far as regards such acts and obligations as arise from acts already done in the agency.

**Illustrations**



- (a) A authorizes B to buy 1,000 bales of cotton on account of A, and to pay for it out of A's money remaining in B's hands. B buys 1,000 bales of cotton in his own name, so as to make himself personally liable for the price. A cannot revoke B's authority so far as regards payment for the cotton.
- (b) A authorizes B to buy 1,000 bales of cotton on account of A, and to pay for it out of A's money remaining in B's hands. B buys 1,000 bales of cotton in A's name, and so as not to render himself personally liable for the price. A can revoke B's authority to pay for the cotton.
- (iii) Agency may also be revoked by an agent by express renunciation after giving reasonable notice to principal.

#### **Compensation for revocation by principal, or renunciation by agent (Section 205)**

Where there is an express or implied contract that the agency should be continued for any period of time, the principal must make compensation to the agent, or the agent to the principal, as the case may be, for any previous revocation or renunciation of the agency without sufficient cause.

#### **Notice of revocation or renunciation (Section 206)**

Reasonable notice must be given of such revocation or renunciation; otherwise the damage thereby resulting to the principal or the agent, as the case may be, must be made good to the one by the other.

#### **Revocation and renunciation may be expressed or implied (Section 207)**

Revocation and renunciation may be expressed or may be implied in the conduct of the principal or agent respectively.

#### **Example:**

A empowers B to let A's house. Afterwards A lets it himself. This is an implied revocation of B's authority.

#### **ii. By Operation of Law:**

- (i) Performance of contract.
- (ii) Expiry of time period for which the agent was appointed even if the work is incomplete.
- (iii) Death or insanity of principal or agent.
- (iv) Insolvency of principal or agent
- (v) Destruction of subject matter.
- (vi) Dissolution of company whether it is principal or agent.
- (vii) When the countries of principal and agent breaks into a war.
- (viii) Sub-agents' authority is terminated on termination of authority of the agent.

#### **1.17.10.1 When Termination of Agent's Authority Takes Effect as to Agent, and as to Third Persons (Section 208)**

The termination of the authority of an agent does not, so far as regards the agent, take effect before it becomes known to him, or, so far as regards third persons, before it becomes known to them.

#### **Illustrations**

- (a) A directs B to sell goods for him, and agrees to give B five per cent commission on the price fetched by the goods. A afterwards, by letter, revokes B's authority. B, after the letter is sent, but before he receives it, sells the goods for 100 rupees. The sale is binding on A, and B is entitled to five rupees as his commission.
- (b) A, at Madras, by letter directs B to sell for him some cotton lying in a warehouse in Bombay, and

afterwards, by letter, revokes his authority to sell, and directs B to send the cotton to Madras. B, after receiving the second letter, enters into a contract with C, who knows of the first letter, but not of the second, for the sale to him of the cotton. C pays B the money, with which B absconds. C's payment is good as against A.

- (c) A directs B, his agent, to pay certain money to C. A dies, and D takes out probate to his will. B, after A's death, but before hearing of it, pays the money to C. The payment is good as against D, the executor.

#### **1.17.10.2 Termination of Agency, where Agent has an Interest in Subject-Matter (Section 202)**

Where the agent has himself an interest in the property which forms the subject-matter of the agency, the agency cannot, in the absence of an express contract, be terminated to the prejudice of such interest.

##### **Illustrations**

- (a) A gives authority to B to sell A's land, and to pay himself, out of the proceeds, the debts due to him from A. A cannot revoke this authority, nor can it be terminated by his insanity or death.
- (b) A consigns 1,000 bales of cotton to B, who has made advances to him on such cotton, and desires B to sell the cotton, and to repay himself, out of the price the amount of his own advances. A cannot revoke this authority, nor is it terminated by his insanity or death.

#### **1.17.10.3 Agent's Duty on Termination of Agency by Principal's Death or Insanity (Section 209)**

When an agency is terminated by the principal dying or becoming of unsound mind, the agent is bound to take, on behalf of the representatives of his late principal, all reasonable steps for the protection and preservation of the interests entrusted to him.

#### **1.17.10.4 Termination of Sub-Agent's Authority (Section 210)**

The termination of the authority of an agent causes the termination (subject to the rules herein contained regarding the termination of an agent's authority) of the authority of all sub-agents appointed by him.

#### **1.17.11 Duties of Agent**

##### **I. To carry out work as per direction of Principal (Section 211)**

An agent is bound to conduct the business of his principal according to the directions given by the principal, or, in the absence of any such directions, according to the custom which prevails in doing business of the same kind at the place where the agent conducts such business. When the agent acts otherwise, if any loss be sustained, he must make it good to his principal, and, if any profit accrues, he must account for it.

##### **Illustrations**

- (a) A, an agent engaged in carrying on for B a business, in which it is the custom to invest from time to time, at interest, the moneys which may be in hand, omits to make such investment. A must make good to B the interest usually obtained by such investments.
- (b) B, a broker, in whose business it is not the custom to sell on credit, sells goods of A on credit to C, whose credit at the time was very high. C, before payment, becomes insolvent. B must make good the loss to A.

##### **II. To carry out with care, skill & diligence (Section 212)**

An agent is bound to conduct the business of the agency with as much skill as is generally possessed by persons engaged in similar business, unless the principal has notice of his want of skill. The agent is always bound to act with reasonable diligence, and to use such skill as he possesses; and to make compensation to his principal in respect of the direct consequences of his own neglect, want of skill or misconduct, but not in respect of loss or damage which are indirectly or remotely caused by such neglect, want of skill or misconduct.

### Illustrations

- (a) A, a merchant in Kolkata, has an agent, B, in London, to whom a sum of money is paid on A's account, with orders to remit. B retains the money for a considerable time. A, in consequence of not receiving the money, becomes insolvent. B is liable for the money and interest from the day on which it ought to have been paid, according to the usual rate, and for any further direct loss — as, e.g., by variation of rate of exchange— but not further.
- (b) A, an agent for the sale of goods, having authority to sell on credit, sells to B on credit, without making the proper and usual enquiries as to the solvency of B. B, at the time of such sale, is insolvent. A must make compensation to his principal in respect of any loss thereby sustained.
- (c) A, an insurance-broker, employed by B to affect an insurance on a ship, omits to see that the usual clauses are inserted in the policy. The ship is afterwards lost. In consequence of the omission of the clauses nothing can be recovered from the underwriters. A is bound to make good the loss to B.
- (d) A, a merchant in England, directs B, his agent at Bombay, who accepts the agency, to send him 100 bales of cotton by a certain ship. B, having it in his power to send the cotton, omits to do so. The ship arrives safely in England. Soon after her arrival the price of cotton rises. B is bound to make good to A the profit which he might have made by the 100 bales of cotton at the time the ship arrived, but not any profit he might have made by the subsequent rise.

III. An agent is bound to render proper accounts to his principal on demand. (Section 213)

IV. It is the duty of an agent, in cases of difficulty, to use all reasonable diligence in communicating with his principal, and in seeking to obtain his instructions. (Section 214)

V. Not to deal in his own account: (Section 215) without consent of the principal. If he does so without consent or knowledge of the principal the principal may either repudiate the contract or ask him to remit the benefit to him. If an agent deals on his own account in the business of the agency, without first obtaining the consent of his principal and acquainting him with all material circumstances which have come to his own knowledge on the subject, the principal may repudiate the transaction, if the case shows either that any material fact has been dishonestly concealed from him by the agent, or that the dealings of the agent have been disadvantageous to him.

If an agent, without the knowledge of his principal, deals in the business of the agency on his own account instead of on account of his principal, the principal is entitled to claim from the agent any benefit which may have resulted to him from the transaction.

### Illustrations

- (a) A directs B, his agent, to buy a certain house for him. B tells A it cannot be bought, and buys the house for himself. A may, on discovering that B has bought the house, compel him to sell it to A at the price he gave for it.
- (b) A directs B to sell A's estate. B buys the estate for himself in the name of C. A, on discovering that B has bought the estate for himself, may repudiate the sale, if he can show that B has dishonestly concealed any material fact, or that the sale has been disadvantageous to him.
- (c) A directs B to sell A's estate. B, on looking over the estate before selling it, finds a mine on the estate which is unknown to A. B informs A that he wishes to buy the estate for himself, but conceals the discovery of the mine. A allows B to buy, in ignorance of the existence of the mine. A, on discovering that B knew of the mine at the time he bought the estate, may either repudiate or adopt the sale at his option.

VI. **To pay the sum received for the principal.** An agent may retain, out of any sums received on account of the principal in the business of the agency, all moneys due to himself in respect of

advances made or expenses properly incurred by him in conducting such business, and also such remuneration as may be payable to him for acting as agent. Subject to such deductions, the agent is bound to pay to his principal all sums received on his account.

- VII. To protect and preserve the interest of principal in case of his death or insanity. **(Section 209)**
- VIII. An agent should not use information obtained in course of agency against the principal.
- IX. He must not set an adverse title to the goods. If he does so he will be liable for conversion
- X. He should not put himself in a position where his duties and interest will conflict.

**Example 1:**

A employed B a stock broker to buy some shares for him. B without disclosing A sold some of his own holding to A. It was held that B could rescind the contract due to set up of adverse title by A. [*Armsstrong v Jackson 1977(KB)822*]

**Example 2:**

A employed B to buy old used maruti car for him at a reasonable price. B sold his own car without disclosing A that he is the owner of the car. A can rescind the contract.

- XI. He must not delegate his authority subject to certain exceptions. As an agent himself is an agent he cannot delegate his authority except under some exceptional cases.
- XII. **He must not make secret profit from agency.** The contract of agency is fiduciary of utmost good faith. Except with the knowledge and consent of the principal he should not make any secret profit other than his normal commission and remuneration.

**Example 1:**

A an auctioneer appointed by B the principal received from the client additional commission in a addition to the commission paid by his principal. A is liable to account for the same to B.

[(*Andrews V Ramaswmay & co, 1903 2 KB635*)]

**Example 2:**

A an agent of B sold his entire stock to B his principal at the prevailing market rate without disclosing the fact to B. Held A is liable to return the profit so made by him to his principal. (*Kimber V Barber*) 1873 LR 8Ch 5

### 1.17.12 Rights of Agent

#### I. **Agent's lien on principal's property (Section 221)**

In the absence of any contract to the contrary, an agent is entitled to retain goods, papers, and other property, whether movable or immovable, of the principal received by him, until the amount due to himself for commission, disbursements and services in respect of the same has been paid or accounted for to him.

**Example:** X is an consignment agent of B and entitled to 10% commission on all the sales made by him plus re-imbusement of reasonable expenses incurred on such transaction. B did not pay him the commission accruing to him. X is entitled to retain the goods or other paper of B until he is paid his commission and remuneration.

- II. Right to receive remuneration as per agreement, or if there is no agreement, reasonable remuneration. A question may arise when the remuneration become due as per section 219 in the absence of any special contract, payment for the performance of any act is not due to the agent until the completion of such act; but an agent may detain moneys received by him on account of goods sold, although the whole of the goods consigned to him for sale may not have



been sold, or although the sale may not be actually complete. However an agent who is guilty of misconduct in the business of the agency is not entitled to any remuneration under section 220 of the Act in respect of that part of the business which he has misconducted.

**Example 1:**

A employs B to recover ₹ 1,00,000 from C, and to lay it out on good security. B recovers the ₹ 1,00,000 and lays out ₹ 90,000 on good security, but lays out ₹ 10,000 on security which he ought to have known to be bad, whereby A loses ₹ 2,000. B is entitled to remuneration for recovering the ₹ 1,00,000 and for investing the ₹ 90,000. He is not entitled to any remuneration for investing the ₹ 10,000, and he must make good the ₹ 2,000 to B.

**Example 2:**

A employs B to recover ₹ 1,000 from C. Through B's misconduct the money is not recovered. B is entitled to no remuneration for his services, and must make good the loss.

- III. The agent has right to be indemnified against all lawful acts done by him in exercise of authority conferred upon him. **(Section 222)**

**Example:**

A an agent of P seized some goods of T, a third party at the command of T, although the goods have been seized improperly it was shown that A had acted bonafidely, Held A was entitled to be indemnified [*Toplis v Crane (1938)5 Bing*]

- IV. The agent has right to be compensated for all injuries sustained by him because of negligence or lack of skill on part of principal. **(Section 225)**

**Example:**

W a whitewash man was employed by P and his agent and deputed him for white wash of three stories flat of B. W fell from the wooden ladder and sustained injury. P must compensate W .

- V. The agent has 'right of stoppage in transit' under following circumstances:

- (i) If he has bought goods on behalf of principal incurring personal liability. This right is similar to that of an unpaid seller.
- (ii) If he is personally liable to principal for price of goods sold, he has this right against buyer in case the buyer becomes insolvent. This right is also similar to that of an unpaid seller.

**1.17.13 Principal's Duty to Agent**

**(A) Agent to be indemnified against consequences of lawful acts (Section 222)**

The employer of an agent is bound to indemnify him against the consequences of all lawful acts done by such agent in exercise of the authority conferred upon him.

**Illustrations**

- (a) B, at Singapore, under instructions from A of Kolkata, contracts with C to deliver certain goods to him. A does not send the goods to B, and C sues B for breach of contract. B informs A of the suit, and A authorizes him to defend the suit. B defends the suit, and is compelled to pay damages and costs, and incurs expenses. A is liable to B for such damages, costs and expenses.
- (b) B, a broker at Kolkata, by the orders of A, a merchant there, contracts with C for the purchase of 10 casks of oil for A. Afterwards A refuses to receive the oil, and C sues B. B informs A, who repudiates the contract altogether. B defends, but unsuccessfully, and has to pay damages and costs and incurs expenses. A is liable to B for such damages, costs and expenses.

**(B) Agent to be indemnified against consequences of acts done in good faith (Section 223)**

Where one person employs another to do an act, and the agent does the act in good faith, the employer is liable to indemnify the agent against the consequences of that act, though it causes an injury to the rights of third persons.

**Illustrations**

- (a) A, a decree-holder and entitled to execution of B's goods, requires the officer of the Court to seize certain goods, representing them to be the goods of B. The officer seizes the goods, and is sued by C, the true owner of the goods. A is liable to indemnify the officer for the sum which he is compelled to pay to C, in consequence of obeying A's directions.
- (b) B, at the request of A, sells goods in the possession of A, but which A had no right to dispose of. B does not know this, and hands over the proceeds of the sale to A. Afterwards C, the true owner of the goods, sues B and recovers the value of the goods and costs. A is liable to indemnify B for what he has been compelled to pay to C and for B's own expenses.

**Non-liability of employer of agent to do a criminal act (Section 224)**

Where one person employs another to do an act which is criminal, the employer is not liable to the agent, either upon an express or an implied promise, to indemnify him against the consequences of that act.

**Illustrations**

- (a) A employs B to beat C, and agrees to indemnify him against all consequences of the act. B thereupon beats C, and has to pay damages to C for so doing. A is not liable to indemnify B for those damages.
- (b) B, the proprietor of a newspaper, publishes, at A's request, a libel upon C in the paper, and A agrees to indemnify B against the consequences of the publication, and all costs and damages of any action in respect thereof. B is sued by C and has to pay damages, and also incurs expenses. A is not liable to B upon the indemnity.

**Effect of agency on contract with third persons enforcement and consequences of agent's contracts (Section 226)**

Contracts entered into through an agent, and obligations arising from acts done by an agent, may be enforced in the same manner, and will have the same legal consequences, as if the contracts had been entered into and the acts done by the principal in person.

**Illustrations**

- (a) A buys goods from B, knowing that he is an agent for their sale, but not knowing who is the principal. B's principal is the person entitled to claim from A the price of the goods, and A cannot, in a suit by the principal, set off against that claim a debt due to himself from B.
- (b) A, being B's agent with authority to receive money on his behalf, receives from C, a sum of money due to B. C is discharged of his obligation to pay the sum in question to B.

**(C) Compensation to agent for injury caused by principal's neglect (Section 225)**

The principal must make compensation to his agent in respect of injury caused to such agent by the principal's neglect or want of skill.

**Illustration**

A employs B as a bricklayer in building a house, and puts up the scaffolding himself. The scaffolding is unskillfully put up, and B is in consequence hurt. A must make compensation to B.



### 1.17.13.1 Principal how far Bound, when Agent Exceeds Authority (Section 227)

#### What happens when an agent exceeds his authority?

At times an agent acting within his authority exceed his authority, can he make the principal liable for his act. Let us refer to section 227 of the act which says as under: 'When an agent does more than he is authorised to do, and when the part of what he does, which is within his authority, can be separated from the part which is beyond his authority, so much only of what he does as is within his authority is binding as between him and his principal.'

#### Illustration

A, being owner of a ship and cargo, authorizes B to procure an insurance for ₹ 4,000 on the ship. B procures a policy for ₹ 4,000 on the ship, and another for the like sum on the cargo. A is bound to pay the premium for the policy on the ship, but not the premium for the policy on the cargo.

### 1.17.13.2 Principal not Bound when Excess of Agent's Authority is not Separable (Section 228)

Where an agent does more than he is authorised to do, and what he does beyond the scope of his authority cannot be separated from what is within it, the principal is not bound to recognise the transaction.

#### Illustration

A authorizes B to buy 500 sheep for him. B buys 500 sheep and 200 lambs for one sum of ₹ 6,000. A may repudiate the whole transaction.

### 1.17.13.3 Consequences of Notice Given to Agent (Section 229)

As the agent is nothing but a shadow of the principal accordingly in order to save the interest of third party dealing with the principal through his authorized agent section 229 provides that "any notice given to or information obtained by the agent, provided it be given or obtained in the course of the business transacted by him for the principal, shall, as between the principal and third parties, have the same legal consequence as if it had been given to or obtained by the principal".

Only condition to be satisfied that it should be given or obtained in the course of business transaction by him for the principal and not otherwise.

#### Illustrations

- (a) A is employed by B to buy from C certain goods, of which C is the apparent owner, and buys them accordingly. In the course of the treaty for the sale, A learns that the goods really belonged to D, but B is ignorant of that fact. B is not entitled to set off a debt owing to him from C against the price of the goods.
- (b) A is employed by B to buy from C goods of which C is the apparent owner. A was, before he was so employed, a servant of C, and then learnt that the goods really belonged to D, but B is ignorant of that fact. In spite of the knowledge of his agent, B may set off against the price of the goods a debt owing to him from C.

### 1.17.14 Agent Cannot Personally Enforce, nor be Bound by, Contracts on Behalf of Principal (Section 230)

In the absence of any contract to that effect, an agent cannot personally enforce contracts entered into by him on behalf of his principal, nor is he personally bound by them.

**Presumption of contract to the contrary—Such a contract shall be presumed to exist in the following cases:**

- (1) Where the contract is made by an agent for the sale or purchase of goods for a merchant resident abroad;
- (2) Where the agent does not disclose the name of his principal; and
- (3) Where the principal, though disclosed, cannot be sued.

#### **1.17.14.1 Rights of Parties to a Contract made by Agent not Disclosed (Section 231)**

If an agent makes a contract with a person who neither knows, nor has reason to suspect, that he is an agent, his principal may require the performance of the contract; but the other contracting party has, as against the principal, the same right as he would have had as against the agent if the agent had been the principal.

If the principal discloses himself before the contract is completed, the other contracting party may refuse to fulfill the contract, if he can show that, if he had known who was the principal in the contract, or if he had known that the agent was not a principal, he would not have entered into the contract.

#### **1.17.14.2 Performance of Contract with Agent Supposed to be Principal (Section 232)**

Where one man makes a contract with another, neither knowing nor having reasonable ground to suspect that the other is an agent, the principal, if he requires the performance of the contract, can only obtain such performance subject to the rights and obligations subsisting between the agent and the other party to the contract.

##### **Illustration**

A, who owes 500 rupees to B, sells 1,000 rupees worth of rice to B. A is acting as agent for C in the transaction, but B has no knowledge nor reasonable ground of suspicion that such is the case. C cannot compel B to take the rice without allowing him to set off A's debt.

**What are rights of a person dealing with agent when agent is personally liable.**

#### **Right of Person Dealing with Agent Personally Liable (Section 233)**

**At times without knowledge of the third party the agent may be acting in his personal capacity in such case the third person can make either the principal or the agent himself liable for it. Section 233 of the act provides as under:**

In cases where the agent is personally liable, a person dealing with him may hold either him or his principal, or both of them, liable.

##### **Illustration**

A enters into a contract with B to sell him 100 bales of cotton, and afterwards discovers that B was acting as agent for C. A may sue either B or C, or both, for the price of the cotton.

#### **1.17.14.3 Consequence of Inducing Agent or Principal to Act on belief that Principal or Agent will be held Exclusively Liable (Section 234)**

Some time gullible person may induce an innocent agent to act upon the belief that he will not incur any personal liability thereon and the principal only will be liable, he himself will be liable for his wrong doing. Section 234 provides as under "When a person who has made a contract with an agent induces the agent to act upon the belief that the principal only will be held liable, or induces the principal to act upon the belief that the agent only will be held liable, he cannot afterwards hold liable the agent or principal respectively."

**Example:** X induces Y an agent of Z to sell Z's shop to someone known to him(x) assuring him that his act is within his scope of authority. This act was outside the scope of Y's authority. Y acting on the belief of X that he will not be personally liable. X cannot proceed against either Y or Z for his misdeed.

#### **1.17.15 Pretended Agent:**

##### **Who is a Pretended Agent?**

A person who not being an authorized agent of another but pretend himself to be authorized agent of another and thereby induces a third party to deal with him as such agent is called pretended agent.



### What is liability of a pretended agent (Section 235)?

A person untruly representing himself to be the authorised agent of another, and thereby inducing a third person to deal with him as such agent, is liable, if his alleged employer does not ratify his acts, to make compensation to the other in respect of any loss or damage which he has incurred by so dealing.

#### Example:

X made Y believe that he is an authorized dealer of XYA Associates, even though he is not in any way connected with XYA Associates and thus induces him to sell goods worth ₹ 50,000 to him on credit. XYA did not ratify the act of X denying him as their agent.

Neither X nor Y have any claim to proceed against XYA Associates.

#### 1.17.15.1 Person Falsely Contracting as Agent not Entitled to Performance (Section 236)

A person with whom a contract has been entered into in the character of agent, is not entitled to require the performance of it if he was in reality acting, not as agent, but on his own account.

**Sometimes it may happens that a principal by his words or conduct induces a third party to believe that the act and obligations of the agent are within his authority the principal is liable for the acts of the agent. Section 237 of the Act provides as under:**

When an agent has, without authority, done acts or incurred obligations to third persons on behalf of his principal, the principal is bound by such acts or obligations, if he has by his words or conduct induced such third persons to believe that such acts and obligations were within the scope of the agent's authority.

#### Illustrations

- (a) A consigns goods to B for sale, and gives him instructions not to sell under a fixed price. C, being ignorant of B's instructions, enters into a contract with B to buy the goods at a price lower than the reserved price. A is bound by the contract.
- (b) A entrusts B with negotiable instruments endorsed in blank. B sells them to C in violation of private orders from A. The sale is good.

#### 1.17.15.2 Effect, on Agreement, of Misrepresentation or Fraud by Agent (Section 238)

Misrepresentations made, or frauds committed, by agents acting in the course of their business for their principals, have the same effect on agreements made by such agents as if such misrepresentations or frauds had been made, or committed, by the principals; but misrepresentations made, or frauds committed, by agents, in matters which do not fall within their authority, do not affect their principals.

#### Illustrations

- (a) A, being B's agent for the sale of goods, induces C to buy them by a misrepresentation, which he was not authorized by B to make. The contract is voidable, as between B and C, at the option of C.
- (b) A, the captain of B's ship, signs bills of lading without having received on board the goods mentioned therein. The bills of lading are void as between B and the pretended consignor.

#### 1.17.16 Irrevocable Agency

##### What is an Irrevocable Agency?

**An agency which cannot be terminated or put to an end is called an irrevocable agency.**

An agency is irrevocable in the following circumstances:

i) Where agency is coupled with interest for the agent over and above his remuneration: An agency is said to be coupled with interest when it is created for securing some benefits to the agent over and above his remuneration as an agent. As per section 202 where the agent has himself an interest in the

property which forms subject matter of agency, the agency cannot in the absence of any express contract be terminated to the prejudice of such interest.

**Example 1:**

A is indebted to B, he appoints him as his agent and thus authorizes him to sell his land and to pay himself in discharge of his debt. A cannot revoke the authority nor put to an end to the authority.

**Example 2:**

A consigns 100 kg of cherry to B who has already made an advance to him on such consignment and now desires B to sell the cherry and to repay himself out of the price, the amount of his own advance. A cannot revoke the authority nor terminate the same

(ii) Where the agent has incurred personal liability.

(iii) Where the agent has already exercised a part of his authority, so far as acts already done: The principal cannot revoke the authority given to his agent after the authority has been partly exercised so far as regards such acts and obligations arise from acts already done in the agency.

**Example:**

A authorizes B to buy some goods on his account and to pay for it out of A's money remaining in B's hand. B buys some goods in his own name, so as to make himself personally liable for the price. A cannot subsequently revoke his authority so far as regards payment for the cotton.

**Let us Recapitulate**

- The Indian Contract, 1872 enunciates the legal provisions governing the business transactions in India. It is not exhaustive and does not profess to be complete and exhaustive. It deals with the general principle of law of contracts and with some special contracts only.
- Law of contract creates jus in personam.
- Jus in personam means a right against or in respect of a specific person for which remedy lies only against the specific person and not against any other person.
- Jus in rem means a right against or in respect of thing. Jus in rem is available against the whole world at large.
- An agreement enforceable by law is a contract.
- All agreements are not contract but all contracts are certainly agreements.
- Only those agreements which are enforceable in law and creates legal obligation are contracts.
- Every promise or set of promises forming the consideration for each other is an agreement.
- An agreement not enforceable by law is a void agreement.
- An agreement is illegal or unlawful if it is forbidden by law or is of such nature that, if permitted would defeat the provision of any law or is fraudulent or involves or implies or injury to person or property of another or court regards it immoral or it is opposed to public policy.
- All illegal or unlawful agreements are void but all void agreements are not illegal.
- An agreement which is enforceable at the option of one or more parties thereto but not at the option of other or others is a voidable contract.
- Agreement culminates into a valid contract if it is made by the free consent of the parties competent to contract for a lawful object and lawful consideration and are not expressly declared to be void.
- Consent means agreeing upon the same thing in the same manner.



- Absence of consent makes the contract void ab-initio but absence of free consent makes a contract voidable.
- Consent means consensus ad idem.
- Consent is said to be free when it is not caused by coercion, undue influence, fraud, mistake and misrepresentation.
- There are some considerations and objects and agreement which have expressly been declared void by Act.
- Consideration means something in return.
- Existence of a valid consideration is essential but it need not be adequate.
- An agreement without consideration is void.
- Under certain circumstances an agreement without consideration is not void.
- No consideration is required for a promise to subscribe for a charitable or a religious cause.
- Consideration in simple terms means Quid Pro quo
- Consideration may be past, present or future but must be real.
- Generally a stranger to a contract cannot sue upon it but there are exception to this rule.
- A stranger to consideration has all the rights to sue in a contract.
- An agreement caused by mistake of fact is void.
- Minor, person of unsound mind and certain other categories of persons are not competent to enter into a contract.
- Minor is a person who has not attained the age of majority.
- A minor can act as an agent but cannot be appointed an agent.
- Agreements in restraint of legal proceedings, wagering agreement, uncertain agreement, agreement to do impossible act etc have been declared void in the Act itself.
- Cross word puzzles is not a wagering agreement if the prize money is less than ₹ 1000.
- Performance means fulfillment of their respective obligations by the parties to the contract as per the contract.
- Only promisee can demand performance of a contract.
- A contract can be performed by the promisor himself, his agent, and his legal representatives or even by a third party.
- A person who finds goods belonging to others and take them into his custody is called a finder of lost goods.
- The duties of a finder of lost goods are same as that of a bailee.
- A finder of lost goods must take reasonable care of the goods, try to find the true owner, must not mix up the goods with his own and should not use the goods found for his own use.
- Lien is a right available to a person to retain that which is in his possession and which belongs to another, until the demands of the person in possession are satisfied.
- Particular or specific lien means the right to retain the particular goods until claims arising on those goods are satisfied.
- General lien means the right to retain goods not only for demand arising out of the goods retained but for a general balance of accounts in favor of certain persons.

- A contract to perform the promise or discharge the liability of third person in case of his death is called a contract of guarantee.
- If guarantee given by a person extends to a series of transactions it is a case of continuing guarantee.
- A continuing guarantee can be revoked by various ways like by notice, death of surety, novation, variation in terms of contract, release of principle debtor, compounding with principal debtor etc.
- There are three parties in a contract of guarantee namely creditor, principal debtor and surety.
- Bailment is the delivery of goods by one person to another for some purpose.
- The person delivering the goods is called bailor and the person to whom the goods are delivered is called bailee.
- Bailor is duty bound to disclose to the bailee material fault in the goods bailed of which he is aware of.
- Bailee is also duty bound to take care of the goods bailed to him as a man of ordinary prudence would take of his own goods and not to mix the goods with other goods without consent of the bailee.
- The bailment of goods as a security for payment of debt or performance of a promise is called pledge.
- The bailor of goods is called pawnor and the bailee the pawnee.
- Generally the owner of the goods can plead the goods but other non-owners like mercantile agent, persons having possession of goods under a voidable contract, person having only limited interest in the goods and co owner with the consent of other co-owners can also pledge the goods.
- A person who is employed to do any act for another or to represent another person in dealing with the third persons is called agent.
- Any person who is of sound mind and is of the age of majority can appoint agent.
- Any person can become agent but a person who is not of the age of majority and of sound mind cannot become agent so as to be responsible to his principal.
- The concept of no consideration no contract is not applicable in case of Agency agreement. Accordingly an agency agreement does not require any consideration.
- A person employed by and acting under the control of, the original agent in the business of the agent is called sub-agent.
- For the act of the sub-agent the agent is responsible to the principal.
- Un authorised appointment of sub agent (without consent of principal) the agent is responsible to both the principal and the third party, the principal is not represented by or responsible for the acts of the person so employed nor is that person responsible to the principal.
- Agent is duty bound to conduct the business of principal in accordance with his directions, with due care, skill and diligence.
- Agent is not to deal in his own account and bound to render proper accounts to his principal on demand.
- The principal is duty bound to indemnify the agent against the consequences of all lawful acts done by agent in exercise of the authority conferred upon him.
- Though the principal is bound by the act of the agent but when the agent exceed his authorised authority the principal is not bound to recognize the transaction.
- Any notice given or information obtained from the agent in the course or business, amount to notice given to the principal or information obtained from the principal.

# Study Note - 2

## LAWS RELATING TO SALE OF GOODS



### This Study Note includes

- 2.1 The Sale of Goods Act, 1930 - Concepts and Definitions
- 2.2 Passing of Property
- 2.3 Conditions and Warrantis
- 2.4 Performance of the Contract of Sale
- 2.5 Rights of an Unpaid Seller
- 2.6 Breach of Contract
- 2.7 Auction Sale
- 2.8 Contracts involving Sea Routes

### 2. THE SALE OF GOODS ACT, 1930 - INTRODUCTION

The sale of goods is the most common of all commercial contracts & knowledge of its main principles is necessary to all of us. The law relating to the Sale of Good or moveable property in India is codified in the Sale of Goods Act, 1930. It contains the basic principles as well as the legal framework of transactions of sale and purchase.

Prior to enactment of the Act, the law relating to the Sale of Goods or movable goods was part of the Indian Contract Act, 1872 and included in Chapter VII section 76 to 123. Due to complexities of the modern business dealing and relations the Indian Contract Act, 1872 was found to be inadequate to deal with the complexities of modern business. Accordingly the provisions relating to the Sale of Goods contained in the Indian Contract Act, 1872 were repealed and re-enacted as the Sale of Goods Act, 1930. The provisions of the Indian Contract Act, 1872 continues to be applicable to the contract of Sale of Goods in so far they are not inconsistent with the express provisions of the Sale of Goods Act, 1930. For example the general provision of the Indian Contract Act, like capacity of the parties, consideration, free consent, legality of the objects and considerations etc not expressly defined and provided in the Sale of Goods Act, 1930 but provided and defined in the Indian Contract Act, 1872 are equally applicable to the Indian Contract of Sales under this Act.

This Act is largely based on the English Sale of Goods Act, 1893. Even now the English authorities interpretation of different sections of this Act are followed in India even though they are not binding on Indian Courts.

The provisions of this Act are applicable to only sale of only those things which can be called goods. Actionable claims and money are out of the ambit of this Act. Actionable claims are claims which can be enforced by an action or suit for example debt. Provisions relating to sale of immovable property and actionable goods are contained in Transfer of Property Act, 1882. Goods are main subject matter of this Act.

Money is excluded from the definition of goods for two reasons (a)it constitute the price for exchange of goods sold and (b)it is governed by a different principles of law due to being a currency.

## 2.1 CONCEPTS & DEFINITIONS

### 2.1.1 Extent and Commencement

This Act is applicable to the whole of India except the State of Jammu and Kashmir and came into force with effect from 1<sup>st</sup> July 1930.

### 2.1.2 Basic Concepts

Section 2 of the Act defines various terms used in the Act. Some of the important terms as defined in the Act are given below:

Unless there is anything repugnant in the subject or context--

- (1) "buyer" means a person, who buys or agrees to buy goods;
- (2) "delivery" means voluntary transfer of possession from one person to another;
- (3) goods are said to be in a 'deliverable state' when they are in such a state that the buyer would under the contract be bound to take delivery thereof;
- (4) "document of title to goods" includes a bill of lading, dock-warrants, warehouse keeper's certificate, wharfingers certificate, railway receipts, multimodal transport documents, warrants or order for the delivery of goods and any other documents used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorize, either by endorsement or by delivery the possessor of the document to transfer or receive goods thereby represented;
- (5) "fault" means wrongful act or default;
- (6) "future goods means goods" to be manufactured or produced or acquired by the seller after making the contract of sale;
- (7) "goods" means every kind of movable property other than actionable claims and money and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale;
- (8) a person is said to be "insolvent" who has ceased to pay his debts in the ordinary course; of business or cannot pay his debts as they become due, whether he has committed any act of insolvency or not;
- (9) "mercantile agent" means a mercantile agent having in the customary course of business as such agent authority either to sell goods or to consign goods for the purpose of sale or to buy goods or to raise money on the security of goods;
- (10) "Price" means the money consideration for a sale of goods;
- (11) "Property" means the general property in goods and not merely a special property;
- (12) "Quality of goods" includes their state or condition;
- (13) "Seller" means a person who sells or agrees to sell goods;
- (14) "Specified goods" means goods identified and agreed upon at the time of a contract of sale is made; and
- (15) Expression used but not defined in this Act and defined in the Indian Contract Act, 1872 have the meanings assigned to them in that Act.

### 2.1.3 Definition of Contract of Sale:

#### Section 4 (1) defines 'Contract of Sales' as:

'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.'

- (a) A contract of sale is made by an offer to buy or sell goods for a price and the acceptance of such offer. The contract may provide for the immediate delivery of the goods or immediate payment of the price or both, or for the delivery or payment by installments, or that the delivery or payment or both shall be postponed.



- (b) Subject to the provisions of any law for the time being in force, a contract of sale may be made in writing or by word of mouth, or partly in writing and partly by word of mouth or may be implied from the conduct of the parties.

From the above definition of the contract of sales given in section 4 of the Act, it emerges that the expression "Contract of Sale" includes both a sale whereby the seller transfer the ownership of goods to the buyer and an agreement to sell where the ownership of goods is transferred at a future time or subject to some conditions to be fulfilled later on

**Example 1:**

A sells his horse in exchange of a dog. This is not a sale but a case of exchange or barter and out of the purview of the Act.

**Example 2:**

X agrees to deliver his car to Y for his use on Y agreeing to pay him user charges. This is not a case of sale as there is no transfer of property in goods but merely transfer of possession.

From the definition of contract of sale given in section 4(1) of the Sales of Goods Act, it may be noted that a contract of sale of goods may be entered into in a number of ways. It may be reduced in writing or it may be by words of the parties, partly written and partly oral. It may also be inferred from the conduct of the parties. However, if any particular mode is prescribed by any law, then the contract of sale must be made in that particular mode[sec 5(2)]. A contract of sale may absolute or conditional. Agreement for sale of contingent goods is a conditional contract of sales, where as in other normal contract of sales of specific goods the contract of sales is absolute. Similarly there can be different stipulation regarding time of payment and delivery, which we will be discussing subsequently.

**Example 1:**

X agree to sell and Y agree to buy X's old car for ₹ 55,000. This is a case of absolute contract.

**Example 2:**

X agree to sell 500 bales of cotton coming from Australia if the ship carrying the consignment safely reaches India. This is a conditional contract, the validity of the contract is contingent upon safe arrival of the goods in India.

**2.1.4 Essentials of a Contract of Sale:**

- (I) It must satisfy all the conditions of a contract as per the Indian Contract Act 1872; Since contract of sale is one type of contract; it must satisfy all the conditions of a valid contract, like capacity of the parties, free consent, consideration, legality of objects and consideration etc.
- (II) There must be at least two parties, as a person cannot sale goods to himself. However there may be a contract of sale between one part-owner and another. It is a bilateral contract between the buyer and the seller. The person having agreed to buy goods means a person has bound himself by the agreement to buy goods. But if a person has option to buy the goods until he exercises the option to purchase the goods, he has neither bought nor agreed to buy the goods. A sale has to be bilateral because the property has to pass from one person to another person, which presupposes existing of two persons. The seller and the buyer must be two different persons to constitute a sale. Thus if a person purchases his own goods, it is no sale. [Ramanlals & co, AIR 1965 Guj 60]

**Example:**

A Partnership firm was dissolved and the surplus assets, including the stock in trade were divided among the partners, in specie. It was held that since the partners were joint owners of the goods, they can not be both buyer as well seller. [State of Gujarat v Raman Lal & Co, AIR (1965) Guj.60]

Thus there must be two distinct parties the seller and the buyer. It is a bilateral contract whereby

the property in goods is to pass from one party to another. A person can not buy goods for himself. In *Graff v Evans (1882) 8 QBD 373*, E was the manager of a club. The club was not licensed for the sale of liquor but E supplied these to members of the club at a fixed price. It has held to be not a sale. This is so because here both buyer and seller were same persons.

In case of a club the transaction is a release of the joint interest of the members and the members are in substance consuming their own property and the mode of payment is a matter of internal arrangement regulated by the rules of the club and agreed to by club members on his own admission. So there is no sale to outside party hence there can not be sale between the club and its members.

In the following cases, the same person can be buyer as well as sellers of the goods.

- (a) When the pawnee sells the goods pledged with him on non-payment of his money, the pawnor may himself buy such goods.
- (b) A part owner can also sell his share to the part owner so as to make the other part owner as the sole owner of the goods.
- (c) A partner may also buy goods from the firm in which he is partner.

**Example 1:** X and Y jointly own a MUV which is used a carrier vehicle. Y sells his interest in the MUV to X another co owner to make him absolute and sole owner of the MUV. This sale is perfectly valid even though X is already the part owner of MUV.

**Example 2:** X had pledged his imported wrist watch to Y to secure a temporary loan of ₹ 1,00,000. X could not redeem the loan so taken from Y. Y in order to recover the amount lend to X put the wrist watch pledged him for sale. X can also buy the wrist watch pledged with Y even though he himself is the owner of the wrist watch.

- (III) There must be a transfer or agreement to transfer the **ownership** of goods from one person to another. Mere transfer of possession is not sale. The object of a contract of sales must be to transfer the property in goods from one person to another. The seller must agree to transfer general property in goods to the buyer

According to the Act, " property" means general property in the goods rather than mere special property. The general property means ownership & special property means only some of rights. Thus a contract of sale occurs when ownership in goods is transferred & not when mere right of possession is transferred by way of hire or pledge.

It may further be noted that the transfer of property must be voluntary and not under any influence of fraud, coercion, misrepresentation etc. The possession obtained by a thief or robber is not a voluntary possession and does not convey better title to the owner.

- (IV) The subject matter of sale must be 'goods' and movable. The transfer of immovable property is not governed by Sale of Goods Act, 1930.

**Example 1:**

X agrees to sell his flat to Y at ₹ 45 lakh. Can the parties refer to any provision of the Sale of Goods Act, 1930 to resolve any issue between them?

The subject matter of is not goods as defined in the Sales of Goods Act. Hence none of the provisions of the sales of Goods Act will be applicable in case any issue arises between the parties. Flat/house property/ Land etc are immovable goods.

**Example 2:**

A hotel company provided residence and food making a consolidated charge for food and services. No rebate was allowed if food is not taken. Held supply of food was not sale of goods but simply a service as the transaction was an indivisible contract of multiple services and did not involve any sale of food. [*Associate Hotels of India v Excise & taxation officer, AIR (1996) Punj 449.*]



- (V) The consideration for sale is called price which should be stated in terms of 'money'. Exchange of 'goods' for 'goods' is barter and not sale. However price may be paid partly in terms of money and partly in kind. It may further be noted that no sale can take place without a price. Thus if there is no valuable consideration to support a voluntary surrender of goods by the real owner to another person, the transaction is gift and is not governed by the Sale of Goods Act.

**Example 1:**

X agreed to exchange with Y 100 quarters of barley at ₹ 100 per quarter for 52 bullocks valued at ₹ 300 per bullock and pay the difference in cash. Held it was a contract of sale as consideration has been paid both in cash as well in kind. [*Aldridge v Johnson (1857)7E &B 385*]

**Example 2:**

Fifty kg of Basmati rice valued @ ₹ 60 per kg were exchanged for 50 kg of MP Ata valued at ₹ 25 per kg and the difference to be made up in cash. This is a contract of sale.

**Example 3:**

S agreed to purchase 50 Black Berry mobile set @ ₹ 15,000 per set in exchange of 5 Laptops each valued ₹ 80,000 and settle the balance in 2 monthly installments. This is a perfect contract sale provided other conditions of a valid contract are met. The simple fact the consideration is partly in goods and partly in cash to be paid in installment does not affect the contract the sale.

- (VI) A contract of sale may be absolute or conditional.

In case of a absolute contract of sale there is no condition to be fulfilled by either of the parties. If the contract of sale is subject to some other acts on the part of either of the parties or on happening or non-happening of some events then the contract is called conditional contract. Agreement to sell future goods or contingent goods is not an absolute contract but a conditional contract.

**Example 1:**

X sell 50 Qtls of MP wheat @ ₹ 2500 per Qtls to Y. This is a absolute contract of sale and there are no conditions attached to the contract.

**Example 2:**

X agree to sell the entire 100 Qtls of onion when the crop of onion is harvested next month. As this is an agreement to sell future goods. The success of the contract is successful harvesting of the crop of onion which is grown. Accordingly this is a conditional contract.

After having discussed the term Contract of Sale and its essential features we can say that the term contract of sale is generic term and encompasses both a sale and an agreement to sell. When the transfer of property in goods is to take place immediately it is a case of sale, but where the transfer of the property in the goods is to take place at a future date or subject to fulfillment of some conditions, the contract is called an agreement to sell. Timing of transfer of property in goods is one of the points of difference between sale and agreement to sell. The other salient difference between sale and agreement to sell is discussed in subsequent section. Here it may again be noted that the term property in goods means general property in goods rather than a mere special property. In other words it means absolute ownership. It may be further being noted that the definition of sales does not relate to either timing of delivery or timing of payment. A contract of sale can have different stipulation regarding time of payment and time of delivery like—

- (a) Immediate payment and immediate delivery.
- (b) Immediate payment and deferred delivery.
- (c) Immediate payment and installment delivery.

- (d) Immediate delivery and deferred payment.
- (e) Immediate delivery and installment payment.
- (f) Deferred delivery and deferred payment etc.

Accordingly time of payment and time of delivery of goods do not change the character of a contract of sales. What is more important is the timing of transfer of property in goods. If the transfer of property is to take place immediately whether price paid or not immediately it is case of contract of sale and if the transfer of property is to take place sometime in future however remote it maybe or on fulfillment of some conditions and not immediately it is a an agreement to sell.

### 2.1.5 Sale and Agreement to Sell:

Where in a contract of sale, the property in goods is transferred from the buyer to the seller immediately the contract is called a sales but where the transfer of the property is to take place sometime in future or subject to fulfillment of some conditions thereafter to be fulfilled, the contract is called an agreement to sell. An agreement to sell becomes a sale when the time elapses or the condition subject to which the property in the goods is to transfer is fulfilled.

Transfer of property in goods for a price is the linchpin of the definition of contract of sale [*Union of India v Central India Machinery Mfg co AIR 1977 SC 1537*]

#### Example 1:

X agrees to sell 50 Black Berry mobile to Y on 1<sup>st</sup> January 2013. Y agrees to pay the price after one week i.e. on 7<sup>th</sup> January. This is sale.

#### Example 2:

On 15<sup>th</sup> December, X agree, to sell 50 Black Berry mobile to Y on 1<sup>st</sup> January 2013. Y agrees to pay the price after one week i.e. on 7<sup>th</sup> January. This is an agreement to sell.

#### Example 3:

On 15<sup>th</sup> December, X sold 50 Black Berry mobile on "sale on approval" basis giving one month's time to approve or return the goods. This is an agreement to sell, as there are to conditions attached to it i.e. either return or approve within one month or lapse of one month. This will become a case of sale either after the expiry of one month or as and when Y signifies his approval of the goods.

#### Difference between sale and agreement to sale:

Sl. No.	Sale	Agreement to Sale
(i)	Sale is an executed contract. Property in the goods passes from seller to buyer.	It is an executory contract. Transfer of property in goods is to take place at a future date subject to fulfillment of certain conditions.
(ii)	If goods are destroyed, the loss will be borne by the buyer even though they may be in possession of the seller.	The loss will be borne by the seller even though the goods may be in possession of the buyer.
(iii)	A sale gives right to the buyer to enjoy the goods against the whole world including the seller.	The buyer only can sue the seller for damages.
(iv)	In case of sale, the buyer can be sued for price of goods.	The buyer can be sued only for damages.
(v)	If buyer becomes insolvent before payment is made, the seller has to deliver the goods to the official receiver unless he has lien on them.	Seller may refuse to deliver the goods to the official receiver.



(vi)	If the seller becomes insolvent after payment of price, the buyer can claim the goods from the official receiver.	The buyer cannot claim the goods. He can only claim ratable dividend for the amount paid by him.
(vii)	The seller cannot resale the goods.	In this case, if the subsequent buyer takes in good faith and for consideration, he gets a good title. The original buyer may only sue the seller for damages.

## 2.1.6 Sale Distinguished from other Similar Transactions

### 2.1.6.1 Sale and Contract for Work and Labor

A contract of sale of goods is different from the contract for work and labor or skill and labor. A contract of sale involves the transfer of ownership and possession to buyer for a price. On the other hand a contract for work and labor involves exercise of skill and labor by one party in respect of material supplied by another party. Delivery of goods is subsidiary condition or incidental to the contract.

For instance when a suit length is supplied to a Tailor for making a suit, it is a contract for work and labor. Here the main substance of the contract is application of skill and labor and the delivery of goods i.e. made out suit is only subsidiary to it. This type of contract does not involve any sale and is accordingly outside the ambit of the of the Sale of Goods Act, 1930.

#### Example 1:

S enters into a contract with Y a gold smith to make some ornaments for his wedding ceremony; Y agreed to make gold jewelry for S from the Gold Bar supplied by S on payment of labor charges to him. This is a contract for work and labor and not a contract for sale of goods.

#### Example 2:

A enters into a contract with D a dentist who agreed to make a set of artificial teeth to fit in the mouth of A. This is a contract for sale of goods [*lee v Griffin (1861)30LJB 252.*]

#### Example 3:

G engaged R an artist to paint a portrait for G and supplied the necessary material. Held it was a contract for work and labor [*Robinson V Graves (1935)1KB 579*]

#### Example 4:

A contract involved the repair of a car and a supply of parts for that purpose. It was held to be a contract for material and works as the contract involves both supply of material as well services. [*Myers & Co v Brent Cross Services co (1934) 1 KB 46*]

The Supreme Court clarified the distinction between a contract of sale and contract of work and labor in *State of Gujarat V Variety Body Builders (1976) SC 2108*. In the instant case the matter to be decided was whether three contracts for coaches on underframes supplied by Western Railways Administration were contract for sale of goods or work and labor. After having examined the terms of contract the court came to the conclusion that the predominant element in the contract was works contract as it was not possible to hold from the terms of the contract that the parties intended that the contractor should transfer the property in railways coaches to the Railway Administration after their completion.

The test generally applied to distinguish between the two is that if as a result of the contract, the property in goods is transferred to the other for price, it is sale. Where the substance of the contract is the exercise of skill and labor it is contract of work and labor. The principal object of the transaction and the intention of the parties in each case determine whether a contract is a contract of sale or a contract for labor and work as evident from the examples given above.

### 2.1.6.2 Sale and Contract for Labor and Materials:

A contract for construction of a building or any other civil construction project where both materials

and labor are to be provided by the contractor is contract for labor and materials. This type of contract is not a contract for sale of material. In such a case the property in building material would pass not on the date of delivery thereof but when the building is constructed.

### 2.1.6.3 Sale and Gift:

In both the cases the ownership of goods passes to other person. The only difference between the gift and sale is that in the case of gift there is no consideration flowing from the donee to the donor. The element of price or consideration is absent in a gift and thus the ownership passes to the done gratis.

### 2.1.6.4 Sale and Hire Purchase:

Sl.No.	Sale	Hire-purchase
(i)	In Sale the payment-may is made cash -down or through installments.	In case of hire purchase, the agreement is that the hirer regularly pays the various installments agreed between the parties.
(ii)	In Sale, the property in goods is transferred to the buyer immediately on signing the contract.	The subject matter of the hire, on payment of the last installment, shall become the property of the hirer, if such installments are not paid, the article will remain the property of the hire-vendor (seller) and the hire vendor will be entitled to regain possession thereof.
(iii)	In case of Sale there is option of bailment.	A hire purchase agreement is both a bailment and an option to buy.
(iv)	In Sale the purchaser can sell the property to third party. This is based on the concept of ownership.	In case of hire purchase the hirer cannot sell the article to a third party.

The following example will make the point clear.

#### Example:

A takes a LED TV from a TV dealer on hire purchase system basis. It is agreed to pay ₹ 2,500 at the time of booking and balance in 10 installments of ₹ 2,500 each commencing from next month with the option to return the LED. After paying 6 installments A makes default in paying the installments, the TV dealer can take back the LED from A and treat the installments so paid as hire charges.

In *KL Johar & Co V Deputy Commercial Tax Officer 91965 SC 1082* the court said, the essence of sale is that the property is transferred from seller to the buyer whether paid at once or paid later in installments. On the other and a hire purchase agreement has two aspects. First is bailment subject to the hire purchase agreement and the second sales which fructifies when the option to purchase is exercised by the intending purchaser. Even when the buyer has no option to return the goods it will an agreement to sell or sale even if the price is paid in installments. The following example will clarify this point.

#### Example:

A purchased a LED TV from B a TV dealer for ₹ 25,000. The dealer suggested him a finance scheme by which on payment of ₹ 2500 he can take away the LED and pay the balance amount in 10 installments of ₹ 2,500/-.

This is not a case of hire purchase even though the price is paid in installment as there is no option to return the goods. This is a clear cut call of sale and not a case of hire purchase agreement.

A lady hired certain furniture from the plaintiff, the price to be paid in two installments and the plaintiff having the right to take back the furniture if an installment was not paid. Before the last installment was paid, the lady sold the furniture to the defendant. It was held that the defendant had acquired a good title the lady being in possession of the furniture under an agreement to buy.



### 2.1.6.5 Sale and Bailment

Sale is different from Bailment. In a contract of bailment goods are delivered by one person to another person for a certain purpose on the condition that the goods will be returned to the bailee on fulfillment of the purpose. Here in the instant case only possession of the goods is given to the bailor and not the ownership.

In case of bailment the ownership does not pass to the bailee, only possession is given to him. Whereas in the case of sale there is absolute transfer of both ownership as well possession by the seller to the buyer and the buyer becomes absolute owners of the goods having all rights to deal with the goods. The difference between Contract of sale and Contract of bailment are summarized as under;

Difference between Contract of sales and Contract of Bailment;

Sl.No	Contract of Sale	Contract of Bailment
(i)	Ownership and goods is transferred from the seller to the buyer	There is transfer of possession and not of ownership from the bailor to the bailee.
(ii)	The buyer may use the goods in any way he likes.	A bailee can use the goods only according to the directions of the bailor.
(iii)	There is no return of goods from the buyer to the seller, unless there is breach.	The goods are necessarily returned after the specified time or accomplishment of the purpose.
(iv)	The consideration is the price in terms of money.	The consideration is an undertaking to return the goods after the accomplishment of the purpose.
(v)	The question of any charges to be paid by the seller to buyer or vice versa does not arise.	The bailor has to repay the charges which the bailee has incurred in keeping the goods safe.

#### Example 1:

X gave a piece of suit length to Y a leading Tailor of his area to be returned to him on payment of his charges after making a Party dress for him. This is not a case of sale but bailment.

#### Example 2:

X left his car in Honda' Motors workshop for repair. Not a case of sale but only a case of bailment

### 2.1.6.6 Sale and Barter

It may be noted that a transaction of sales does not become a case of barter if a part of the purchase price is paid in kind. It will become a case of barter only when the entire purchase consideration is in the form of exchange of other commodities.

A sale is always for a 'price'. But in case of 'barter ', the transfer of ownership of one thing is in return for transfer of another thing.

#### Example 1:

S delivered his old car to a car dealer and took away a new car by paying the difference in cash amounting to ₹ 250,000. The purchase price was ₹ 300000 and the old car was valued at ₹ 50,000. This is a clear-cut case of sale even though some element exchange of commodity is involved.

#### Example 2:

X purchased a new car of ₹ 300000 in exchange of his old MUV which was also valued ₹ 300000. This is a case of barter

### 2.1.6.7 Sales and Mortgage Pledge

Pledge is a bailment of goods by one person to another to secure payment of a debt and if the pledger defaults in payment of the debt, the pledge can sell the goods after due notice to the pledger. A mortgage of property is a transfer of special interest in the property from the mortgagor to secure a debt in which the ownership of the property remain vested with the mortgagor and only the possession is transferred to the mortgagee .If the mortgagor makes a default in paying the debt, the mortgagee may sell the property after due notice to the mortgagor. In both pledge and mortgage, ownership does not pass to the pledgee or mortgagee unlike in the case of sale where ownership passes to the buyer of the goods. The difference between the Contract of Sale and Contract of Mortgage are discussed as under:

Difference between Contract of Sale and Contract of Mortgage

Sl. No.	Contract of Sales	Contract of Mortgage
(i)	Buyer becomes absolute owner of the goods sold	Ownership of the goods remain vested with the mortgagor.
(ii)	Ownership of the goods as a whole is transferred from the seller to the buyer.	Only the possession is transferred and ownership transferred to some interest only.
(iii)	Consideration is the price.	Consideration is the advance of the loan and the securing of the debt.

### 2.1.7 Concept of Goods:

As per 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.

To be classified as goods two conditions are required to be met:

- (i) It must be movable property.
- (ii) It should not be actionable claim and money.

Stock and shares have been treated as goods by the Act itself, so there is no dispute about their inclusion or exclusion from the definition of "goods".

Growing crops, grass and things attached to or forming part of the land are not goods by themselves unless they are agreed to be severed before sale. If they are not to be cut or severed from the land they are not goods.

The Standing timber on land to be severed from the land before the sale is a movable property. While 'tree' is an immovable property, because the standing timber or crop is in a state ready to cut, while a tree continues to draw nourishment from soil so it cannot be treated as goods. [*Shantabhai v State of Bombay AIR 1958 SC 532*]

In *Badri Prasad V State of Madhya Pradesh, AIR 1970 SC 706* the SC held that the definition of goods under section 2(7) of the Act makes it plain that the things fixed to the land may, notwithstanding the definition of movable and immovable property in the General Clauses Act, be subject matter of a contract of sale of goods, provided that by the terms of contract it is clear that they are to be severed from the land.

Trade mark, copy right, patents, electricity, water, gas etc have been treated as goods as per various judgments.

Actionable claims and money are excluded from the definition of goods. Actionable claim has not been defined in the Act. As per section 3 of the Transfer of Property Act, an actionable claim means a claim to any debt or any beneficial interest in moveable property not in possession. It is something which can only be enforced in a court of law. A debt due from one person to another is an actionable claim as the same cannot be brought or sold.

Money means current currency note and not old date currency coins which are considered to be goods.

In *Tata Consultancy Services v State of Andhra Pradesh*, AIR 2005 SC 371 the apex court observed that the definition of the "Goods" in the Act is of wide import which means every kind of movable property.

Benjamin in Sale of Goods has said that water, oil, gas and even air and minerals if severed from soil are goods. However, right to take water or to extract oil or gas or several minerals from soil can be granted by landowner as a disposition of an interest in land and not as Sale of Goods.

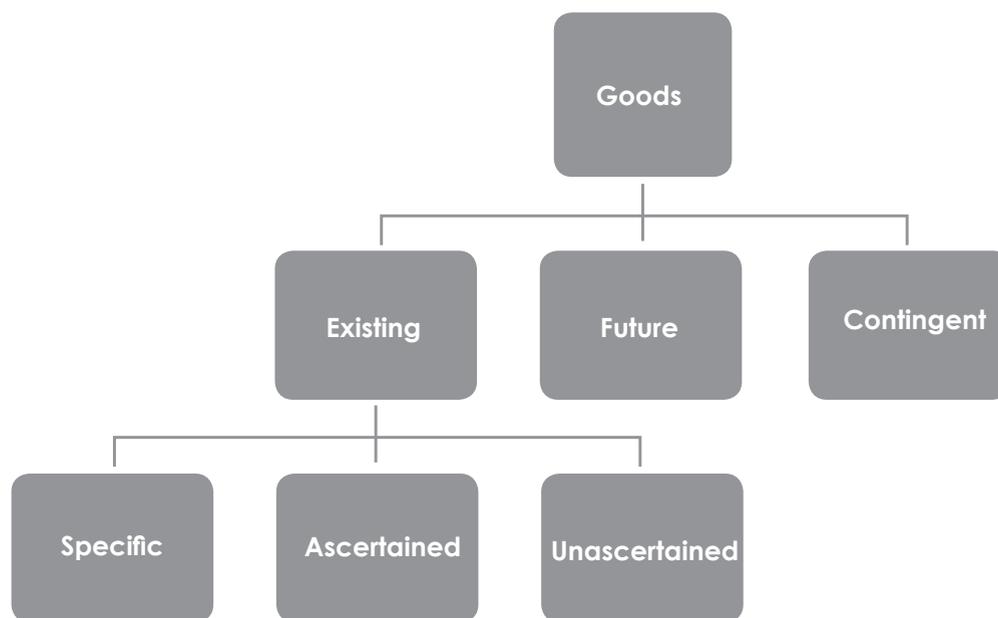
In *SBI V Neeta Ashok Naik*, AIR 2000 Bom 151 the Court held the fixed deposit receipts as goods within the meaning of section 176 of the Indian Contract Act and section 2(7) of the Sale of Goods Act, 1930

In *Vikas Sales Corporation v CCT(1996(SC) 2082 SC* held that transfer of REP License by the holder to another person constitutes sale of goods and therefore liable to sales tax. It held that REP Licence are not in the nature of actionable claims but are goods.

### 2.1.7.1 Classification of Goods

Goods can be existing goods, future goods, and contingent goods.

Existing goods are the goods owned by the seller at the time of sale, future goods are those goods which are not owned by the seller/manufacturer at the time of sale but to be acquired or manufactured subsequent to sale. On the other hand contingent goods are those goods the acquisition of which depends upon some contingency, which may or may not happen. Let us discuss in details the classification of goods.



(I) **Existing goods:** As per section 6 of the Act, existing goods means goods which are owned or possessed by the seller at the time of contract of sale. The seller is either the owner of the goods or he is in possession of such goods. These are the goods which are in existence at the time of making the contract of sales. Generally the seller is the owner of the goods. But in case of sale by an agent or pawnee the goods are possessed but not owned by the seller. Only existing goods can be the subject matter of sales. Existing goods in turn may be:

(a) **Specific goods:** These are the goods which are identified and agreed upon at the time of sale. Goods are not specific merely because they are capable of identification they must be actually identified.

**Example 1:**

S agreed to sell his motor car to Y. This is case of specific goods if S has only one motor car. But if S has five cars then it will not be a case of sale of specific goods but sale of unascertained goods.

**Example 2:**

A has number of horses and out of them he sells Black horse to B. Since the particular horse being sold is identified and agreed upon at the time of sale, this becomes a contract for sale of specific goods.

It may further be noted that specific goods it is necessary that such goods must be identified and agreed upon at the time of making contract and not subsequently. Actual sales can take place only of the specific goods and property in goods passes from seller to buyer at the time of contract provided the goods are in a deliverable state and the contract is unconditional

- (b) Unascertained goods:** The term unascertained goods is not defined in the Act. The goods which are not identified and ascertained at the time of sale are unascertained goods. They are defined by description only and may form part of lot.

**Example 1:**

S agreed to sell his motor car to Y. This is case of specific goods if S has only one motor car. But if S has five cars then it will not be a case of sale of specific goods but sale of unascertained goods.

**Example 2:**

X has 20 chairs he agrees to sell 10 of them to Y. This is a case of sale of unascertained goods. Such goods are sometimes called generic goods.

**Example 3:**

X has 25 LED he agrees to sell 10 of them to Y. The goods are unascertained goods till these 10 LEDs are separated from each others.

- (c) Ascertained goods:** The goods which are ascertained or identified only after the formation of the contract of sale are known as ascertained goods. The goods which were unascertained at the time of making contract may become ascertained when they are agreed upon by the parties. In the examples given above the motor car, chair or LED will become ascertained goods when they are identified by the seller or buyer.

- (II) Future goods:** - These are the goods which are yet to be produced, manufactured or acquired by the seller after making the contract of sale. There can not be sale of future goods. As future goods are not in the possession of the seller at the time of contract, accordingly any contract to sell them only operates as an agreement to sell rather than sale.

**Example:**

X a manufacturer of readymade garments agree to sell 50 pieces of shirts to Y, these shirts are yet to be manufactured by X. This is case of future goods and hence will be an agreement to sell.

- (III) Contingent goods:** These are the goods the acquisition of which by the seller depends upon a contingency which may or may not happen. Such a contract is enforceable only when the event on happening of which performance of the contract depends has happened. If the event does not happen the contract becomes a void contract.

Continent goods are a type of future goods but whereas future goods are more certain to come to existence, contingent goods are less certain to come into existence .If the production of goods is within the control of the parties it is future goods. On the other hand if the production or procurement of the said goods is not within the control of the seller, the goods are contingent goods.



### Example:

X agrees to sell 50 laptops which are to arrive by ship from England. In this case the goods are contingent goods as the performance of the contract depends upon safe arrival of ship from England. If the ship does not reach its destination safely, the contract will become void.

### 2.1.8 Price (Secs 9 and 10)

Another essential element of a contract of sale is price. Unless goods are sold for some price there can not be sale. Transfer of ownership without any consideration is not a sale but merely a gift.

Goods must be sold for some price. Price means the money consideration for sale of goods. In a contract of sale 'price' is the consideration for sale of goods and is expressed in terms of money. It forms essential part of contract and any contract of sale/agreement to sell without price is void abinitio. There is no such stipulation that the entire price should be in money term only. It can be paid partly in money terms and partly in kind. But the entire consideration cannot be in kinds other than money. Where goods are exchanged for goods, it is not a case of sale but a case of barter which is not within the scope of this Act. Similarly if there is no price, it is not a sale but a case of gift. If any consideration other than money is given/ to be given for the goods purchased/sold it is not a case of sale. The general principle of contract regarding consideration equally applies in the case of contract of sale as a contract of sale is nothing but a kind of contract. So the general requirement of a valid consideration also applies in a contract of sale; there must a lawful consideration, which need not be adequate. **Price being a consideration can be present price (present consideration), past price (Past consideration) or price to be paid in future (future consideration).**

#### Example 1:

X agreed to exchange with Y 100 quarters of barley at ₹ 100 per quarter for 52 bullocks valued at ₹ 300 per bullock and pay the difference in cash. Held it was a contract of sales as consideration has been paid both in cash as well in kind. [*Aldridge v Johnson (1857)7E &B 385*]

#### Example 2:

Fifty kg of Basmati rice valued @ ₹ 60 per kg were exchanged for 50 kg of MP Ata valued at ₹ 25 per kg and the difference to be made up in cash, this is a contract of sale.

#### Example 3:

S agreed to purchase 50 Black Berry mobile set @ ₹ 15,000 per set in exchange of 5 Laptops each valued ₹ 80,000 and settle the balance in 2 monthly installments. This is a perfect contract sale provided other conditions of a valid contract are met. The simple fact the consideration is partly in goods and partly in cash to be paid in installment does not affect the contract the sale.

#### Example 4:

X agree to buy one used car from Y a old car dealer for ₹ 50,000 price to paid after one week.(Future price or future consideration) This is a perfect valid contract of sale subject to fulfillment other conditions of a valid contract.

#### Example 5:

X agreed to buy one use car from Y for ₹ 50,000/- which was already paid to Y two days ago.(Past consideration ) This is also a perfectly valid contract of sale despite price paid well before the date of sale.

### 2.1.8.1 Ascertainment of Price:

The Act provides different ways in which price can be ascertained. Provisions regarding determination of price are contained in section 9 and 10 of the Act. It can be fixed in contract itself or left to be fixed in an agreed manner or determined in the course of dealing between the parties or it may be fixed by the valuation of a third party. If the third party does not or cannot make such valuation the

contract becomes void. If the goods or any part thereof have been delivered to, and appropriated by, the buyer, he is required to pay a reasonable price. If such third party is prevented from making the valuation by the fault of the seller or buyer, the party not in fault may maintain a suit for damages against the party in fault.

**Example:**

X agree to sell 5 LCD TVs to Y at a price to be determined by Z. Z refuses to fix the price, the agreement is void. However, if Z is prevented from fixing the price by either of the parties, the aggrieved party is entitled to sue for damages from the defaulting party.

**Where the price is not determined in the manner provided in the contract the buyer will pay the seller a reasonable price.** The term reasonable price is question of fact which depends upon various other factors. Where there is a market price for the goods that may also be a reasonable price.

In *MS Madhusoodhanan v Kerla Kaumudi Pvt Ltd AIR 2004 SC 909* the consideration or price of shares was left to be determined at a later date. It was argued that such a contract would be void for want of uncertainty. The Apex Court rejected the pleas by holding that this argument was not valid because section 9 of the Sales of Goods Act, 1930 allow the parties not to fix the price at the time of the transfer of and to leave the determination of the amount of consideration at a later date. An agreement which provides for future fixation of the price either by the parties themselves or by a third party is capable of being made certain and is not invalid as provided under section 29 of the Indian contract Act 1872 and its illustration (e)

**Addition to or deduction from price of tax.**

Section 64 of the Act provides that unless a different intention appears from the contract, if after making the contract of sale any custom or excise duty is increased or decreased or any other tax is imposed or exempted upon the goods, the seller may add to the contract price additional tax or duty. Similarly if any tax or duty is reduced the benefit of the same can be passed on to the buyer.

**Example 1:**

X agrees to purchase 50 bales of cotton from Y @ ₹ 500 per bales. Next day excise duty on bales was raised 8% to 10 %. Y is entitled to add the additional duty element in the price on the contracted price.

**Example 2:**

X agrees to purchase 50 bales of cotton from Y @ ₹ 500 per bales. Next day excise duty on bales was reduced from 10% to 8 %. X is entitled to ask reduction of price to that extent from Y.

**2.1.8.2 Mode of payment:** The seller is not bound to accept the payment for goods otherwise than in the form of currency unless there is an agreement to the contrary or unless the seller is estopped from disputing the mode of payment. The payment should be in legal tender money. Seller is not bound to accept the payment by cheque.

**2.1.8.3 Agreement to Sell at Valuation**

(a) Where there is an agreement to sell goods on the terms that the price is to be fixed by the valuation of a third party and such third party cannot or does not make such valuation, the agreement is thereby avoided:

Provided that, if the goods or any part thereof have been delivered to, and appropriated by, the buyer, he shall pay a reasonable price therefore.

(b) Where such third party is prevented from making the valuation by the fault of the seller or buyer, the party not in fault may maintain a suit for damages against the party in fault.

As is clear from section 10 of the Act, the parties to the contract of sales may agree to the valuation done by the third party which have no interest in the contract except making a fair valuation of the subject matter of sales. It is quite possible that the third party may not do the valuation may be



due to its own inability or due to fault of either party to the contract. If the third party did not make any valuation for the reasons not attributable to any party the contract is void. If non valuation of the goods by the third party is attributed to any fault on the part of any party to the contract, the aggrieved party i.e., party not at fault may sue the party at fault for breach of contract and demand even damages from him.

**Example 1:** X agree to sell and Y agree to buy old used car of X at the valuation to be done by Z a used car valuation expert. However, Z due to his commitment did not did the valuation. The contract is void due to non determination of value.

**Example 2:** X is having some antique collection which he desired to sell to Y . Y also agreed to buy the same. However, the valuation was referred to Z an expert in antique valuation. X prevented Z in arriving at fair valuation who tried to influence him for higher valuation. Accordingly Z refused to proceed further and did not make any valuation. The contract is void, however Y can sue X for breach of contractual obligations and demand damages/compensation from him.

It may be noted that where the contract is declared void under this section due to non fixation price, if the buyer has received or appropriated the goods or any part thereof he becomes liable to pay a reasonable price.

### 2.1.9 Stipulation Regarding Time in a Contract;

**Stipulation regarding time in a contract falls in two categories;**

**(a) Those relating to time of payment**

**(b) Stipulation as to performance of other contractual obligations.**

**Section 11 of the Act contains the provisions regarding stipulation as to time of payment.**

As per section 11 of the sale of Goods Act, unless a different intention appears from the terms of the contract, stipulations as to time of payment is not deemed to be of the essence of a contract of sale.

However, stipulation as to time of delivery of goods may be essence of contract. Whether any other stipulation as to time is of the essence of the contract or not depends on the terms of the contract. When we say essence of contract, it means essential condition of the contract non adherence of which may entitle the aggrieved party to put an end to the contract. If time of delivery is fixed in a contract, non delivery of the goods on the date and time fixed can be treated breach of contract entitling the buyer to rescind the contract.

#### **Example:**

X agreed to sell his motor car to Y for ₹ 50, 000. The delivery date of the motor car was agreed on Magh purnima being an auspicious day. Considering the fact of the case it can be reasonably inferred that stipulation as to time of delivery of motor car is the essence of the instant contract and motor car must be delivered on the date so fixed.

It may be noted that stipulation as to time may be waived by the party in whose favor they are inserted either expressly or by implications and if he does he cannot afterwards treat the failure to comply with them by the other party as giving a right to rescind the contract.

#### **Example:**

If A agrees to sell and deliver goods to B on a certain day, he must deliver the goods on that day. If he fails to do so B is entitled to put an end to the contract.

In *China cotton Exporters V Beharilal Ramdharan Cotton Mills Ltd AIR 1961 SC 1295* the court held that in mercantile contract stipulation as to time are usually essence of the contract. If therefore the seller fails to deliver the goods within the stipulated time there is a breach of condition emitting the buyer to

reject the goods and treat the contract repudiated. Ordinarily the seller cannot be heard to say that his failure to deliver the goods was due to default on the part of his supplier or due to circumstances beyond his control. The seller is bound to show that he has done all that he could do to ensure timely supply

In *Arson Enterprises Ltd V Union of India (1999)* 9 SCC 499 the apex court held that time cannot be taken to be essence of the contract in a case where the contract itself does not stipulate the time for payment of the price.

### **Earnest money:**

In all contract there is a practice of buyer giving some token money as a token of good faith as a security for due performance of the contract. This token money is known as Earnest money. On successful completion of the contract, the earnest money is refunded or adjusted against the contract/purchase price. If the contract cannot or could not be performed due to fault attributed to buyer earnest money can be forfeited if so provided in the contract.

### **2.1.10 Document of Title of Goods**

Section 2(4) of the Act defines Document of title as "Document of title to goods" includes a bill of lading, dock-warrants, warehouse keeper's certificate, wharfingers certificate, railway receipts multimodal transport documents, warrants or order for the delivery of goods and any other documents used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorize, either by endorsement or by delivery the possessor of the document to transfer or receive goods thereby represented. It symbolizes the goods and confers a right to the owner to take possession of the same or further transfer the right to some other person. This may be done by delivery or by endorsement and delivery. A delivery order, railway receipt, bill of lading, dock warrant, warehouse-keeper or wharfingers certificate are some of the examples of document of title to goods.

## **2.2 PASSING OF THE PROPERTY**

### **Introduction**

One of the important questions in a contract of sale is when does the property in goods passes from the seller to the buyer. This is so because the risk associated with the goods is attached with the property and not with the possession. It is associated with ownership. A Sale is defined as transfer of ownership of the goods from the seller to the buyer for a price. Therefore what is important in a transaction of sale is the transfer of the ownership. It is essential to determine the exact point of time at which the property in the goods is transferred in favor of the buyer. The term "property in goods" means the ownership of the goods. The term transfer of property means the transfer of ownership from seller to buyer so as to constitute the buyer the real owner of the goods. When the ownership of the goods is transferred to the buyer, he becomes the real owner of the goods and the seller ceases to be the owner from that point of time. This ultimately determines the various rights and liabilities of the buyers and sellers in respect of the goods sold.

When it is said that the property in goods has passed on to the buyer, the buyer has become true owner of the goods and any risk and reward associated with the ownership of the goods also stands transferred to the buyer.

It may further be noted that transfer of property in the goods is however, different and distinct from the delivery or possession of goods. Property in goods may pass from the seller to buyer even without delivery of goods. Similarly, the buyer may have physical possession of goods before the property has passed from the seller to the buyer. Thus in the context, ownership and possession are two different concepts and these two can at times remain separately with two different persons.

The Sections 18 to 25 of the Sale of Goods Act, determine when the property passes from the seller to the buyer.



### 2.2.1 Rules for Ascertaining Passing of Property:

The provisions are discussed hereunder:

#### A) Goods must be ascertained(section 18)

As per section 18 in a contract for sale of unascertained goods, the property in the goods does not pass to the buyer unless and until the goods are ascertained.

##### Example:

Under a contract B was entitled to cut teak trees of more than 12 inches girth. The stumps of trees after cutting had to be 3 inches high. It was held that property in the timber that was cut could pass to B when the trees were felled. Till the trees were felled, they were not ascertained. [*Badri Prasad v State of MP AIR (1970) SC 706*]

#### B) Intention of the parties for such transfer(section 19)

As per section 19(2), in 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. The intention of the parties is ascertained from the terms of the contract, the conduct of the parties and the circumstances of the case.

In an auction sale, tender with adequate fair price was accepted. Contract was entered into between liquidator and auction purchaser. Subsequent sale of property also took place. Possession of property had already been handed over. Petitioner challenged the sale which was rejected. It was also rejected because it was filed one month after completion of sale. [*Pratap Scrap Traders v State of Gujarat AIR 2005 Guj 13*]

In *Agricultural Market Committee V S halimar Chemical works Ltd JT 1995(5) SC 272* it was held that an attempt was made to give affect to the elementary principle of law of contract that the parties may fix the time when the property in the contract of sale shall be treated to have passed. It may be at the time of delivery or the time of payment of price or even at the time of making the contract.

When intention of the parties cannot be ascertained, rules contained in section 20-24 are required to be applied for ascertaining the time of transfer of property which is discussed hereunder:

#### (i) Specific goods (Secs 20 to 22)

##### (a) Specific goods in a deliverable state(section 20)

In an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when 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, is postponed. (sec 20). Goods are said to be in deliverable state when they are in such a state that the buyer would under the contract is bound to take delivery thereof.

##### Example:

X selected some party wears in a retail show room. He agreed to take the delivery next day, agree to pay next week. The party wears are destroyed by fire that took place same day. The property in goods has passed on to the buyer and he is liable to pay for it whether delivery hertaken place or not or paid or not.

In *Appleby v Myres (1867)LR 2CP 65*, S offered to sell to B a certain machine for ₹ 5,000. B refused to buy it unless certain work was done on it. S asked B to get the work done himself and deduct the expense from the cost of the machine. To this B agreed and took the machine to a repair shop. While being repaired the machine was destroyed without any fault of the repairmen. The property in machine did not pass to B from S.

In *Agricultural Market Committee V Shalimar Chemicals Works Ltd JT 1997(5) SC 272* it was held in order that section 20 is attracted two conditions have to be fulfilled (i) the contract of sale is for a specific goods which are in a deliverable state and (ii) the contract is an unconditional contract. If these two conditions are satisfied section 20 becomes applicable.

In *Tarling v Baxtor 1827 6 B\*C 360* A contracted on 4<sup>th</sup> January to buy a hay –stack which was the sellers' land the price to be paid on the 4<sup>th</sup> February. It was also agreed that the hay was to remain on the sellers land until the 1<sup>st</sup> May and that the hay should not be interfered with until the price was paid. The property in the hay-sack passes on making of the contract. If the stack is accidentally destroyed by fire, A the buyer must bear the loss.

**(b) Specific goods 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(sec 21).

**Example 1:**

There was a contract for sale of timber from oak trees. The buyer marked out the selected parts of the tree. As per trade practice the seller was required to remove the rejected portion from the trees. But before he could do so, he was declared bankrupt. It was held that the property in goods has not passed on to the buyer so he cannot take away the timber. Until the seller had severed the rejected portion, the goods cannot be said to be in a deliverable conditions to enable transfer of property therein [*Acraman v Morrice (1849)137ER584*].

**Example 2:**

A offer to sell his car to B for ₹ 51, 000 the car to be delivered on stated day and the price to be paid on another stated day. B accepted the offer. The car becomes B's property as soon as the offer is accepted.

**Example 3:**

X offer to sell his horse to Y for ₹ 1,00,000. The price is to be paid after one week and delivery of horse to be made on Dhan Teras.

The property in horse passes to Y whether paid or not.

**Example 4:**

X offer to sell his horse to Y for ₹ 1,00,000. The price is to be paid after one week and delivery of horse to be made on Dhan Teras.

Before Y could take delivery of the horse on Dhan teras, the horse died of swine flue. The property in horse has passed on from X to Y whether the delivery thereof is taken or not. The loss will be borne by Y only.

**(c) Specific goods in a deliverable state, when the seller has to do anything thereto in order to ascertain price(section 22)**

If there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof. (sec 22)

**Example:**

X agreed to sell the entire quantity of oil in a cistern to Y As per the agreement the oil



was to be filled in casks by X and then the buyer was to take them away. Some of the casks were filled in by X in the presence of Y before the same could be taken away by Y and the remaining filled up in casket, the entire quantity of oil was destroyed in fire. It was held that the buyer is to bear the loss of quantity filled in casket and the remaining was to be borne by the seller [*Rugg v Minett (1809) East 210*].

So if the seller has done his part of obligation the property in goods passes to the buyer whether delivery has taken place or not.

In *Hoe Kim Seng v Maung Ba Chit (1953) 62 IA 242 157 IC 89* it was held that the section does not apply when the things which has to be done by the buyer and not the seller.

## (ii) Unascertained goods (Sec 23)

- (a) Where there is a contract for the sale of unascertained or future goods by description and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.

In case of transfer of property from buyer to seller when the goods are unascertained, their ascertainment and unconditional appropriation to the contract are two pre-conditions.

Ascertainment is the process by which the goods answering the description to the contract are identified and set apart. Ascertainment is the unilateral act of seller; appropriation involves selection of goods with the intention of using them in the performance of the contract and with the mutual consent of the seller and buyer.

### Example 1:

In a sale of 20 hogsheads of sugar out of a larger quantity, 4 were filled and taken away by the buyer. The remaining 16 hogsheads were subsequently filled and the buyer was informed of the same. The buyer promised to take them away, but before he could do so, the goods were lost. Held the property had passed to the buyer at the time of the loss [*Rhode v Thwaites (1827) (6B\$C388)*].

### Example 2:

X agrees to sell 200 qts of wheat to Y out of a larger quantity lying in his godown. The agreed price is to be paid on the appointed date under the contract. Unless the quantity 200 qts of wheat is separated from the larger quantity and the goods have been ascertained the property in goods remain with the seller. So if any loss happens to the goods the seller will be responsible.

### Example 3:

X agrees to sell 200 qts of wheat to Y out of a larger quantity lying in his godown. The agreed price is to be paid on the appointed date under the contract X separated 200 qts of wheat and kept them ready for delivery to be taken by Y. The property in goods has transferred from X to Y.

### Example 4:

X agree to sell 100 qts of sugar to Y out of a larger quantity lying in his godown. The agreed price is to be paid on the appointed date under the contract X separated 100 qts of wheat and kept them ready for delivery to be taken by Y. Before Y could take delivery thereof the entire quantity of 100 qts of sugar was spoiled in the heavy rainfall that occurred that very day before Y could take delivery thereof. The property in goods has passed on to Y and the entire loss will be borne by Y alone.

**(b) Delivery to carrier:** Where, in pursuance of the contract, the seller delivers the goods to the buyer or to a carrier or other bailee for the purpose of transmission to the buyer and does not reserve the right of disposal, he is deemed to have appropriated the goods for the purpose of the contract.

**(iii) Goods on approval or 'on sale or return'**

In order to push up the sales generally there is a practice of sending goods to the customer with the clear cut understanding that he has option to approve or return the goods within a given period. This type of sales is known as "approval or sale or return" In such cases the transaction does not culminate into sale until the goods are approved by the customer and the property in goods still remains with the seller.

When goods are delivered to the buyer on approval or on sale or return or other similar terms, the property therein passes to the buyer—

**(a)** When he signifies his approval or acceptance to the seller

**Example:**

A sent 3 dozen of Silk Saris to B 'on approval' 'on sale or return' basis with a option to return the same within 21 days. B sends a letter of approval of goods to A within 15 days. Sales has taken place after 15 days and the property in goods get transferred to B

**(b)** When he does any other act adopting the transaction.

**Example 1:**

A sent 25 tons of cement to B 'on approval' or 'on sale or return' basis, with the option to return the goods within 30 days receipt if not acceptable to him. B used the cement in his project. Since B has appropriate the goods the sale has crystallized property in. goods stands transferred to B.

**Example 2:**

A sent 20 bales of cotton to B 'on approval' or 'on sale or return' basis. B has a choice to return the goods within 3 weeks. However, B instead of conveying his approval or rejection of the goods sold the same to C. Here also B by his act has signified his approval, the sale is complete and property in goods passes on to B.

**(c)** If he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, then, if a time has been fixed for the return of the goods, on the expiration of such time, and, if no time has been fixed, on the expiration of a reasonable time.

**Example 1:**

A horse was delivered to B on the condition of sale or return within 8 days. The horse died within 8 days. It was held that the loss would fall on the seller as the property in goods has not passed on to the buyer. [*Elphick v Barnes (1880)5cpd321*]

**Example 2:**

A delivered some jewellery to B on sale for cash only or return. Before B paid price, he pledged the jewellery with C. Held the pledge was not valid and A could recover jewelery from C [*Weiner v smith (1906)2.kb574*].

**Example 3:**

S ltd agreed to sell a tractor to HC Municipality on the condition that if the latter was not satisfied, it could reject the tractor. The municipality used the tractor for a month and a half and then wanted to reject. Held a reasonable time to reject having elapsed, the property in the tractor had passed to the municipality and therefore it could not reject. [*Hooghly Chinsurah Municipality v Spencer Ltd AIR Cal 49*]



### 2.2.1.1 Reservation of Right of Disposal (Sec 25)

Where there is a contract for the sale of specific goods or where goods are subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled. In such case, notwithstanding the delivery of the goods to a buyer, or to a carrier or other bailee for the purpose of transmission to the buyer, the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.

The seller is deemed to have reserved the right of disposal:

- (1) Where goods are shipped or delivered to a railway administration for carriage by railway and by the bill of lading or railway receipt, as the case may be, the goods are deliverable to the order of the seller or his agent, the seller is prima facie deemed to reserve the right of disposal.

#### **Example:**

A placed an order with B requesting him to send the goods by Sea. B took a bill of lading in the name of A and sends it to his own agent. The goods were destroyed in route. B had to suffer the loss as the property in good had not passed on from B to A.

- (2) Where the seller of goods draws on the buyer for the price and transmits to the buyer the bill of exchange together with the bill of lading or, as the may be, the railway receipt, to secure acceptance to payment of the bill of exchange, the buyer is bound to return the bill of lading or the railway receipt if he does not honour the bill of exchange, and, if he wrongfully retains the bill of lading or the railway receipt, the property in the goods does not pass to him.

### 2.2.2 Effect of Destruction of Goods:

As per section 26 of the Act, the goods remains at the seller's risk until the property therein is transferred to the buyer, but when the property in goods is transferred to the buyer the goods are at the risk of the buyer whether delivery of the goods has been made or not. Thus risk prima facie passes with property unless otherwise is agreed by the parties. In other word the parties may in the contract have different stipulation as to time of passing of risk irrespective of what is provided in section 26 of the Act. It is once again reiterated that the general rule is that in the absence of special terms, the risk follows ownership and not possession. Whoever is the owner of the goods has to bear the loss associated with the goods. Sec 26 further provides that the provision of this section does not affect the duties and liabilities of either the seller or buyer as the bailee of goods of the other party.

**Quite often it may happen without knowledge of the seller the goods have perished or so damaged as not to answer the description of the goods contracted to be sold**, the contract is void if the goods without the knowledge of the seller have, at the time when the contract was made, perished or become so damaged as no longer to answer to their description in the contract.

**Goods perishing before making of contract (Sec 7)** – Where there is a contract for the sale of specific goods, the contract is void if the goods without the knowledge of the seller have, at the time when the contract was made, perished or become so damaged as no longer to answer to their description in the contract.

**Goods perishing before sale but after agreement to sell (Sec 8)** – Where there is an agreement to sell specific goods, and subsequently the goods without any fault on the part of the seller or buyer perish or become so damaged as no longer to answer to their description in the agreement before the risk passes to the buyer, the agreement is thereby avoided.

Sec (7 & 8) is applicable only in case of specific goods and not uncertained/generic goods.

#### **Example 1:**

A cargo of dates was sold. The dates were contaminated with sea water so as to be unsaleable as dates, though they could be used for making spirits. The contract was held to be void as the subject matter of contract that is dates no longer answered their description in the contract. [Asfar & co V Blundell(1896)QB123

**Example 2:**

On Dushera X agree to sell his horse to Y for ₹ 10, 000. However, ten days later the horse was found to dead due to swine flue.

The contract become void due to non existence of the goods

**2.2.3 Risk Prima Facie Passes with Property: Exceptions**

The rule regarding risk passes with the property enshrined in section 26 is subject to the following exceptions.

- (a) This rule of 26 will apply only if there is no agreement to the contrary. It is permissible for the parties to provide in the agreement that although the property does not pass, the risk passes and they may fix the point of time when it is to pass.

In *Consolidated Coffee Ltd v Coffee Board 1980 3 SCC 358*, one of the terms of the Coffee Board for auction of coffee was that the property in the coffee knocked down to a bidder would not pass until the payment of price and in the meantime the goods would remain with the seller but at the risk of the buyer. In such cases the risk and property passed on at a different stages.

- (b) Where delivery has been delayed through the fault of either party the buyer or the seller, the goods are at the risk of the party at fault as regards any loss which might not have been occurred but for such loss. The goods are at the risk of the party who is at fault in delay of delivery.

**Example 1:** In *Demby Hamilton & Co Barden Endeavor Wines Ltd 1949 All ER 435* A contracted to purchase 30 tons of apple juice from B Deliveries were to be made in weekly truckloads. B crushed the apples and put them in juice cask for delivery. A delayed the delivery. As a result juice deteriorated in quality. It was held that the loss was to be borne by the buyer.

**Example 2:** X of Kolkata sell 500 bags of cement to C of Chennai. However, C requested X to retain the cements bags in his godown for next four days as he is yet to make transportation arrangement. However, due to heavy rainfall in Kolkata, 150 bags of cement turned into hard stone due to moisture exposure and rainfall. As the delivery has been delayed at the instance of the buyer the loss will be borne by C even though the goods were in the custody and possession of the seller X.

**Example 3:** X of Kolkata sold 500 bags of cement to C of Chennai, the goods were to be delivered at Chennai by the seller, However, X requested C to give him three days time to deliver the goods as he is yet to make transportation arrangement. However, due to heavy rainfall in Kolkata 150 bags of cement turned into hard stone due to moisture exposure and rainfall. As the delivery has been delayed at the instance of the seller the loss will be borne by X.

- (c) If there is a custom in that particular trade that the risk does not pass with property, in such a case the risk will pass as per the custom.
- (d) Risk and property may be separated by agreement between the parties. Section 40 of the Act also provides that where the seller agrees to deliver the goods at his own risk at a distant place from where they are, the buyer shall unless otherwise agreed, not take any risk of deterioration in the goods incidental to the transit. This will be discussed subsequently in the paragraph dealing with delivery of goods

**2.2.4 Transfer of Title by Non Owners of Goods:**

Generally only the true owner can sell the goods and convey better title to the next owner of the goods. But at times non owners sells the goods, As per section 27 of the Sale of Goods Act where goods are sold by a person who is not the owner thereof and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had, unless the owner of the goods is by conduct precluded from denying the seller's authority to sell.



A buyer cannot get good title to the goods unless he purchased the goods from a person who is the owner thereof and sell them under the authority or with the consent of real owner.

**Example 1:**

X found a golden ring of Y lying in a park. X instead of returning it to Y sold it to Z who purchased in good faith and for value. Y is entitled to recover it from Z as X has no title to sell it, accordingly he cannot give a title which he does not have.

**Example 2:**

X took a bicycle on hire from Y he sold it for value to Z who purchased it in good faith and for value. Y can recover the same from Z.

Generally the owner alone can transfer property in goods. “*Nemo dat qui non habet*” means that no one can give what he himself does not have. It means a non owner cannot make valid transfer of property in goods. If the title of the seller is defective, the buyer’s title will also be subject to same defect. If the seller has no title, the buyer does not acquire any title although he might have acted honestly and might have acquired the goods after due payment. This rule is to protect the real owner of the goods. Though this doctrine seeks to protect the interest of real owners, but in the interest of the trade and commerce there must be some safeguard available to a person who acquired such goods in good faith for value; Accordingly the Act provides the following **exceptions** to this doctrine which seeks to protect the interest of bonafide buyers:

**(i) Sale by mercantile agent:** Where a mercantile agent is, with the consent of the owner, in possession of the goods or of a document of title to the goods, any sale made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorized by the owner of the goods to make the same, provided that the buyer acts in good faith and has not at the time of the contract of sale notice that the seller had not authority to sell.

As per section 2(9) Mercantile agent means a mercantile agent having in the ordinary course of business as such agent authority either to sell goods or to consign goods for the purpose of sale or to buy goods or to raise money on the security of goods. This definition of mercantile agent is nearly the same as that contained in the English Factories Act, 1889

It may further be noted that in order to enable a mercantile agent to convey good title, he should be in possession of the goods as a mercantile agent. If the goods are entrusted to him in any other capacity other than a mercantile agent, he cannot convey good title .

It may also be understood that the goods should be in the possession of the mercantile agent with the consent of the owner. This requirement is satisfied when it is shown that the true owner did intentionally deposit the goods in question. When this is so, then it is immaterial whether the consent was obtained by fraud or trick or any other method.

**Example 1:**

F the owner of a car, delivered it to H, a mercantile agent for sale at not less than ₹ 39,000. H sold the car for ₹ 17,000 to K who bought it in good faith and without notice of any fraud. H misappropriated the money. F sued to recover the car from K.

Held as H was in possession of the Car with F's consent for the purpose of sale, K obtained a good title to the Car [*Folkes v King 1923 1KB282*].

**Example 2:**

X left his car with Y a mercantile agent and authorised him to receive offers but not to execute any sale. Y the agent obtained possession of registration book of the car without knowledge of X and promptly sold it to Z. In the instant case, the mercantile agent would not be in position to pass good title to Z who have purchased it from Y in good faith as the registration without which sale of car is not possible was obtained through fraud.

- (ii) **Sale by one of joint owners (Section 28):** If one of several joint owners of goods has the sole possession of them by permission of the co-owners, the property in the goods is transferred to any person who buys them of such joint owner in good faith and has not at the time of the contract of sale notice that the seller had not authority to sell.

**Example 1:**

X and Y were joint owner of a car. While the car was in possession of X, Y secretly took possession of the car without notice of X and sold it to Z an innocent buyer who had no knowledge of this fact and paid for it.

Z will not get a valid title to the car as though the car has been sold by one of the co owner, but it has been sold by Y without consent of X.

**Example 2:**

X and Y were joint owner of a car. While the car was in possession of X, X without notice of Y and sold it to Z an innocent buyer who had no knowledge of this fact and paid for it.

Z will get a valid title to the car as though the car has been sold by one of the co owner without consent of another one but it was in the possession of the joint owner who sold it.

- (iii) **Sale by person in possession under voidable contract (Section 29):** When the seller of goods has obtained possession thereof under a contract voidable under Section 19 or Section 19A of the Indian Contract Act, 1872, but the contract has not rescinded at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith and without notice of the seller's defect of title.

The first condition to be satisfied for the application of this exception is that the goods should have been obtained under a voidable contract rather than under a void contract. Where the possession of the goods is obtained under a void contract, the buyer does not get good title to it.

The second requirement is that the contract must have not been rescinded at the time of sale. The usual method of rescinding a contract is by giving a notice to the other party of the intention to rescind the contract.

The third requirement is that the buyer should act in good faith and should not have notice of the seller's defective title. The following illustrations would make it clear:

**Example 1:** In *Car and Universal Finance Co Ltd v Caldwell (1964) All ER 290*, on 1<sup>st</sup> Jan the owner of a car was induced to sell for a cheque. Next day it was discovered that the cheque was worthless. He immediately informed the police and requested the Automobile Association to trace the location of the car. On 5<sup>th</sup> January the so called buyer sold the car to another person who acted in good faith. It was held that the third party would not get a good title to it as the owner of the car had effectively shown his intention to rescind contract.

**Example 2:** X presented before Y a jeweller to be a respectable and influential person of the area and purchased a diamond studded gold ring on the strength of a cheque which was later on discovered to be worthless. Before the fraud could be discovered X pledged it to Y who obtained it in good faith. Y got a good title to the ring as the contract was voidable and still not rescinded and had gone in the hand of third party before the fraud could be discovered and it is rescinded.

**Example:**

A purchased a mobile set from B by fraud. A has avoidable title to the mobile set at the option of B. Before B could rescind the contract A sold the same to C who purchased it from A in good faith and without knowledge of fraud by A and paid for it. C had a good title to the goods

- (iv) (a) **Seller in possession after sale [Sec 30(1)]:**

Where a person, having sold goods, continues or is in possession of the goods or of the



documents of title to the goods, the delivery or transfer by that person or by a mercantile agent acting for him of the goods or documents of title under any sale, pledge or other disposition thereof to any person receiving the same in good faith and without notice of the previous sale shall have the same effect as if the person making the delivery or transfer were expressly authorised by the owner of the goods to make the same.

In order to get benefit of exception under this section it is necessary that the seller should continue to be in possession of the goods after having sold the same. In *Staffs Motors Guarantee Ltd v British Wagons Co Ltd* the owner of a lorry sold it to the defendant and took it back on hire purchase. He then sold it to the plaintiffs. The latter would not get a good title to it because the seller was not in possession as seller but as a bailee under a hire purchase agreement. Where, however, the seller never parts with the goods and the hire purchase agreement under which he retains them is a sham, any bonafide buyer from him will get a good title to it. This is so because the seller should remain in possession as seller and not in an altered capacity like bailee.

It is also worth noting that it is not necessary that the seller should be in personal possession of the goods. It is enough that the goods are at his disposal even if they are in the custody of a warehousekeeper. In *City Fur Manufacturing Co v Pureenbond(Brakers ) London Ltd*, one H purchased a quantity of skins from a broker. The goods remained in the broker's warehouse pending payment. H sold them to the plaintiff who gave him a bill of exchange to enable him to pay the broker and arrange delivery to the plaintiffs. Instead H pledged the goods with the defendants. The defendant was held to have acquired good title to the goods.

By acting in good faith and without notice of the fact, the goods in question were already second the sale must take place in the seller's ordinary course of business of a mercantile agent.

#### **Example 1:**

A sold his blackberry mobile to B. He promised to deliver the same after one week. However A instead of delivering to B sold it to C who purchased it from A in good faith and paid the price. C gets a good title to it.

#### **Example 2:**

X sold 50 ton of sugar to Y. Y delayed taking delivery on one pretext or another. Meanwhile X sold the same to Z, another innocent buyer who has no knowledge of the goods have already been sold to Y and paid for it. Z would get a valid title to the goods.

### **(b) Buyer in possession before sale [Sec 30(2)]**

Where a person, having bought or agreed to buy goods, obtains with the consent of the seller, possession of the goods or the documents of title to the goods, the delivery or transfer by that person or by a mercantile agent acting for him, of the goods or documents of title under any sale, pledge or other disposition thereof to any person receiving the same in good faith and without notice of any lien or other right of the original seller in respect of the goods shall have effect as if such lien or right did not exist.

Under this section the sale may have been made by actually transferring the goods or by transfer of document of title. The pledge or any other disposition of goods will be equally effective. However, it is necessary that the second buyer must act in good faith without notice of the seller's rights.

It may be noted that possession obtained under a hire purchase agreement does not make the possessor a buyer in possession so that a sale by him will not convey a good title to the buyer.

It is also necessary that the original seller should have the right to sell the goods otherwise he will not convey good title.

- (v) **Sale by estoppel (Section 27):** Under certain circumstance the true owner of the goods may be prevented by his conduct from denying the seller's authority to sell Let us say, A is the owner of some goods. He by his conduct make B believe that C is the owner of the goods. On this belief B buys the goods from C. Under these circumstances the court will not allow A to prove his ownership. Thus Y gets good title to the goods even though he has not got it from the true owner A. This called doctrine of estoppels. Section 27 provides as under---

Where the owner by his conduct or omission, leads the buyer to believe that the seller has authority to sell, he is estopped from denying the fact afterwards. The buyer thus gets a better title than the seller.

**Example 1:**

A tells B in presence of C that A is agent of C. C maintains silence instead of denying it. Later if A sells C's goods to B, C cannot dispute B's title to the goods.

**Example 2:**

P the owner of certain machinery left them in the possession of Q, A person named R who had obtained a decree against Q seized the goods in execution of the decree. P took no steps for several months to claim the goods. He also conversed with R's solicitor regarding the execution without mentioning his title to the machinery. R then had the machinery sold in execution. It was held that P was estopped from denying that the machinery was Q's. [*Pickard v Sears*.1973 6 AE 469]

- (vi) Sale by an unpaid seller after exercising his right of lien or stoppage in transit. According to section 54(3) an unpaid seller of goods who has exercised his right of lien or stoppage in transit can even though the ownership in them has passed to the buyer resell the goods and can convey valid title to another buyer, though no notice of resale of goods has been given to the original buyer

**(vii) Exceptions in other Acts:**

- (a) Sale by Official Receiver or Liquidator.
- (b) Sale by a pawnee or pledgee in certain cases.

A person to whom goods have been pledged or pawned as a security of some loan taken can sell the goods so pledged if his dues are not settled. In such cases the buyer of the goods get good title to the goods.

**Example:**

S took a loan of ₹ 150,000 from T by pledging his car. However, despite repeated follow up S failed to pay back the loan. T sold the car to U in order to recover the sum loaned to St gets a good title to the car.

- (c) Sale by finder of lost goods in certain cases.

A finder of lost goods in certain conditions can sell the goods so found if the goods are of perishable nature and the true owner could not be found with reasonable efforts. Similarly when the lawful charges of the finder form 2/3rd of the value of the goods he can sell them.

**Example 1:**

A found a package of 15 kg of apples in a fruit and vegetable market, he made reasonable efforts to trace the owner of the apples but could not find him. After waiting for three days he sold the same to B. B will get good title to the goods sold by A even though he is not the true owner of the goods.

**Example 2:**

A found a wrist watch in a shopping mall. He made all efforts to trace the true owner of



the wrist watch but could not find him. As his lawful expenses in tracing the true owner now constitute about 2/3d of the value of the wrist watch, he sold the same to B. B will get good title to it.

### **Cases not coming within the exceptions discussed above:**

It may be noted that apart from the general cases mentioned above, the general rule applies and no seller can give a better title than he himself has. This will be clear from the following examples;

#### **Example 1:**

X found a ring. He made a reasonable search for the true owner but could not find him. He subsequently sold the ring to Y. It was held that the true owner can recover the ring from Y [*Farquaharson Bros v King & co*].

#### **Example 2:**

A horse was sold in a public auction. The horse was stolen property but this was not known to either the auctioneers or the buyer. Held the true owner can recover the horse [*Lee v Bayes 1902 1 AC 325*]

#### **Example 3:**

B let out a motor car on hire to M at ₹ 1,000 per month. It was agreed between the parties that M could purchase the car by paying in all ₹ 30,000 at any time within 24 months. After a few months M pledged the car with C. B sued to recover the car from C. It was held that as M had only an option to purchase he cannot give good title to C and hence B can recover the car. [*Bexize Motor Co v Cox. 1914 KB 244*]

## **2.3 CONDITIONS AND WARRANTIES**

### **Introduction**

At the time of selling the goods, a seller himself or through his employee makes a lot of statements or representation about the nature of the goods, quality, price, mode of payment, mode of delivery, suitability and durability etc of the goods with a view to induce the intending buyer to buy the goods. Such statements made by the seller or his employee before sale are known as representations. Such representations may be merely expression of his opinion or his recommendations.

Whatever representations the parties make during negotiation may or may not become part of the contract. It all depends upon the circumstances of the case whether the statement made with reference to the goods is merely expression of opinion or a stipulation forming part of the contract.

The question which arises here is that whether the statements made by the seller forms the part of the contract of sale or not?

If they do form the part of the contract and if there is a difference between the actual goods and the goods described in the statement, whether the buyer can treat that as a breach of contract? Reply to all these questions depends whether the statement/stipulation made is a condition or warranty. Such stipulations may be either conditions or warranties. A statement/stipulation/representation, which forms an important part of the contract of sale and affects the contract is called condition. On the other hand a stipulation/statement/representation, which is of lesser importance, is called warranty.

**Conditions and warranty defined:** Every contract of sale has a number of stipulations regarding the nature and quality of the goods being offered for sale. Such stipulation may be either condition or warranty depending upon the contract. A representation which forms a part of the contract of sale and affects the contract is called condition. However, every stipulation is not equal in importance. In

simple words we can say that a stipulation which is most important for the formation of the contract is known as a condition and a stipulation which is of lesser importance in the formation of a contract is known as a warranty.

### **2.3.1 Condition [Section 12(2)]**

A condition is a stipulation essential to the main purpose of the contract, the breach of which gives rise to right to treat the contract as repudiated.

A condition in a contract of sale of goods is of fundamental nature for breach of which the buyer can repudiate the contract

The following case can help in understanding the concept of Condition:

In *Baldry v Marshall (1925) KB260* B consulted M a car dealer for a car suitable for touring purpose. M suggested that a Bugatti car would be appropriate. Relying upon the stipulation made by M. B purchased the Bugatti car as suggested by M. Later on the car was found to be unsuitable for touring purpose. B wanted to return the car and wanted to have the price refunded to him. It was held that the car suitable for touring purpose was main stipulation which was essential to the contract and was held to be a condition. The term was so important that its non fulfillment thereof frustrated the very purpose of purchase of the car. Therefore B was entitled to reject the car and have the price refunded.

#### **Example 1:**

It was agreed a charter party that ship M of 420 tons now in the port of Amsterdam should proceed direct to Newport to load cargo. In fact at the time of the contract, the ship was not in the port of Amsterdam and when the ship reached Newport, the charterer refused to load. Held the words "now in the port of Amsterdam" amounted to a condition, the breach of which entitled the charterer to repudiate the contract [*Behn v Burnes (1863) 3 B&S 751*]

#### **Example 2:**

X asks a cloth dealer to show him a shirt piece that will not shrink and lose color after wash. Y the cloth dealer showed him a shirt piece and reiterated that the shirt will neither shrink nor give color while washing. However, only after first wash the shirt not only lost color but also shrank in length.

This is a breach of condition and X has right to return the shirt piece and claim refund of price paid.

#### **Example 3:**

X sells food stuff to Y. It is essential terms of the contract though it may not expressly stated that the goods will be fit for human consumption, so if it is found that the food contains some poisonous elements Y will be entitled to reject the goods and to repudiate the contract. This is an essential term of a contract for sale of foodstuff that the goods should be wholesome. This essential term is condition.

In the above example if the contract stipulates that the foodstuff should be packed into one kg box but the seller packs them in half kg boxes, only an auxiliary or minor term of the contract, a warranty is breached. The stipulation that it should be packed in one kg boxes is only warranty and not condition. Y cannot repudiate the contract for breach of warranty and claim only compensation for loss suffered by him

### **2.3.2 Warranty [Section 12(3)]**

A warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated.

Section 12(4) further states "Whether a stipulation in a contract of sale is condition or a warranty depends in each case on the construction of the contract, a stipulation may be a condition though called warranty in a contract."

A condition in a contract of sale is a stipulation of fundamental nature the breach of which gives the opposite party the right to repudiate the contract. Buyer may claim refund of price. However, warranty



is subsidiary to main purpose of the contract. The breach of warranty only gives rise to a right to claim damages for any loss which may arise. Thus if condition is not fulfilled the buyer can repudiate the contract reject the goods and ask for refund of price if paid. But in the case of breach of warranty the buyer can simply demand damages but has no right to reject the goods and claim refund of price.

The following case can help understand the concept of warranty.

H brought two small ships from K relying upon the particulars furnished by K that the capacity of each ship was 460 tons. Actually the capacity was 360 tons only. H wanted to reject the ship. It was held that the representation of capacity of ship was a warranty for which H could only sue for damages and not entitled to have the contract repudiated. [*Harrison v Knowles and foster (1917)2KB606*]

#### Example 1:

S sells his dog to B saying that is a very lucky one. B buys the dog. But the dog does not prove to the lucky rather B got himself injured while taking the dog for a morning stroll. Has B any action against S? No this is merely a statement not amounting to breach of condition. B has no action against S.

#### Example 2:

X ordered Y to deliver a new party wear to him by 19<sup>th</sup> November as he is required to wear the same on 20<sup>th</sup> November on the occasion of his brother's wedding. Here time of delivery of the party wear is essence of the contract and failure to deliver the same on or before the date stipulated is breach of condition entitles X to repudiate the contract if the party wear is not delivered by 19<sup>th</sup> November.

Suppose X intended to use the party wear on the Christmas party on 25<sup>th</sup> December. In such case time of delivery cannot be treated essence of the contract. X cannot repudiate the contract for failure to deliver the same by 19<sup>th</sup> November . This stipulation as to time will be treated as warranty only and not a condition.

### 2.3.3 Distinction between a condition and a warranty

Sl. No.	Basis of distinction	Condition	Warranty
(i)	Value	A condition is a stipulation which is essential to the main purpose of the contract.	A Warranty is a stipulation which is collateral to the main purpose of the contract.
(ii)	Rights	The aggrieved party can repudiate the contract of sale in case there is a breach of a condition	The aggrieved party can claim damages only in case of breach of a warranty.
(iii)	Treatment	A breach of condition may be treated as a breach of a warranty. This would happen where the aggrieved party is contended with damages only	A breach of a warranty, con not be treated as a breach of a condition.

### 2.3.4 Breach of Condition to be Treated as Breach of Warranty:

Under certain circumstances a breach of condition is to be treated as a breach of warranty, i.e. the right of repudiate the contract is deemed to have been lost. These conditions are provided in **section 13** of the Act which are as under:

Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for relating the contract as repudiated.

#### Example 1:

X agreed to supply 10 trucks of first class bricks to Y @ ₹ 5000 per truck. However X instead of supplying first class bricks, supplied second grade bricks which are valued only ₹ 4,500 per truck. This is a breach

of condition and entitled Y to reject the goods and claim refund of price from X. If Y agree to accept the goods this can be treated as breach of warranty and claim damages @ ₹ 500 per truck

**Example 2:**

X agreed to supply 10 Qt of sugar of best quality to Y @ ₹ 5000 per Qt, however X instead of supplied only second grade sugar the price of which is only ₹ 4,000 per Qt. This is a breach of condition and entitled Y to reject the goods and claim refund of price from X. If Y agree to accept the goods, this can be treated as breach of warranty and claim damages @ ₹ 1000 per Qt.

Where a contract of sale is not severable and the buyer has accepted the goods or part thereof, the breach of any condition to be fulfilled by the seller can only be treated as a breach of warranty and not as a ground for rejecting the goods and treating the contract as repudiated, unless there is a term of the contract, express or implied, to that effect.

Where the buyer has accepted the goods and subsequently comes to know of the breach of condition, he can not reject the same, but only maintain an action for damages. Similarly if the buyer has accepted only part of the goods and the contract is indivisible, he will have to accept the remaining part also. However, in the case of divisible contracts, he can repudiate the contract as regards remaining goods if he has accepted only part thereof.

**Example:**

A asked for a special quality of Dehra dun rice from B, B supplied Dehradun rice to A. When the rice was cooked though it was good but not the same as required by A. A cannot rescind the contract, he can treat the breach of condition as breach of warranty and just claim damages.

**2.3.5 Remedies Available to the Buyer for Breach of Conditions;**

- (a) Affected party may claim refund of price and reject the goods;
- (b) Elect to treat breach of condition as breach of warranty and claim damages or compensation;
- (c) When the affected party treat breach of condition as breach of warranty he can not repudiate the contract but claim damages only;
- (d) No remedy is available when the fulfillment of condition is excused by law by means of impossibility or otherwise (13(3)).

**2.3.6 Consequences of Breach of Warranty:**

- (a) The breach of warranty gives right to a claim for damages but not to reject the goods and treat the contract as repudiated.
- (b) Buyer may sue for damages.
- (c) No remedy is available if the fulfillment of warranty becomes impossible by law.

**2.3.7 Conditions and Warranties May be Either Expressed or Implied**

When terms of contract expressly provide for them, they are known as express conditions or warranties. Implied conditions and warranties are incorporated in every contract of sale unless the circumstances show a different intention.

**2.3.7.1 Implied conditions are of the following types:**

**(i) Condition as to title [Sec 14(a)]**

In a contract of sale, unless the circumstances of the contract are such as to show a different intention, there is—

- (a) An implied condition on the part of the seller that, in the case of a sale, he has a right to sell the goods and that, in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass.



- (b) An implied warranty that the buyer shall have and enjoy quiet possession of the goods.
- (c) An implied warranty that the goods shall be free from any charge or encumbrance in favour of any third party not declared or known to the buyer before or at the time when the contract is made.

**Example:**

R purchased a second hand car from D who has no title thereto. R used the car for only four months as after four months the true owner of the car traced the car and took back the car from R as the same was stolen from his shop. This is a breach of implied condition as to title of the goods. R has right to repudiate the contract and recover full price from D [*Rowland V Divall (1923)*].

If the goods delivered can only be sold by infringing a trade mark, the seller has broken the condition that he has a right to sell the goods.

**Example:**

A brought 300 tins of condensed milk from USA. The tins were labeled in such a way as to infringe the trade mark of Nestle. The goods were detained by the custom agency and accordingly the goods have to be sold after removal of level at a loss.

It was held that the supplier had broken the condition as to title to goods. [*Niblett Ltd v Confectioners Materials co (1921) 3KB387*].

**(ii) Sale by description (Sec 15)**

Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description, and, if the sale is by sample as well as by description, it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.

Goods are sold by description when they are described in the contract such as MP Atta, Dehradun Rice, Kashmiri Rajama, Amul butter and the buyer contracted relying on such description of goods by the seller.

**Example1:**

A ship was contracted to be sold as a copper fastened vessel to be taken with all faults, without any allowance for any defect whatsoever. The ship turned out to be partly copper fastened. Hence the buyer is entitled to reject the goods as there is breach of condition of sale by description. [*Shepherd v kain (1821)5 B & Aid 240*].

**Example2:**

X brought a computer printer from Y which he did not see previously. Y told that the printer is heavy duty fast printer but is just one month old. Relying on the stipulation made by Y, X purchased the printer. When used, the same was found to be too old and not confirming to the description made by Y. X could repudiate the contract for breach of condition as to sale by description by Y. X can return the printer and claim refund of price from him.

**Example3:**

In an auction sale X purchased some napkins and table cloths which were described as dating from 17<sup>th</sup> century. X purchased the same after seeing them. But they were found to be only 18<sup>th</sup> Century old. Held there is a breach of condition and X could reject the goods and claim refund of money [*Nicholson & Venn v Smith Marriott (1947)177LT189*].

**(iii) Condition as to quality or fitness (Sec 16)**

As per Sec 16 of the Sale of Goods Act, the buyer is supposed to satisfy himself about the quality of goods he purchased and is also charged with the responsibility of seeing that the goods suit the

purpose for which they were purchased by him. Later on if the goods does not turn out to be as per his purpose, the seller cannot be asked to compensate him. This is based on the famous doctrine of **CAVEAT EMPTOR** which means 'let the buyer beware'. However, there are some exceptions to this which are as under:

- (a) Where the buyer, expressly or by implication, makes it known to the seller the particular purpose for which the goods are required, so as to show that the buyer relies on the seller's skill or judgment, and the goods are of a description which is in the course of the seller's business to supply (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be reasonably be fit for such purpose. However, in the case of a contract for the sale of a specified article under its patent or other trade name, there is no implied conditions as to its fitness for any particular purpose.

**Example 1:**

An order was placed for supply of some lorries to be used for heavy traffic in hilly areas. The lorries supplied were unfit and broke down when used in hilly roads. There is a breach of condition as to fitness.

**Example 2:**

X an athletic wanted a wrist watch to give accurate time to the extent of 1/1000 fraction of a second. He told the shopkeeper about his requirement and purpose. The wrist watch supplied gave accurate time but was not different from other wrist watches and accurate only upto 1/10<sup>th</sup> fraction of second. There is a breach of condition as to fitness for a particular purpose. X can repudiate the contract.

**Example 3:**

A having no special knowledge of hot water bottle, purchased a hot water bottle from a chemist. The bottle burst and injured his wife. There is a breach of condition and the chemist is liable to refund the price and pay damage to the customer as there was breach of condition as to fitness.

**Example 4:**

A dealer in home appliances sell a refrigerator to B. The refrigerator performed all the functions but could not make ice.

This is a breach of condition as to fitness as refrigerator is meant for cold water and making ice. There is a breach of condition as to fitness. So A, the dealer is liable to refund the price.

In *Grant v Australian Knitting Mills (1936)*, Dr Grant purchased from a retailer two woolen underpants manufactured by the defendant. After wearing one of them he contracted skin diseases which was due to some chemical irritant which left un-removed during the manufacturing process. It was held that there was breach of implied condition of fitness.

- (b) Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality. However, if the buyer has examined the goods, there shall be no implied conditions as regards defects which such examination ought to have revealed.

In order to apply the implied condition as to merchantability the following requirements must be satisfied.

- (i) the seller should be dealer in goods of that description;
- (ii) the buyer must have not opportunity to examine the goods or there must be some latent defect in the goods which would not be apparent on reasonable examination of the same.



It may be noted the term merchantability has not been defined in the Act. As per English Sale of Goods Act, goods of any kind are merchantable quality if they are as fit for the purpose or purposes for which goods of that kind are commonly brought as it is reasonable to expect having regard to any description applied to them, the price and all other relevant circumstances.

**Example 1:**

[In *Moreli v Fitch & Gibbons(1928)*], the plaintiff asked for a bottle of stone's ginger wine at the defendant's shop which was licensed for the sale of wines. While drawing the cork with a corkscrew, the bottle broke at the neck and injured him. The court held that the sale was one by description and that the bottle was not of merchantable quality and consequently the plaintiff was entitled to damages from the defendant.

**Example 2:**

A radio set was sold to a laymen. The radio set did not work despite repair by the buyer. It was held there is a breach of condition as to merchantability and the buyer is entitled to return the radio set and claim refund of price. [*RS Thakur V HGE corporation AIR 1971 Bomb 97*]

**Example 3:**

P sold a plastic catapult to G, a boy of six year old. G while using it properly got injured as the catapult broke due to bad material quality. G sustained some eye injury. Held G is entitled to claim refund of price as the goods were not of merchantable quality and there is a breach of condition. [*Godley v Perry 1960 All ER36*]

- (c) An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade.

In some cases the purpose for which the goods are required may be ascertained from the acts and conducts of the parties to the sale or from the nature of the description of the article purchased. For example if a hot water bottle is purchased, the purpose for which it is purchased is implied in the thing itself. In such a case the buyer need not tell the seller the purpose for which the bottle is purchased. Similarly if a thermometer is purchased in common usage, the purpose of thermometer is well known, the buyer need not tell the seller.

**Example:**

C brought a set of false teeth from a dentist. The teeth did not fit well into the mouth of C. Held C could reject the set as the purpose for which anybody would buy a set of false tooth is impliedly known to the seller, the buyer need not tell him. This is a case breach of condition. [*Dr Baretto v TR Price AIR 1939 Nag 19*]

- (d) An express warranty or conditions does not negative a warranty or condition implied by this Act unless inconsistent therewith.

**(iv) Sale by sample (Sec 17)**

A contract of sale is a contract for sale by sample where there is a term in the contract, express or implied, to that effect.

In the case of a contract for sale by sample there is an implied condition -

- That the bulk shall correspond with the sample in quality.
- That they shall have a reasonable opportunity of comparing the bulk with the sample.
- That the goods shall be free from any defect, rendering them un-merchantable, which would not be apparent on reasonable examination of the goods.

**Example 1:**

S sold some shoes by description. C a customer purchased a pair of shoes which were found to be containing card board and paper rather than leather or rubber material This was not visible by ordinary inspection. There is a breach of condition. C is entitle to return the shoes and claim refund of money from S.

**Example 2:**

In a contract for sale of brand by sample, the brandy supplied has been found to be colored with a dye. The buyer is entitled to return the brandy and claim refund of money as there is breach of condition.

- (v) In case of eatables and provisions, in addition to the implied condition as to merchantability, there is another implied condition that the goods shall be wholesome.

**Example:**

C bought milk from K which contained germs of typhoid. C's wife after consumption of the milk got infected with typhoid and died. Held, C could recover damages. [*Frost v Aylesbury Dairy Co. Ltd., (1905) 1 K.B. 608*]

**2.3.7.2 Implied warranties are of following types:**

In addition to implied conditions as discussed above there are implied warranties in a contract of sales. These implied warranties are as under:

- (i) **Warranty of quiet possession [Sec.14(b)]** If the buyer in any way is disturbed from enjoying the quiet possession of goods purchased because of seller's defective title, the buyer can claim damages from seller.

It is a warranty that the seller shall not nor shall any body claiming under a superior title or under his authority interfere with the quite enjoyment of the superior title or under his authority interfere with the quite enjoyment of buyer.

**Example:**

R purchased a motor car from D. The car turned out to be stolen one and R had to restore the same to the true owner. R was held to entitled to claim the whole price from D in spite of the fact that he had used the car for some months. (*Rowland v Divall*) 1923 2 KB 500

- (ii) **Warranty of freedom from encumbrances [Sec.14(c)]**

The buyer is also entitled to additional warranty that the goods are free from any charge or right of any third party, not declared or known to the buyer.

It is presumed that the goods are free of third parties charges if it is otherwise the buyer is entitled to claim damages from the seller.

**Example:**

A pledged some goods with B. Later on A took the goods back and sold them to C. Goods being subject to an encumbrance, there was a breach of warranty. The buyer could recover compensation if his possession was disturbed.

- (iii) **Warranty as to quality or fitness by usage of trade:** An implied warranty as to quality or fitness for a particular purpose may be annexed by usage of trade.

- (iv) **Warranty to disclose dangerous nature of goods:** Where a person sell goods knowing that the goods are inherently dangerous or they are likely to be dangerous to the buyer and the buyer is ignorant of the danger he must be warn the buyer of the probable danger, otherwise he will be liable in damages.

**Example:**

S sold a tin of disinfectant powder to C. He knew that it was likely to be dangerous to C if it was opened without special care being taken by C. C opened the tin whereupon the disinfectant powder flew into her eye. Held S was liable in damages to C as he should have warned C of the probable danger nature of goods. [*Clarke v Army & Navy co operative society ltd (1963) 1 KB155*]

Implied conditions and warranties in a contract may be negative or varied by:

- (a) express agreement between the parties or
- (b) the course of dealing between them or
- (c) the custom or usage of trade.

**2.3.7.3 Goods must be ascertained**

Where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are sanctioned.

**2.3.8 Doctrine of Caveat Emptor**

The term Caveat Emptor is a Latin word which means 'let buyer be aware'. This principle underlines the concept that it is for the buyer to satisfy himself that the goods which he is purchasing are of the quality required by him. It is a fundamental principle of law of sale of goods and implies that the seller is under no obligation to point out the defects in his own goods. The buyer must take care while purchasing the goods and if he makes a wrong selection he cannot blame the seller if the goods turn out to be defective or do not serve his purpose. This principle was applied in the case of *Ward v Hobbs*. However the doctrine of Caveat Emptor does not mean that the buyer must take a chance, it only means he must take care.

**Example 1:**

H bought oats from, S a sample of which had been shown to H .H erroneously thought that the oats were old. The oats were however new, held H could not avoid the contract [*Smith v Hughes (1871) LR 6QB 597*].

**Example 2:**

H sent to market 32 pigs to be sold by auction. The pigs were sold to W with all faults and errors in description. H knew that the pigs were suffering from swine fever but he never disclosed this to W. Held there was no implied warranty by H and the sale was good and H was held not liable in damages [*Ward v Hobbs (1878) 4 App cas 13*]

However this rule is not without any exception. With the passage of time this doctrine has been considered to be too unreasonable to the buyers. Hence the law in section 16 recognized certain exception to the rule. The doctrine is subject to following exceptions as provided in section 16 of the Act.

- (a) **Fitness for buyers purpose:** Where the buyer expressly or by implication makes known to the seller the particular purpose for which he require the goods and relies on the seller's skill or judgment and the goods are of a description which it is in the course of the seller business to supply the seller must supply the goods which shall be fit for the buyers purpose.

**Example**

*In Grant V Australian Knitting Mills 1936 AC 85* G who was a doctor, purchased from a retailer two woollen underpants manufactured by AK Mills. After wearing one of them he becomes ill. His illness was diagnosed as dermatitis caused by a chemical irritant in the product which was not removed during the process of manufacturing. It was held that in this case the implied condition as to fitness for buyer's purpose was broken and therefore the seller was liable for damages.

It may be noted that the buyer is required to make his purpose known to the seller, but in case where the goods can be used for one purpose only that need not be told by the buyer. It is the seller's duty to supply goods suitable for that purpose

- (b) Sale under a patent or trade name:** In the case of a contract for the sale of a specified goods under the patent or other trade name, there is no implied condition that the goods shall be reasonably fit for any particular purpose.

Provision to sec 16(1) provides that ' in the case of a contract for the sale of a specified article under a patent or trade name, there is no implied condition as to its fitness for any particular purpose. This means that if the goods are purchased by the buyer under a patent name he is not relying upon on the skill and judgement of the seller and therefore the condition as to fitness for a particular purpose does not apply. However, if he buyer while asking for an article of a named make and indicates to the seller that he relies on his skill and judgement for its suitability the condition regarding fitness applies and it is the sellers duty to supply goods suitable for the buyer's purpose.

**Example 1:**

S wanting a slimming machine went to a supplier of Medical and Sports Equipment and asked for a slimming machine of a named leading imported brand. The supplier supplied the slimming machine as demanded by S. However, S was not satisfied with the performance of the machine as the results of one months use were no where near to those claimed by the manufacturer in his daily advertisement. S can not hold the seller liable for breach of implied condition as to fitness for a particular purpose as he has purchased the equipment under a brand or trade name without relying upon the skill and judgement of the seller.

**Example 2:**

S wanting a slimming machine went to a supplier of Medical and Sports Equipment and asked him to suggest a suitable machine to the desired slimming results within one months time. D the dealer after ascertaining the requirement and purpose of S suggested him a slimming machine of leading imported brand. S agreed to buy the machine suggested by D the dealer. However, S was not satisfied with the performance of the machine as the results of one months use were no where near to those claimed by the manufacturer in his daily advertisement. S can hold the seller liable for breach of implied condition as to fitness for a particular purpose as he has relied upon the skill and judgment of the seller while purchasing the machine.

- (c) Mercantable quantity:** When the goods are bought by description from a seller who deals in goods of that description there is an implied condition that the goods shall be of mercantable quality. But if the buyer has examined the goods there is no implied condition as regards defects which such examination ought to have revealed.

The term merchantable means two things. First it means that if the goods are purchased for resale they must be capable of passing in the market under the name or description by which they are sold. Secondly it means that if the goods are purchased for self use, they must be reasonably fit for the purpose of which they are generally used.

**Example:**

X purchased 5 dozen of pencil sharpeners from Y for the purpose of resale by him. When X took delivery of the pencil sharpeners and put them in his sales counter, he noticed that most of the sharpeners were blunt and were taken by the students. Y has committed breach of implied condition of merchantability.

It may be noted that in the above example even if X had purchased the sharpeners for his self use even then Y has committed breach of implied condition as to merchantability.



- (d) **Usage of trade:** An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade.
- (e) **Consent by fraud:** Where the consent of the buyer in a contract of sale is obtained by the seller by fraud or where the seller knowingly conceals a defect which he could not have discovered on a reasonable examination, the doctrine of caveat emptor will not apply.

## 2.4 PERFORMANCE OF THE CONTRACT OF SALE

### INTRODUCTION

After the formation of a valid contract of sale next stage is its performance. The contract of sales imposes mutual obligations upon both the parties which needs to be performed according to the terms of agreement. Performance of a contract of sales is subject to the general principles laid down in the Indian Contract Act. In addition the Sale of Goods Act also provides some special rules governing the performance of a contract of sale. Performance of the contract of sale means due discharge of the contractual obligations by both the parties to the contract i.e. buyer and seller. The obligation of the seller is to deliver the goods in accordance with the terms of the contract as to time and place and obligation of the buyer is to accept the goods and pay the price agreed upon. As per section 31 it is the duty of the seller to deliver the goods and the buyer to accept and pay for the price settled/decided/fixed. Delivery of goods and payment for thereof are concurrent conditions, however the parties may agree otherwise also. In order to discharge the contractual obligations the seller must be ready and willing to deliver the goods. However, unless otherwise provided in the contract, seller can not demand payment advance of delivery. Refusal to deliver the goods unless agreed price is paid in advance is breach of contract. But the buyer is required to apply for delivery.

**Performance of a contract involves two things: timely delivery on the part of the seller and payment of the price as per the terms of contract by the buyer.** Unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions, that is to say, the seller shall be ready and willing to give possession of the goods to the buyer in exchange for the price, and the buyer shall be ready and willing to pay the price in exchange for possession of the goods.

#### 2.4.1 Delivery of Goods:

As per the Sale of Goods Act, 'Delivery' is defined as the voluntary transfer of possession from one person to another [Sec 2(2)]. Delivery is a bilateral act. It requires two parties to act. It is the duty of the seller to deliver the goods and the duty of buyer is to accept and take delivery of the goods. If the transfer of possession of goods is not voluntary i.e. if it is obtained by theft, it is no delivery. Before discussing the rules as to delivery first let us discuss the modes of delivery.

##### 2.4.1.1 Modes of Delivery:

The modes of delivery of goods is provided in section 33 which says that: 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.

Delivery as contemplated in the act may be actual, symbolic or constructive.

- (A) **Actual Delivery:** Where the seller hand over the goods to the buyer or his duly authorized agent, the delivery is treated as actual delivery. It may also be done by doing anything which has the effect of putting the goods in possession of the buyer.

##### Example:

S agreed to sell 200 kg potato to T @ ₹ 15 per kg. S delivered the goods at the Godown of T. This is a case of actual delivery.

- (B) **Symbolic Delivery:** A Symbolic delivery takes place when the seller hands over the key of godown

where goods are kept by the buyer. This type of delivery has the same effect as that of an actual delivery even though there is no change in possession of the goods and the goods remain in the custody of seller until they are removed by the buyer.

- (C) Constructive Delivery:** This is also called delivery by attornment. Where a third person who is in possession of the goods of the seller at the time of sale acknowledges to the buyer that he holds the goods on his behalf delivery by attornment or constructive delivery take place.

**Example:**

S sold 10 qt of sugar to T lying in the godown of U. S instruct U to transfer 10 qt of sugar to T. U acknowledge the instruction of S and transfers the goods in his books to T. This is delivery by attornment and has the same effect as that of actual delivery.

This rule of delivery by attornment is subject to the transfer of documents of title, because where, for example a bill of lading is transferred, the transferee is deemed to have got possession of the goods even when they are in the hands of a carrier who has not acknowledged to the buyer.

**2.4.1.2 Rules as to Delivery:**

- (A)** Delivery of goods and payment of price are concurrent conditions unless otherwise agreed upon. In other words seller must be ready and willing to make delivery and buyer must also be willing to take delivery and ready to pay the price.
- (B)** Effect of part delivery: As per **section 34**, a delivery of part of 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, but a delivery of part of the goods, with an intention of severing it from the whole, does not operate as a delivery of the remainder.

**Example:**

A sold five bales of certain goods to B. B received one bail, paid for it and refused to accept the remaining four which were delivered later on. It was held that this amounted to part delivery. [*Mitchel Reid co v Baldev Dass (1888) 15 cal*]

**Example:**

A directed the wharfinger to deliver his goods lying at the wharf to B to whom these goods had been sold. B weighted the goods and took away a part of them. Held, the delivery of a part of the goods had taken place which has the effect as delivery of the whole. [*Hammond v Anderson (1803) RR763*]

- (C) Buyer to Apply for Delivery (Section 35):**

Apart from any express contract, the seller of goods is not bound to deliver them until the buyer applies for delivery. It may also happen that the goods are subsequently acquired by the seller, he is to intimate the buyer and the buyer then should apply for delivery. Buyer has no cause of action against the seller if he does not apply for delivery, unless otherwise agreed upon.

**Example:**

If S agreed to sell his old car to T and T agreed to take delivery thereof on the auspicious day of Deepawali, S kept the car ready for delivery to T but T did not approach him for delivery. T has no reason to take any action against S if delivery of car did not take place on that day.

- (D) Place of Delivery:**

As per section 36(1), Goods must be delivered at the place and time specified in the contract. Whether it is for the buyer to take possession of the goods or for the seller to send them to the buyer is a question depending in each case on the contract, express or implied, between the parties. Apart from any such contract, goods sold are to be delivered at the place at which they are the



time of the sale, and goods agreed to be sold are to be delivered at the place at which they are at the time of the agreement to sell, if not then in existence, at the place at which they are manufactured or produced.

**(E) Time of Delivery:**

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. If demand or tender of delivery is not at reasonable tender delivery may be treated as ineffectual. What is a reasonable hour is a question of fact which has to be decided taking into consideration various factors.

**(F) Goods in Possession of a Third Person:**

Where the goods at the time of sale are in the possession of a third person, there is no delivery by seller to buyer unless and until such third person acknowledge to the buyer that he holds the goods on his behalf.

**Example:**

X sold 50 ton of rice to Y, the goods are lying in the godown of Z which is near the office of B. X ask Y to take delivery from the godown of Z. Delivery shall not be treated as completed unless Z acknowledges to Y that he hold the goods on his behalf

**(G) Cost of Delivery:**

Unless otherwise agreed, the expense of and incidental to putting the goods into a deliverable state are borne by the seller. All the expenses incurred for putting the goods into a deliverable state are to be borne by the seller. Similarly all the expenses relating to taking possession the goods must be borne the buyer.

**Example:**

S agree to sell 50 ton of Basmati Rice to B at FOR Delhi. All the expenses for delivering the goods up to Delhi will be borne by S. subsequent expenses from Delhi Railway station to office of B will be borne by B himself.

**(H) Mode of Delivery:**

Delivery of goods may be actual, symbolic or constructive. This we have discussed already.

**(I) Delivery of Wrong Quality:**

(i) It is not necessary that the delivered quantity always confirm to the ordered quantity. If less than contracted quantity is supplied, the buyer may reject them, but if the buyer accepts the goods so delivered he shall pay for them at the contract rate.

**Example:**

A sells to B 2000 gross of 200 yards reels of swing cotton. After taking delivery B finds that the length of the cotton per reel is less than 200 yards, the average being shortage of about 6%. B may reject the goods. If he waives the right of rejection, he is liable to pay the price of the goods at the contract price. (*Beck etc v Synzmanoski (1924) AC43*)

(ii) Similarly if a quantity of goods larger than contracted to sell is delivered, the buyer may accept the goods included in the contact and reject the rest, or he may reject the whole. If the buyer accepts the whole of the goods so delivered, he shall pay for them at the contract rate.

(iii) If the goods agreed to be supplied are delivered with goods mixed with goods of a different description not included in the contract, the buyer may accept the goods which are in accordance with the contract and reject the rest, or may reject the whole.

**Example:**

A buyer inspected certain timber and branded by hammer marks those which he accepted. When the timber arrived, it contained a large quantity of unbranded timber. Held, the buyer could reject the whole consignment. [*London Plywood Ltd v Nasik Oak Ltd (1939)2KB343*]

The above provisions are subject to any usage of trade, special agreement or course of dealing between the parties.

**(J) Installment Delivery:**

Buyer is not bound to accept installment unless agreed by the parties. If the contract provide for installment delivery which are to be separately paid for, and the seller makes no delivery or defective delivery in respect of one or more installments, or the buyer neglects or refuses to take delivery of or pay for one or more installments, it is a question in each case depending on the terms of the contract and the circumstances of the case, whether the breach of contract is a repudiation of the whole contract, or whether it is a severable breach giving rise to a claim for compensation, but not a right to treat the whole contract as repudiated.

**Example:**

X brought from Y 25 tons of pepper Oct-Nov shipment. Y shipped 20 tons in November and 5 tons in December. Since the goods have not delivered as per the contractual provisions, X is not bound to accept installment delivery unless they had already agreed for it. X could reject the whole lot. (*Renter v sala (1879)48LJ492*)

**(K) Delivery to Carrier or Wharfinger**

If, in pursuance of a contract of sale, the goods are delivered to a carrier for transmission to the buyer or to a wharfinger for safe custody, delivery of goods to them is prima facie deemed to be delivery of goods to the buyer. In such a case the seller must enter into a reasonable contract with the carrier or wharfinger on behalf of the buyer for same transmission or custody of goods. Failure to do so coupled with loss of goods in transit, buyer may reject delivery to carrier/wharfinger as delivery to himself and may held the seller responsible for such loss. Unless otherwise agreed, if goods are sent by the seller to the buyer by a route involving sea transit, in circumstances in which it is usual to insure, the seller is required to give such notice to the buyer as may enable him to insure them during their sea transit and if the seller fails so to do, the goods are deemed to be at his risk during such sea transit.

**Example 1:**

In *Clark v Hutchins 1811 14 Eaxt 475 A* of Agra placed an order with B of Calcutta for the supply of casks of 41 members to be sent by Railways. B delivered three casks to the Railway Company. He left goods at the railway station without conforming to the rules which were to be complied with in order to render the Railways liable for their safety. The goods did not reach A. Held there was no sufficient delivery to charge A in a suit for price.

**Example 2:**

In *Wimble V Rosenberg & Sons 1913 3KB 743 CA* the buyer directed the seller to ship the goods by any ship to Odhissa. The ship sailed on 25<sup>th</sup> August and was lost the next day. The buyer received the notice of shipment on 29<sup>th</sup>. The buyer was to pay for goods as he had sufficient information to enable him to insure.

**(L) Risk Where Goods are Delivered at Distant Place**

It is quite possible sometime the buyer asks the seller to deliver the goods at the place they were agreed to be delivered. If the seller agrees to deliver the goods at the risk of the buyer at place other than that where they are when sold, the buyer shall, nevertheless, unless otherwise agreed, take any risk of deterioration in the goods necessarily incident to the course of transit.



**Example:**

S sold 50 ton of sugar to T, T requested him to deliver the same to him at his risk at China instead of Delhi. S agreed to deliver the same at China at the risk and cost of T. During transit 5 ton of sugar was lost due to transit leakage and another 5 ton got moisturized. The loss in transit and deterioration in quality will be borne by T instead of S.

**(M) Buyer's Right of Examination the Goods:**

Section 41 gives buyer right to examine the goods which are delivered to him which he has not previously examined. He is not deemed to have accepted them unless and until he has a reasonable opportunity of examining them for the purpose of ascertaining whether they are in conformity with the contract. Unless otherwise agreed, when the seller tenders delivery of goods to the buyer, he is bound, on request of buyer, to afford him a reasonable opportunity of examining the goods for the purpose of ascertaining whether they are in conformity with the contract.

**(N) Buyer not Bound to Return Rejected Goods:**

As per section 43 unless otherwise agreed, if the goods are delivered to the buyer and he refuses to accept them, he is not bound to return them to the seller. But at the same time he is to intimate the seller that he refuses to accept them. Quite possible the seller may also refuse to take back the delivery In such cases the buyer becomes bailee and his position is that of a bailee for which he can charge reasonable amount for keeping the goods.

**2.4.1.3 Acceptance of Delivery: (Sec 42)**

The buyer is deemed to have accepted the goods-

- (a) When he has intimated the seller that he has accepted the goods.
- (b) When the goods have been delivered to him and he does any action in relation to them which is inconsistent with ownership of the seller.

**Example:**

A sells wheat to B and sends wheat to B by ship. On arrival B took delivery of the goods and the same day sold a part of wheat to C. He shall be deemed to have accepted the goods by doing an act inconsistent with the ownership of the seller.

**2.4.1.4 Liability of Buyer for Rejecting, Neglecting or Refusing Delivery of Goods.**

- a)** Buyer not bound to return rejected goods (Sec 43). As per section 43 unless otherwise agreed, if the goods are delivered to the buyer and he refuses to accept them, he is not bound to return them to the seller. But at the same time he is to intimate the seller that he refuses to accept them. Quite possible the seller may also refuse to take back the delivery In such cases the buyer becomes bailee and his position is that of a bailee for which he can charge reasonable amount for keeping the goods.
- b)** As per section 44 failure of the buyer to take delivery of goods within a reasonable time of seller's request, the buyer 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. This does not affect the rights of the seller where the neglect or refusal of the buyer to take delivery amounts to a repudiation of the contract.

**2.4.2 Rights and Duties of Buyer:**

**Rights of Buyer:**

- A. To have delivery of the goods as per contract. (Sec. 31 & 32)
- B. To reject the goods when they are not of the description, quality or quantity as specified in the contract (Sec 37).

- C. To repudiate the contract when goods are delivered in installments without any agreement to that effect [Sec. 38 (1)]
- D. To be informed by the seller, when the goods are to be sent by sea route, so that he may arrange for their insurance [Sec 39 (30)]
- E. To have a reasonable opportunity to examine the goods for ascertaining whether they are in conformity with the contract. (Sec. 41)
- F. To sue the seller for recovery of the price, if already paid, when the seller fails to deliver the goods.
- G. To sue the seller for damages if the seller wrongfully neglects or refuses to deliver the goods to the buyer (Sec 57)
- H. To sue the seller for specific performance.
- I. To sue the seller for damages for breach of a warranty or for breach of a condition treated as breach of a warranty (Sec 59).
- J. To sue the seller the damages for anticipatory breach of contract (Sec 60).
- K. To sue the seller for interest where there is a breach of contract on the part of the seller and price has to be refunded to the buyer (Sec 61).

#### **Duties of Buyer**

- A. To accept the delivery of goods, when the seller is willing to make the delivery as per the contract (Sec. 31).
- B. To pay the price in exchange for possession of the goods.
- C. To apply for delivery of the goods (Sec. 35).
- D. To demand delivery of the goods at a reasonable hour [Sec 36 (4)].
- E. To accept delivery of the goods in installments and pay for them, in accordance with the contract. [(Sec. 38 (2)].
- F. To bear the risk of deterioration in the course of transit, when the goods are to be delivered at a place other than where they are sold (Sec 40).
- G. To inform the seller in case the buyer refuses to accept or rejects the goods (Sec 43)
- H. To take the delivery of the goods within a reasonable time after the seller tenders the delivery (Sec. 44)
- I. To pay the price, where the property in the goods are passed to the buyer, in accordance with the terms of the contract (Sec 55)
- J. To pay damages for non-acceptance of goods (Sec 56)

#### **2.4.3 Rights and Duties of Seller:**

##### **Rights of Seller**

- A. To reserve the right of disposal of the goods until certain conditions are fulfilled. (Sec 25 (1))
- B. To assume that the buyer has accepted the goods, where the buyer:
  - i) Conveys his acceptance;
  - ii) Does an act adopting the sale; or
  - iii) Retains the goods without giving a notice of rejection, beyond specified date (or reasonable time), in a sale on approval. (Sec 24)
- C. To deliver the goods only when applied for by the buyer ( Sec 35 ).
- D. To make delivery of the goods in installments, when so agreed [Sec 39 (1)]



- E. To exercise lien and retain possession of the goods, until payment of the price (Sec 47 (1))
- F. To stop the goods in transit and resume possession of the goods, until payment of the price (Sec 49 (2) and 50]
- G. To resell the goods under certain circumstances (Sec 54)
- H. To withhold delivery of the goods when the property in the goods has not passed to the buyer (Sec 46 (2))
- I. To sue the buyer for price when the property in the goods has passed to the buyer or when the price is payment on a certain day, in terms of the contract, and the buyer fails to make the payment (Sec 55)

#### **Duties of Seller**

- A. To make the arrangement for transfer of property in the goods to the buyer.
- B. To ascertain and appropriate the goods to the contract of sale
- C. To pass an absolute and effective title to the goods, to the buyer.
- D. To deliver the goods in accordance with the terms of the contract (Sec 31)
- E. To ensure that the goods supplied conform to the implied / express conditions and warranties.
- F. To put the goods in a deliverable state and to deliver the goods as and when applied for by the buyer (Sec 35)
- G. To deliver the goods within the time specified in the contract or within a reasonable time and a reasonable hour. [Sec 36 (2) and (4)]
- H. To bear all expenses of and incidental to making a delivery (i.e. up to the stage of putting the goods into a deliverable state [Sec 36 (5)]
- I. To deliver the goods in the agreed quantity. (Sec. 37 (1))
- J. To deliver the goods in installments only when so desired by the buyer. [Sec 38 (1)]
- K. To arrange for insurance of the goods while they are in transmission or custody of the carrier. [Sec. 39 (2)]
- L. To arrange for insurance of the goods while they are in transmission or custody of the carrier. [Sec. 39 (2)]

## **2.5 RIGHTS OF AN UNPAID SELLER**

### **Introduction**

In a transaction of sale it is not possible to avoid credit sales. In credit sales there is a risk of a debtor not paying the price of the goods even after the credit period is over. The seller of the goods therefore must possess some rights which he can use to secure payment of the price. If the recovery of the price is not possible due to the reason of bankruptcy of the buyer, he must have some other remedies. The Sale of Goods Act has made elaborate provisions regarding the rights of an unpaid seller

### **Meaning of unpaid seller**

In simple words, a seller who has not received the full price of goods sold is termed as unpaid seller. Section 45 of the Sale of Goods Act, 1930 has defined an unpaid seller as follows:

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

Thus to be called an unpaid seller, the following conditions needs to be satisfied:

The goods have been sold and price is due;

The full price has not yet been paid;

A bill of exchange or other negotiable instrument has been received as payment of price but the same was dishonoured.

From the above it may be noted that even if a major portion of price has been paid and a small portion remains to be paid, even then the seller is termed as unpaid seller. But it must be remembered that it is only for. non payment of price that seller is termed as unpaid seller.

Thus if the price has been paid but some other expenses remains to be paid, the seller cannot be termed as unpaid seller The term "seller" 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 has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for, the price.

The protection given to an unpaid seller under this act also extend to any person who is in the position of a seller, as such, for instance an agent of the seller to whom the bill of lading has been endorsed or a consignee or a consignor or agent who has himself paid, or is directly responsible for the price.

**Examples:**

- (a) Z sells goods worth ₹ . 50,000/- to B on credit of 5 months. After 5 months B did not pay the price. Z shall be regarded as an unpaid seller.
- (b) In the above example if B accepts a bill of exchange and it is dishonoured by him on due date, A shall be considered as an unpaid seller.

**Rights of an Unpaid Seller:**

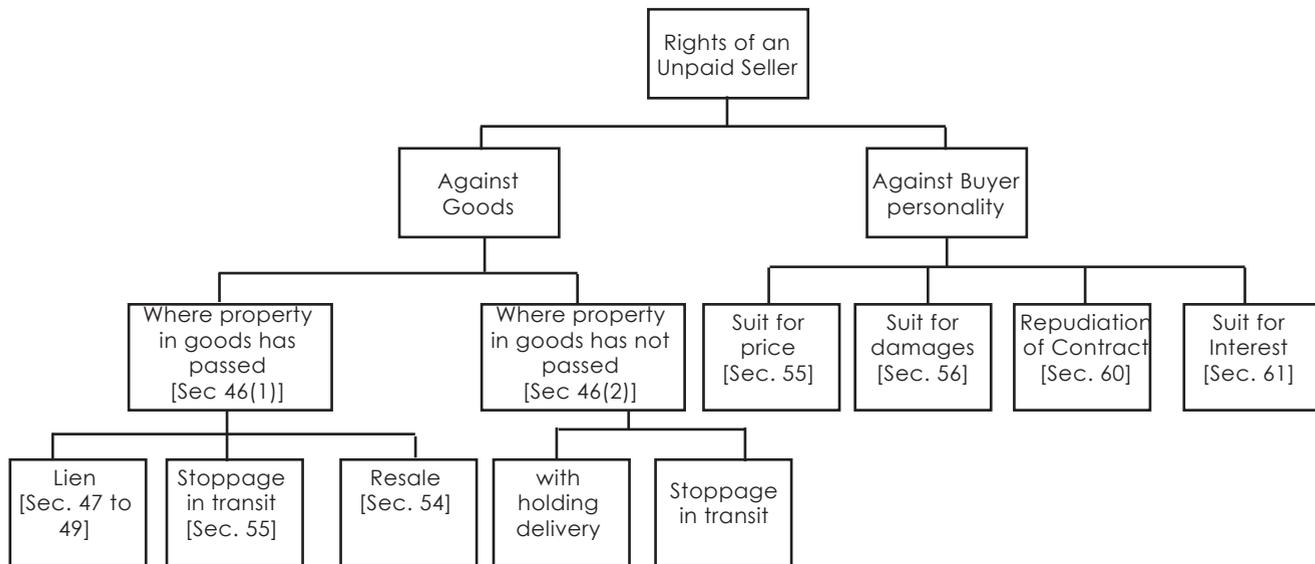
The rights of an unpaid seller can be broadly discussed under two heads: (I) Rights against the goods; and (II) Rights against the buyer personally.

**(I) Rights against the goods are as follows:**

- a) Where the property in goods has passed to the buyer:
  - (i) Right of lien; a lien on the goods for the period while he is in possession of them,
  - (ii) Right of stoppage in transit; In case of the insolvency of the buyer a right of stopping the goods in transit after he has parted with the possession of them,
  - (iii) Right of resale.
- b) Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery

**(II) The Rights against the buyer personally are as follows:**

- i) Right to file a suit for price;
- ii) Right to file for damages; and
- iii) Right to file a suit for interest.
- iv) Repudiation of Contract



Let us now discuss these rights in detail:

## I. Rights Against the Goods

**Where the property in goods has passed to the buyer:**

### A) Right of lien (Seller's lien) (Section 47)

The unpaid seller of goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases, namely -

- (i) Where the goods have been sold without any stipulations as to credit,
- (ii) Where the goods have been sold on credit, but the term of credit has expired,
- (iii) Where the buyer becomes insolvent,

The seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer.

Where the goods are sold on credit, the right of lien is suspended during the term of credit. But on the expiry of the terms if the goods are still in the possession of the seller, his lien revives.

It may also be noted that the right of lien is linked with possession and not with the title. In case where the seller has transferred to the buyer the documents of title to the goods, his lien is not defeated as long as he remains in possession.

#### Example 1:

On 1<sup>st</sup> June X sold goods to Y on the condition that the price must be paid on 1<sup>st</sup> July. X neither delivered the goods nor Y applied for delivery and the goods remained in possession of X till 1<sup>st</sup> July. Y did not make payment on 1<sup>st</sup> July. X is entitled to retain possession of the goods until the price is paid.

#### Example 2:

On 1<sup>st</sup> June X sold goods to Y on the condition that the price must be paid on 1<sup>st</sup> July. Y neither delivered the goods nor Y applied for delivery and the goods remained in possession of X till 1<sup>st</sup> July when Y paid the price of the goods but not the expenses incurred on storage of goods for 30 days. X can not refuse deliver goods on the ground that the lawful charges incurred on storage of goods have not been paid.

### Part delivery (Section 48)

Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien.

Where the contract envisages delivery of goods by installments, the buyer's default in paying for one installment does not entitle the seller to stop delivery of the rest of the installments unless (a) the buyer has become insolvent or (b) the buyer's default amounts to repudiation of the whole contract. In *McEwan v Smith 1849 2HL cas 309* it was held that where the goods are at the time of sale in the custody of a third person, they are considered to be in the seller's possession for the purpose of his lien until the third person attorns to the buyer and thereby becomes a bailee for the buyer.

#### Example:

X sells 51 bales of cotton yarns to Y on one month credit. After 15 days of signing the contract X delivered 26 bales of cotton yarn to Y making it very clear that this may not be construed as his intention of waiving the right of lien. Y did not make the payment on the due date. X can retain possession of the goods until the payment is made.

### Termination of lien (Section 49)

- (I) The unpaid seller of goods loses his lien thereon—
  - (a) When he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods;
  - (b) When the buyer or his agent lawfully obtains possession of the goods;
  - (c) By waiver thereof.
- (II) The unpaid seller of goods, having a lien thereon, does not lose his lien by reason only that he has obtained a decree for the price of the goods.

Delivery of goods to a carrier for the purpose of transmission to the buyer operates as a delivery to the buyer himself and thus put to an end to the right of lien. But still the seller has right of stoppage of goods in transit. Accordingly if the seller regain possession of the goods from the carrier by exercising the right of stoppage of goods in transit, his right of lien is revived. But if he takes back the goods from the carrier for any other purpose, the lien does not revive. Thus, in *Valply v Gibson 1847 4 CB 837 72 RR 740*, the goods sold were delivered to the buyer's shopping agents who had put them on board a ship. But the goods were returned to the seller for repacking. While they were still with the seller on his mission the buyer becomes insolvent and the seller being still unpaid, claimed to retain the goods in exercise of their lien. It was held that having lost their lien by delivery to the shipping agents, their refusal to deliver was wrongful. Where the seller has reserved the right of disposal of the goods his lien continues till the end of the transit.

The seller's right to lien is lost when the goods are delivered to the buyer or his agent even when the goods are redelivered to the seller for some specific purpose such as repair of machine sold. The sellers' lien is however not lost when the buyer obtained the possession unlawfully without the consent of the seller.

#### Example 1:

X sold certain goods to Y on one months credit. Y without consent or authorisation of X got possession of the goods in connivance of the security guard. On the due date Y did not make the payment, X still has right of lien over the goods even though Y has taken possession of the goods unlawfully.



### Example 2:

X sold certain goods to Y on one months credit and delivered to the carrier for onward transmission to Y. On the due date Y did not make the payment, X exercised the right of stoppage of goods in transit and regained possession of the goods. X's right of lien over the goods is regained.

It may further be noted that when buyer tenders the payment the seller ceases to be an unpaid seller if the seller wrongfully refuses to accept the tender of payment. The seller cannot in such cases, convert himself into an unpaid seller by voluntary refusal. He therefore loses his right of lien by tender of price by the buyer.

### Example 3:

X agreed to sell his bike to Y with the stipulation of one months credit for payment and delivery of bike to be made after tender of payment. Y tendered the payment but X refuses to accept the payment and want to exercise his right of lien over the bike. This right of lien can not be exercised on tender of payment by Y.

It may further be noted that the unpaid seller's right of lien is not lost merely because he has obtained from the court a decree for the payment of the price.

## B) Right of stoppage in transit (Section 50)

When the buyer of goods becomes insolvent, the unpaid seller who has parted with the possession of the goods has the right of stopping them in transit, that is to say, he may resume possession of the goods as long as they are in the course of transit, and may retain them until payment or tender of the price.

This is one of the methods of protecting the unpaid seller against the risk of his goods going to the possession of an insolvent. As Lord Reading said in *Booth Steamship Co v Cargo Fleet from Co* 1916 2 KB 570 at 580 "It is a right founded upon the plain reason that one man's goods shall not be applied to the payment of another man's debt.

Distinction between Lien and Stoppage in transit. Both the rights are designed for the protection of the unpaid seller. The effect of both the rights is same, still the point of difference between the two are as under.

The seller's lien attaches when the buyer is in default whether he be solvent or insolvent. The right of stoppage in transit occurs when the buyer is insolvent.

Lien is exercisable as long as the seller is in possession, stoppage in transit as long as the goods are passing through channels of communication for the purpose of reaching the hands of the buyer.

Lien ends where the right of stoppage commences. When the seller hands over possession to the carrier, his lien ends and the right of stoppage in transit commences.

Right of lien is exercised to retain possession of goods while the right of stoppage in transit is exercised to regain or resume the possession of goods by seller from the carrier or other bailee.

The right of stoppage in transit is only against the goods and can be exercised only when the following three conditions are satisfied:

- (a) the seller must be unpaid;
- (b) buyer must be insolvent;
- (c) the seller must have parted with the possession of the goods and buyer must have not acquired the goods.

**Example:**

P of Pune sold goods to M of Mumbai and delivered the goods to C, a common carrier for onward delivery to M. Before the goods could reach M, he is declared insolvent. In the instant case P can exercise the right of stoppage of goods in transit by giving notice thereof to M.

**Duration of transit (Section 51)**

- (i) 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 in that behalf takes delivery of them from such carrier or other bailee.
- (ii) If the buyer or his agent in that behalf obtains delivery of the goods before their arrival at the appointed destination, the transit is at an end.
- (iii) If, after the arrival of the goods at the appointed destination, the carrier or other bailee acknowledges to the buyer or his agent that he holds the goods on his behalf and continues in possession of them as bailee for the buyer or his agent, the transit is at an end and it is immaterial that a further destination for the goods may have been indicated by the buyer.
- (iv) If the goods are rejected by the buyer and the carrier or other bailee continues in possession of them, the transit is not deemed to be at an end, even if the seller has refused to receive them back.
- (v) When goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of the particular case, whether they are in the possession of the master as a carrier or as agent of the buyer.
- (vi) Where the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent in that behalf, the transit is deemed to be at an end.
- (vii) Where part delivery of the goods has been made to the buyer or his agent in that behalf, the remainder of the goods may be stopped in transit, unless such part delivery has been given in such circumstances as to show an agreement to give up possession of the whole of the good.

**Example 1:**

X sold goods to Y which are first sent by rail and then by ship to the ultimate destination. X gives notice to Railways to stop the goods but in the meanwhile the ship sails away. X then gives notice to shipping company before the goods arrive at their destination. Seller X can exercise the right of stoppage of goods in transit as the lost is still not lost.

**Example 2:**

*In Lyons v Honffnung 1890 15 AP Cas 391 PCJ-X* at Sydney purchased certain goods from Y and instructed the seller to send the goods to Sydney from where they were to be taken to Kimberley. X also took a seat in the same ship. X became insolvent and the seller gave notice to stop the goods. It was held that the notice was effective and the mere fact that B was going in the ship did not end the transit of goods.

**Example 3:**

A sells to B 500 packets of 'Dates'. A deliver 100 packets and remaining 400 packets were in transit. Meanwhile B becomes insolvent. A being the unpaid seller stops 400 packages in transit held is entitled to hold 400 packages until he gets the price of 500 packages.

**How stoppage in transit is effected (Section 52)**

- (i) The unpaid seller may exercise his right to stoppage in transit either by taking actual possession of the goods, or by giving notice of his claim to the carrier or other bailee in whose possession the goods are. Such notice may be given either to the person in actual possession of the goods or to



his principal. In the later case the notice, to be effectual, shall be given at such time and in such circumstances, that the principal, by the exercise of reasonable diligence, may communicate to his servant or agent in time to prevent a delivery to the buyer.

- (ii) Whether notice of stoppage in transit is given by the seller to the carrier or other bailee in possession of the goods, he shall re-deliver the goods to, or according to the directions of, the seller. The expenses of such re-delivery shall be borne by the seller.

### **Effect to sub-sale or pledge by buyer (Section 53)**

- (i) Subject to the provisions of this Act, the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer may have made, unless the seller has assented thereto.

Provided that where a document of title to goods has been issued or lawfully transferred to any person as buyer or owner of the goods, and that person transfers the document to a person who takes the document in good faith and for consideration, then, if such last mentioned transfer was by way of sale, the unpaid seller's right of lien or stoppage in transit is defeated, and, if such last mentioned transfer was by way of pledge or other disposition for value, the unpaid seller's right of lien or stoppage in transit can only be exercised subject to the rights of the transferee.

- (ii) Where the transfer is by way of pledge, the unpaid seller may require the pledgee to have the amount secured by the pledge satisfied in the first instance, as far as possible, out of any other goods or securities of the buyer in the hands of the pledge and available against the buyer.

The unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods by the buyer. In *Mordaunt Brothers v British Oil and Cake Mills 1910 2 KB 502*, an oil merchant sold a quantity of oil to B without appropriating any particular oil to the contract. B sold some of it to C and gave him a delivery order. C lodged the delivery order with the merchant requesting him to await his orders. Meanwhile B failed to pay the merchant, who therefore became an unpaid seller. It was held that the merchant's lien on the goods for the price was not defeated by B's sale to C and he could retain the goods till the price was paid. But there are two cases in which the seller's right of stoppage or lien is defeated.

- (a) **Seller's consent;** Where the buyer sells or makes other disposition of goods with the consent of the seller, the seller is bound by it. But mere acknowledgement of the receipt of information is not considered sufficient unless the circumstances show that the seller intended to renounce his rights against the goods.

#### **Example:**

In *Mordaunt Bros V The British Oil and Cake Mills Ltd 1910 KB 502*, B sold a quantity of oil to a merchant who resold a portion of it to M giving him delivery order addressed to B requiring him to deliver to M "ex our contract" B retained the orders when presented and made no comments. Meanwhile the merchant defaulted in payment and B claimed to exercise the right of lien and refused to make further delivery to M. It was held that B was entitled to do so as the circumstances of the case did not show that B had intended to renounce his right against the goods.

- (b) **Transfer of document of title;** When the seller has issued to the buyer documents of title to the goods and the buyer has sold or pledged the goods by transferring the documents of title then in case of sale, the seller's right of lien or stoppage in transit is defeated. If the last such sale was by way of pledge or other disposition for value, the rights of unpaid seller becomes subject to the pledge. But it is necessary that the transferee should act on good faith and for consideration.

#### **Example 1:**

S sells goods to T for ₹ 51000 and forwarded a bill of lading to T who deposited it with U to

secure an advance of ₹ 25,000. T became insolvent. S can exercise the right of stoppage of goods in transit but subject to paying ₹ 25000 to U.

**Example 2:**

A sold some goods to B and consigned the same to Railways and send the RR to B. While the goods were in transit, B was declared insolvent. However B sold the goods to C for cash and transferred the RR to C. C was not aware of B's insolvency. In the instant case A's right of stoppage of goods in transit is defeated. But if C's was aware of first sale and A's right over the goods, then A could exercise the right of stoppage of goods in transit.

**C) Right of re-sale**

- (i) A contract of sale is not rescinded by the mere exercise by an unpaid seller of his right of lien or stoppage in transit.
- (ii) Where the goods are of a perishable nature, or where the unpaid seller who has exercised his right of lien or stoppage in transit gives notice to the buyer of his intentions to re-sell, the unpaid seller may, if the buyer does not within a reasonable time pay or tender the price, re-sell the goods within a reasonable time and recover from the original buyer damages for any loss occasioned by his breach of contract, but the buyer shall not be entitled to any profit which may occur on the re-sale. If such notices are not given, the unpaid seller shall not be entitled to recover such damages and the buyer shall be entitled to the profit, if any, on the re-sale.
- (iii) Where an unpaid seller who has exercised his right of lien or stoppage in transit re-sells the goods, the buyer acquires a good title thereto as against the original buyer, notwithstanding that no notice of the re- sale has been given to the original buyer.
- (iv) Where the seller expressly reserves a right of re-sale in case the buyer should make default, and on, the buyer making default, re-sells the goods, the original contract of sale is thereby rescinded, but without prejudice to any claim which the seller may have for damages.

**Example 1:**

X of Delhi sold 200 apple juice packets to K of Kanpur K was to make payment within seven days of contract of sale. Even after 10 days K did not tender the payment despite repeated request by X. After 10 days X exercised the right of stoppage of goods in transit and regained possession of the goods from the transporter. X served a notice upon K to tender payment failing which he will be compelled to sell the goods at the risk and loss of K. K did not respond to X's notice. Failure of K to tender the payment even after reasonable notice, X sold the goods and suffered a loss of ₹ 5,000. X is entitled to claim the loss from K.

**Example 2:**

D of Delhi sold 100 pant pieces to K of Kolkata K was to make payment within seven days of contract of sale. Even after 10 days K did not tender the payment despite repeated request by D. After 10 days D exercised the right of stoppage of goods in transit and regained possession of the goods from the transporter and resold the goods without any notice to K and suffered a loss of ₹ 5,000. D is not entitled to claim the loss from K as he had not given any notice of resale to him.

**Example 3:**

D of Delhi sold 100 pant pieces to K of Kolkata K was to make payment within seven days of contract of sale. Even after 10 days K did not tender the payment despite repeated request by D. After 10 days D exercised the right of stoppage of goods in transit and



regained possession of the goods from the transporter and resold the goods without any notice to K and made a profit of ₹ 5,000. D is not entitled to retain any profit on this sale and as he has not given any notice of resale to him.

### **Where the property in goods has not passed to the buyer**

Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and co-extensive with his rights of lien and stoppage in transit where the property has passed to the buyer. The right is similar to and co-extensive with his right of lien and stoppage in transit where property has passed to the buyer [Sec 46(2)]

## **ii. Right Against the Buyer Personally:**

### **A) Suit for Price (Sec 55):**

- (a) Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods.
- (b) Where under a contract of sale the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, 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.

#### **Example:**

X sold goods to Y for ₹ 20,000 and price is agreed to be paid after 10 days of the contract. Y fails to pay the price on agreed day. X can file a suit for price against Y even though the goods have not been delivered or property has not been transferred to X.

### **B) 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. What shall be the amount of damages is to be determined in accordance with provisions laid down in Sec 73 of the Indian Contract Act, 1872.

- C) Suit for interest: (Sec. 61)** When under a contract of sale, the seller tenders the goods to buyer and the buyer refuses to pay the price, the seller has a further right to claim interest on the amount of the price. The unpaid seller can claim interest only when he can recover the price. The rate of interest to be awarded is at the discretion of the court.

### **D) Repudiation of contract before due date (Sec 60)**

Where the buyer repudiates the Contract before due date, the seller may:

- (a) treat the contract as subsisting and wait till due date;
- (b) treat the contract as rescinded and sue for damages for breach. This is known as anticipatory breach of contract.

## **2.6 BREACH OF CONTRACT**

### **Introduction**

There can be contractual obligation of breach from either party. On the part of the buyer the breach can be in the form of non-acceptance of delivery which is otherwise tendered strictly as per the contractual understanding or nonpayment of the price or delay in payment of the price when the delivery has been made. Similarly there can be breach on the part of the seller either non delivery or delay in delivery or delivery not as per the agreed terms and conditions.

When the buyer wrongfully refuses or neglects to accept the delivery or to pay for the goods, the seller is entitled to sue for damage for non acceptance of delivery or of the price if delivery has already taken place. Similarly the buyer can claim damages from the seller for non –delivery of goods or even sue for specific performance of the contract in case of specific or ascertained goods. The aggrieved party can seek remedies available under the Sale of Goods Act, or the Indian contract Act in addition to invoking provisions of Specific Relief Act.

Section 58 of the sale of Goods Act provides that subject to the provisions of Chapter II of the Specific Relief Act, 1877, in any suit for breach of contract to deliver specific or ascertained goods, the Court may, if it thinks fit, on the application of the plaintiff, by its decree direct that the contract shall be performed specifically, without giving the defendant the option of retaining the goods on payment of damages. The decree may be unconditional, or upon such terms and conditions as to damages, payment of the price or otherwise, as the Court may deem just, and the application of the plaintiff may be made at any time before the decree.

**The Remedies Available Under the Sale of Goods Act are Discussed Below:**

**(A) Suit for price (Sec 55)**

- (a) Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods.
- (b) Where under a contract of sale the price is payable on a day certain irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, 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.

**(B) 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

**(c) Damages for non-delivery (Section 57)**

Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery.

**(D) Remedy for breach of warranty (Section 58)**

- (a) Where there is a breach of warranty by the seller, or where the buyer elects or is compelled to treat any breach of a condition on the part of the seller as a breach of warranty, the buyer is not by reason only of such breach of warranty entitled to reject the goods; but he may:
  - (i) Set up against the seller the Breach of warranty in diminution or extinction of the price; or
  - (ii) Sue the seller for damages for breach of warranty.
- (b) The fact that a buyer has set up a breach of warranty in diminution or extinction of the price does not prevent him from suing for the same breach of warranty if he has suffered further damage.

**(E) Repudiation of contract before due date (Section 60)**

Where either party to a contract of sale repudiates the contract before the date of delivery, the other may either treat the contracts as subsisting or wait till the date of delivery, or he may treat the contract as rescinded and use for damages for the breach.

**(F) Interest by way of damages and special damages (Section 61)**

- (a) Nothing in this Act shall affect the right of the seller or the buyer to recover interest or



special damages in any case where by law, interest or special damages may be recoverable, or to recover the money paid where the consideration for the payment of it has failed.

- (b) In the absence of a contract to the contrary, the Court may award interest at such rate as it thinks fit on the amount of the price—
- (i) To the seller in a suit by him for the amount of the price. - from the date of the tender of the goods or from the date on which the price was payable.
  - (ii) To the buyer in a suit by him for the refund of the price in a case of a breach of the contract on the part of the seller- from the date on which the payment was made

## 2.7 AUCTION SALES

### Introduction

Auction sale is way of marketing goods without a set price. Bids are taken verbally on the spot, by phone, by mail, by telegram, etc., and the property is sold to the highest bidder. In other words an auction sale is a public sale to any person bidding the highest price, upon terms and conditions previously announced. When goods are to be sold by auction, the auctioneer gives wide publicity regarding the time, date and place of sale. The bidders are also given opportunity to inspect the goods. **It should however be remembered that advertisement to sell goods by auction is not an offer but invitation to offer.** The auctioneer is not bound to sell on date and time and place announced earlier. He may postpone or even cancel the same.

### 2.7.1 Rules Regarding an Auction (Sec. 64)

In the case of sale by auction-

- (a) Where goods are put up for sale in lots, each lot is prima facie deemed to be the subject of a separate contract of sale. [Sec 64(1)]
- (b) The sale is complete when the auctioneer announces its completion by the fall of the hammer or in other customary manner, and, until such announcement is made, any bidder may retract his bid.
- (c) A right to bid may be reserved expressly by or on behalf of the seller and, where such rights is expressly so reserved, but not otherwise, the seller or any one person on his behalf may, subject to the provisions hereinafter contained, bid at the auction, [Sec 64(3)]
- (d) Where the sale is not notified to be subject to a right to bid on behalf of the seller, it shall not be lawful for the seller to bid himself or to employ any person to bid at such sale, or for the auctioneer knowingly to take any bid from the seller or any such person, and any such person, and any sale contravening this rule may be treated as fraudulent by the buyer. [Sec 64(4)]
- (e) The sale may be notified to be subject to a reserved or upset price.
- (f) If the seller makes use of pretended bidding to raise the price, the sale is voidable at the option of the buyer.

### 2.7.2 Important Terms Used in Auction:

The following are some of the important terms used in Auction Sale;

- A. Knockout Agreement:** It is sort of tacit understanding/agreement among the intending bidders to stifle competition by not bidding against each other in an auction sale. Such agreements are illegal and the seller can protect his interest against such agreement by reserving his right to bid at the auction or by fixing a reserve price.
- B. Damping:** Damping is an act to dissuade the intending buyer from bidding or from raising the price by pointing out defects in the goods or by doing some other acts which prevent persons

from forming a fair estimate of the price of the goods. Damping is illegal and the auctioneer can withdraw the goods from auction.

- C. Puffers:** Puffer is a person who is employed by the seller to raise the price by fictitious bids. Such persons are known as By-bidders or Decoy Ducks.

### 2.7.3 Implied Warranties in an Auction Sale:

When an auctioneer sells goods, he impliedly undertakes following obligations:

- A) He warrants that he has authority to sell goods.
- B) He also warrants that he does not know of any defects in the title of principal.
- C) He undertakes to give possession of the goods against price paid.
- D) He guarantees quiet possession of goods by the purchases.

### 2.7.4 Case Laws on Auction Sales:

- (a) A bid by an intending buyer is construed as an offer. As an offer it can be withdrawn any time before acceptance, which in this case occurs by the fall of hammer or any other customary manner. It has been held that it is customary in this country to repeat the final offer three times. [*Agra Bank v Hamlin*].
- (b) A combination between intending buyer not to be bid against each other is known as a knock out" agreement. Such agreement are illegal. [*Jyoti v Jhowmall 1909 36 Cal 134*]
- (c) Agreements which are likely to prevent the property put up from realising its fair value and to damp the sale, would certainly be against the public good, but an agreement between two or more persons not to bid against each other at an auction is not illegal or against public good. [*Lachman Das and others v Hakin Sita Ram and others AIR 1975 Delhi 159*]
- (d) Sec 64(2) of the Sale of goods Act does not deal with question of passing of the property in the goods sold at auction sale but instead it deals with completion of the contracts of sale. [*Consolidated Coffee Ltd v Coffee Board Bangalore AIR 1980 Supreme Court 1948*]
- (e) An auctioneer can set his own terms and conditions for holding an auction. If he does so those conditions would govern the rights of the parties. The seller is not bound to accept the highest bid, it necessarily implies that he can accept any lower bid. Lapses on the receipt of a higher bid, and if the highest bid was not to be accepted for any reason, the auction must be abandoned and fresh auction would be required to be held. [*M Lachia Setty and Sons Ltd v The Coffee Board Bangalore AIR 1981 SC 162*]

## 2.8 CONTRACTS INVOLVING SEA ROUTES

Sea rout is the most common and cheapest mode of transportation in cases of international trade. In case of contracts through sea routes, the contract may have the following three forms.

- (A) CIF contract:** Cost, insurance and freight contract. In this case of contract the price includes the cost of insurance and freight which is already built in the price charged from the buyer. Under such a contract the seller insures the goods and delivers the same to the shipping company for being sent to the buyer. In such a case the ownership is transferred to the buyer when the shipping documents are delivered to the buyer and he receive them by paying them the price. If the buyer refuse to take delivery of these documents, seller can claim damages for breach of the contract. However the parties may vary the terms of the contract. That is the reason CIF contract is also called a contract of sale of document as the buyer has to accept the documents and; pay the price even if the goods are destroyed.



**In a CIF contract the seller has the following duties towards the goods and the buyer.**

- (i) to make an invoice of the goods sold;
- (ii) to ship the goods at the port of destination;
- (iii) to enter into a contract of transportation with the shipping company and obtain a bill of lading;
- (iv) to arrange for insurance of the goods upon the terms current in the trade which will be available for the benefit of the buyer.
- (v) to send all the relevant documents like shipping documents, invoice, bill of lading, insurance policy to the buyer.

If the seller fails to deliver these documents to the buyer within a reasonable time it may amount to breach of contract. The buyer may refuse to accept the shipping documents by proving that –

- (a) the documents are invalid, i.e., bill of lading is not correctly dated; or
- (b) that the goods are of different quality; or
- (c) that the goods shipped are less in quantity.

**Duties of the buyer under a CIF contract:**

- (a) to accept the shipping documents and pay the price.
- (b) to pay customs and import duties.
- (c) to pay the unloading and wharfage charges at the port of destination.

- (B) FOB Contracts:** Section 39(3) of the Sale of Goods Act applies to FOB contracts. In the FOB contract the seller places the goods on board a ship at his own expense. He simply put the goods on the ship at his own expense and then the goods are the risk of the buyer who has to bear the risk and bear the responsibilities for freight, insurance and subsequent expense.

**Duties of seller under FOB contract;**

- (a) To hold the sold goods on the ship named by the buyer.
- (b) To meet the expenses of loading the goods.
- (c) To arrange for transportation of the goods with the shipping company and obtain bill of lading.
- (d) To deliver the bill of lading to the buyer.
- (e) To give notice of shipment to buyer so that he can insure goods during transit.

**Duties of a buyer under a FOB Contract;**

- (a) To arrange for contract of affreightment.
- (b) To name the ship or authorise the seller to select the ship.
- (c) To pay all charges and bear all risks subsequent to delivery of goods on board the ship.

**(c) Ex-Ship Contracts:**

An ex-ship contract is a contract for the sale of goods in which the seller has to deliver the goods to the buyer at the port of destination from a ship which has arrived at the usual place of delivery therein for the discharge of goods of the kind in question. Where delivery is ex-ship the seller commits a breach of his duty under section 31 if he stores the goods in the godown and ask the buyer to take goods from his godown.

**In a contract of sales under ex-ship contract the duties of a seller includes;**

- (a) To deliver the goods to the buyer at the port of destination;
- (b) To pay freight charges; and
- (c) To hand over the proper delivery orders to the buyer to enable him to obtain delivery of goods from shipping company.

**Let us Recapitulate**

- Initially the Sale of Goods Act, 1930 was a part of the Indian Contract Act, 1872 in Chapter VII.
- This Act is applicable to whole of India except the State of Jammu and Kashmir.
- Sale of Goods Act is applicable to movable goods other than actionable claims and money.
- Contract of Sale of Goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.
- Goods means every kind of movable property other than actionable claims and money.
- Old coins which are not current money can be treated as goods.
- Only movable goods are subject matter of Sale of Goods Act.
- Contract of Sales is different from the Agreement to sales.
- In a contract of sale of property in goods passes immediately whereas in the case of agreement to sale the property in goods passes sometime in future.
- Property means general property in goods and not merely special property in goods.
- Goods identified and agreed upon at the time of making contract of sale are called specific goods.
- Goods not identified and agreed upon at the time of making contract of sale are called unascertained goods.
- Goods which are to be manufactured/produced or acquired by the seller after making the contract of sale are called future goods.
- In case of contingent goods, their acquisition is contingent upon a contingency which may or may not happen.
- In a contract of sale parties are free to fix the price in any manner they feel like. It can be provided in the contract itself or manner provided in the contract or determined by the course of dealing between the parties or by third party.
- Contract of Sale creates right in rem i.e., right against the whole world.
- Agreement to sell creates right against personal right against the specified person.
- A sale in an executed contract whereas an agreement to sell is an executory contract.
- Performance of a contract of Sale is absolute and unconditional whereas performance of an agreement to sell is conditional and in future.
- Stipulations as to time of payment are not essence of the contract of sale.
- Condition refers to those Stipulations which are essential to the very nature of the contract.



- Breach of condition give the aggrieved party right to repudiate the contract.
- Warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives right to claim damages but not to repudiate the contract.
- Conditions and warranties can be implied or expressed.
- Condition as to title, condition as to description, condition in a sale by sample, condition as to wholesomeness and condition as to merchantability etc are implied conditions.
- Quiet possession, freedom from encumbrance, disclosing dangerous nature of goods etc are implied warranties.
- Caveat emptor means buyer be aware.
- Under the Caveat Emptor buyer is expected to take utmost care and diligence while purchasing the goods and the seller is not bound to disclose defects in the goods.
- Risk is associated with ownership of goods.
- Seller can sue for price only when property in goods has passed on to the buyer.
- Appropriation means selection, setting apart, weighing, measuring or counting or other acts with the intention of using the same for performance of the Contract.
- Generally the owner alone can transfer the property in goods.
- *Nemo dat quod habet* means that no one can give what he himself does not have.
- The doctrine of *Nemo dat quod habet* seeks to protect the interest of real owner.
- A non owner can make valid transfer of property in goods in the case of sale by a mercantile agent, sale by joint owner, sale by seller in possession of goods after sale, sale by a person in possession of goods under a voidable contract, sale by unpaid seller and sale by finder of lost goods etc.
- A mercantile agent is one who has in the customary course of his business as such agent, authority to sell goods or to consign goods for the purpose of sale or to buy goods or to raise money on the security of the goods.
- Voluntary transfer of possession of goods from one person to another is called delivery of goods.
- Delivery of goods can be actual, symbolic and constructive.
- When goods are physically handed over by the seller to the buyer it is called actual delivery.
- Symbolic delivery occurs by doing some act, which has the effect of putting the goods in the possession of the buyer. Delivery of the keys to a godown or warehouse is symbolic delivery.
- Change in possession of goods without any change in their actual and visible custody, which has the effect of delivery, is called Constructive delivery.
- All expenses incidental to delivery are born by the seller.
- All expenses incidental to taking delivery are born by the buyer.
- A person to whom the whole of the price has not been paid or when a bill of exchange or other instrument has been receive but which has been dishonored is called an unpaid seller.
- Unpaid seller has right of lien, stoppage of goods in transit, resale, sue for price, sue for specific damages, sue for interest etc.

- Right of stoppage of goods in transit can be exercised subject to fulfillment of some conditions.
- If a finder of lost goods could not trace the owner or the owner refuses to pay the lawful charges of the finder, the finder can resell the goods when the thing is perishable or when his lawful charges for finding the owner amount to 2/3rd of value of goods.
- A pawnee may under certain circumstances sell the goods pledged to him on giving the pawnor reasonable notice of the sale.

# Study Note - 3

## LAWS RELATING TO EMPLOYEES



This study note includes Laws relating to Employees:

- 3.1 Factories Act, 1948
- 3.2 Industrial Disputes Act, 1947
- 3.3 Employee's Compensation Act, 1923
- 3.4 Payment of Wages Act, 1936
- 3.5 Minimum Wages Act, 1948
- 3.6 Payment of Bonus Act, 1965
- 3.7 Payment of Gratuity Act, 1972
- 3.8 Employees State Insurance Act (E.S.I) Act, 1948
- 3.9 Employees' Provident Funds and Miscellaneous Act, 1952.
- 3.10 The Child Labour (Prohibition and Regulation) Act, 1986

### 3.1 THE FACTORIES ACT 1948

Factories Act, 1948 is one of the major Central Act aimed to regulate the working conditions in the factories. It lays down all essential provisions relating to proper working conditions, working hours, holidays, overtime, employment of children, women and young person, safety, health and welfare of the workers employed in a factory etc. The main objective of the Act is not only to ensure adequate safety measure but also to promote health and welfare of the workers employed in a factory as well to prevent haphazard growth of factories through the provisions relating to approval of plans before creation of a factory. The Act has been enacted primarily with the object of protecting workers employed in factories against industrial and occupational hazards. Toward that objective, it impose upon the owner or occupier certain obligations to protect the workers and secure for them employment in conditions conducive for their health and safety.

This Act was enacted in 1948 and came into force with effect from-1st April 1949. Prior to the present Act first time Indian Factories Act 1881 was enacted. The then existing law relating to the regulation of labor employed in Factories were embodied in the Factories Act, 1934. It was amended several times but its general framework remained unchanged. Application of this Act revealed a number of defects and weaknesses which hampered effective administration. The provisions for safety, health and welfare of workers were generally found to be inadequate and unsatisfactory and even such protection as was provided did not extend to a large number of workers employed in work places not covered by the Act. Accordingly the need for a fresh legislation was felt. The present Factories Act, 1948 is applicable to factories wherein ten or more workers are or were working on any day of the preceding twelve months and in which manufacturing process is being carried on with the aid of power or twenty or more workers without the aid of power.

The Act has been amended several times but major amendments were in 1976 and in 1987 wherein emphasis has been laid on safety measures. This Act contains 120 sections and 3 schedules. The important concepts and sections are discussed as under;

#### 3.1.1 Objectives of Factories Act

- (1) The object of the Factories Act is to regulate the conditions of work in manufacturing establishments coming with the definition of the term "Factory" as used in the Act.

### 3.1.2 Extent and Commencement

- (1) This Act may be called the Factories Act, 1948.
- (2) It extends to the whole of India.
- (3) It – came into force on the 1st day of April, 1949.

### 3.1.3 Basic concepts (Section 2)

In this Act, unless there is anything repugnant in the subject or context, —

- (a) “Adult” means a person who has completed his eighteenth year of age;
- (b) “Adolescent” means a person who has completed his fifteen year of age but has not completed his eighteenth year;
- (bb) “Calendar year “ means the period of twelve months beginning with the first day of January in any year; (4) “Child” means a person who has not completed his fifteenth year of age;
- (ca) “Competent person”, in relation to any provision of this Act, means a person or an institution recognised as such by the Chief Inspector for the purposes of carrying out tests, examinations and inspections required to be done in a factory under the provisions of this Act having regard to—
  - (i) The qualifications and experience of the person and facilities available at his disposal; or
  - (ii) The qualifications and experience of the persons employed in such institution and facilities available therein, with regard to the conduct of such test, examinations and inspections, and more than one person or institution can be recognised as a competent person in relation to a factory;
- (cb) “Hazardous process” means any process or activity in relation to an industry specified to the First Schedule where, unless special care is taken, raw materials used therein or the intermediate or finished products, bye-products, wastes or effluents thereof would—
  - (i) Cause material impairment to the health of the persons engaged in or connected therewith, or  
(Result in the pollution of the general environment: Provided that the State Government may, by notification in the Official Gazette, amend the First Schedule by way of addition, omission or variation of any industry specified in the said Schedule;
- (d) “Young person” means a person who is either a child or an adolescent
- (e) “Day” means a period of twenty-four hours beginning at midnight;
- (f) “Week” means a period of seven days beginning at midnight on Saturday night or such other night as may be approved in writing for a particular area by the Chief Inspector of factories;
- (g) “Power “ means electrical energy, or any other form of energy which is mechanically transmitted and is not generated by human or animal agency;
- (h) “Prime mover “means any engine, motor or other appliance which generates or otherwise provides power;
- (i) “Transmission machinery” means any shaft, wheel drum, pulley, system of pulleys, coupling, clutch, driving belt or other appliance or device by which the motion of a prime mover is transmitted to or received by any machinery or appliance;
- (j) “Machinery” includes prime movers, transmission machinery and all other appliances whereby power is generated, transformed, transmitted or applied;
- (k) “Manufacturing process” means any process for—
  - (i) Making, altering, repairing, ornamenting, finishing, packing, oiling, washing, cleaning, breaking up, demolishing, or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery or disposal, or



- (ii) Pumping oil, water, sewage or any other substance; or; (iii) Generating, transforming or transmitting power; or
- (iii) Composing types for printing, printing by letter press, lithography, photogravure or other similar process or book binding; [ra-6 ] [ ra-7 or ra-7 ]
- (iv) Constructing, reconstructing, repairing, refitting, finishing or breaking up ships or vessels; (Inserted by the Factories (Amendment) Act, 1976, w.e.f. 26-10-1976.)
- (v) Preserving or storing any article in cold storage;

The following case laws will help in understanding the concept of manufacturing process.

SC in the case of Uttarakhand forest Development Corporation and Another v Jabar Sing and others 2007 LLJ 95 Sc held that the process of cutting trees by axe and changing the shape by saw and conversion of trees into logs for the purpose of preserving any article such a milk in cold storage is a manufacturing process

- (ii) In the case of KVV Sharma 1950 1 LLJ 29 conversion of raw films into a finished production was held to be a manufacturing process.
  - (iii) In New Taj Mahal café Ltd Mangalore v Inspector factories Mangalore 1956 1 IJ29 the preparation of foodstuffs and other eatables in the kitchen of restaurant and use of a refrigerator for treating or adapting any article with a view to its sale were also held to be manufacturing process.
- (l) “worker” means a person employed, directly or by or through any agency (including a contractor) with or without the knowledge of the principal employer, whether for remuneration or not, in any manufacturing process, or in cleaning any part of the machinery or premises used for a manufacturing process, or in any other kind of work incidental to, or connected with, the manufacturing process, or the subject of the manufacturing process but does not include any member of the armed forces of the union;
- (m) “Factory” means any premises including the precincts thereof –
- (i) Whereon ten or more workers are working, or were working on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on with the aid of power, or is ordinarily so carried on, or
  - (ii) Whereon twenty or more workers are working, or were working on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on without the aid of power, or is ordinarily so carried on, but does not include a mine subject to the operation of the Mines Act, 1952 (35 of 1952), or a mobile unit belonging to the armed forces of the union, a railway running shed or a hotel, restaurant or eating place;

#### **Explanation I:**

For computing the number of workers for the purposes of this clause all the workers in different groups and relays in a day shall be taken into account.

#### **Explanation II :**

For the purposes of this clause, the mere fact that an Electronic Data Processing Unit or a Computer Unit is installed in any premises or part thereof, shall not be construed to make it a factory if no manufacturing process is being carried on in such premises or part thereof;

The following cases will help in understanding the concept of Factory under this Act;

- (i) It was held in Employees' State Insurance Corp. V. Jalandhar Gymkhana Club 1993 1LLJ 477, that the preparation of food and drinks in the kitchen attached to the club and the preservation and

storing of articles in the cold storage would be a manufacturing process under Section 2(k) of the Factories Act and therefore it follows that the premises of the club is a factory under Section 2(m) of the Factories Act, 1948.

- (ii) In *VP Gopala Rao v. Public Prosecutor, Andhra Pradesh* AIR 1970 Sc, sun-cured tobacco leaves was subjected to processes of moistening, stripping and packing in a company's premise with a view to their use and transport to company's main factory for manufacturing cigarettes. More than twenty persons under supervision of management were working in the premises. It was held that the manufacturing process was carried on in the premises and the persons employed were 'workers' and premises a 'factory' within the meaning of Section 2(m) of the Act.
  - (iii) In *Dr PSS Sundar Rao, GS v. Inspector of Factories Vellore* 1984 II LLJ 237 Mad, the question was whether a laundry attached to the Christian Medical College & Hospital; Vellore is factory within the meaning of this Act. The Madras High Court held that the laundry run by the Hospital cannot be separated from the main institution. In order to ensure high degree of hygienic standard the Hospital is having its worn laundry for washing the linen used in the Hospital. Therefore, laundry is only subsidiary, minor or incidental establishment of the Hospital which is not a factory. One department of the Hospital established for the efficient functioning of the Hospital cannot be therefore be disjoined from the main institution and termed to be a factory. The paramount or the primary character of the main institution alone has to be taken into consideration and when the main institution is not a factory; a department thereof cannot become so, even though a manufacturing process is carried on there.
  - (iv) It was held in *Parry's (Cal.), Employees' Union and another v. Third Industrial Tribunal, West Bengal and others* 2001 II 39 Cal, that mere designation of an employee as a packer will not make the establishment a factory unless it is shown that the ingredients of factories as amended in Section 2(m) of the factories Act 1948 are present. Since this point was not raised before Tribunal, hence petitioners are not entitled to raise it in writ petition.
  - (v) It was held in *Bhakra Beas Management Board v. Employees' State Insurance Corporation and another* 2003 II 637 Del, that the sub-stations of the petitioner Electricity Board did not satisfy the definition of factory, since no manufacturing process was carried on in them.
  - (vi) In the case of *KVV Sharma* 1953 1 LLJ 269 conversion of raw films into a finished production was held to be a manufacturing process
- (n) "Occupier" of a factory means the person who has ultimate control over the affairs of the factory: Provided that -
- (i) In the case of a firm or other association of individuals, any one of the individual partners or members thereof shall be deemed to be the occupier;
  - (ii) In the case of a company, any one of the directors shall be deemed to be the occupier;
  - (iii) In the case of a factory owned or controlled by the Central Government or any State Government, or any local authority, the person or persons appointed to manage the affairs of the factory by the Central Government, the State Government or the local authority, as the case may be, shall be deemed to be the occupier:

Provided further that in the case of a ship which is being repaired, or on which maintenance work is being carried out, in a dry dock which is available for hire, -

- (1) the owner of the dock shall be deemed to be the occupier for the purposes of any matter provided for by or under—



- (a) section 6, section 7, section 7A, section 7B, section 11 or section 12;
  - (b) Section 17, in so far as it relates to the providing and maintenance of sufficient and suitable lighting in or around the dock;
  - (c) Section 18, section 19, section 42, section 46, section 47 or section 49, in relation to the workers employed on such repair or maintenance;
- (2) The owner of the ship or his agent or master or other officer-in-charge of the ship or any person who contracts with such owner, agent or master or other officer-in-charge to carry out the repair or maintenance work shall be deemed to be the occupier for the purposes of any matter provided for by or under section 13, section 14, section 16 or section 17 (save as otherwise provided in this proviso) or Chapter IV (except section 27) or section 43, section 44 or section 45, Chapter VI, Chapter VII, Chapter VIII or Chapter IX or section 108, section 109 or section 110, in relation to—
- (a) The workers employed directly by him, or by or through any agency; and
  - (b) The machinery, plant or premises in use for the purpose of carrying out such repair or maintenance work by such owner, agent, master or other officer-in-charge or person;
- (o) “prescribed” means prescribed by the State Government under this act
- (r) Shift means where work of the same kind is carried out by two or more sets of workers working during different periods of the day, each of such sets is called a “group” or “relay” and each of such periods is called a “shift”.

#### **At a glance:**

In order to be termed as a factory under this act ten or more workers are/were working on any day of the preceding 12 months and manufacturing process is being carried out with the aid of power.

In case manufacturing process is being carried on without the aid of power at least twenty or more workers are or working on any day during the previous 12 months.

Mines subject to operation of Mines Act, mobile unit of armed forces of union, a railway running shed or a hotel, restaurant or eating place etc are not treated factory.

Occupier is the person who has ultimate control over the affairs of the factory.

Precincts mean a space enclosed by wall.

The State Government on its own or on an application made by an occupier has power to direct that different department or branches of a factory may be treated separate factories or two or more factories of the occupier may be treated as a single factory.

The State Government in case of public emergency exempts any factory of class of factories from all or any provisions of this Act except section 67. No such exemption can be granted for more than 3 months at a time.

A written notice at least 15 days before begins to occupy or use any premises as a factory the occupier is required to give to the chief Inspector.

As and when a new manager is appointed the occupier is required to send to the Inspector a written notice within seven days from the date on which such person takes over charge.

Every occupier is required to ensure the health, safety and welfare of all the workers while they are at the work in the factory.

In every factory wherein one thousand or more workers are ordinarily employed or where the State Government is of the opinion that the manufacturing process or operations used involves any risk of body injury, poisoning, disease or any other hazard to health, the occupier to appoint such number of safety

officers as may be specified in the notification.

State Governments have power to make rules to prescribe in every factory wherein more than two hundred and fifty workers are ordinarily employed a canteen or canteens shall be maintained by the occupier.

In every factory wherein more than thirty women workers are ordinarily employed a suitable room or rooms is required to be maintained by the occupier for the use of the children under the age of six years of such women.

In every factory wherein five hundred or more workers are ordinarily employed such number of welfare officers are required to be appointed as prescribed.

In every factory wherein more than one hundred and fifty workers are ordinarily employed suitable shelters or rest rooms and a suitable canteen with provision for drinking water is required to be provided by the occupier.

In every factory wherein more than five hundred workers are ordinarily employed an ambulance room with proper medical facilities under the charge of medical and nursing staff to be maintained.

Every District Magistrate is also Inspector of his district.

The State Government appoint person having prescribed qualification as inspector for this Act.

Every Inspector appointed by the State Government has power to enter any place, make examination of premises, inquire into any accident or dangerous occurrence, requires production of any prescribed documents/register, seize/take copies of any register/record etc.

The inspector appointed by the State Government has no power to compel any person to answer any question or give any evidence tending to incriminate him.

Chief Inspector appointed by the State Government under section 8(2) of the Act recognises a person or an institution as a competent person under section 2(ca) of the Act.

Chapter III of the Act deals with the provisions regarding health, welfare, safety of workers.

No adult worker can be allowed or required to work more than 48 hours in a week.

No adult worker can be allowed or required to work more than nine hours in a day.

The manager of every factory is required to maintain a register of adult workers which shall be available to the inspector at all times during working hours or when any work is being carried on in the factory.

A Child who has not completed 14 years of age is allowed or required to work in a factory.

A child worker who has completed 14 years of age or an adolescent is allowed or required to work in a factory only when the manager of the factory is having the certificate of fitness granted to such child or adolescent worker in his custody and the token carried by the child/adolescent bears reference to such certificate.

No child worker can be employed or permitted to work in a factory for more than four and a half hours in any day and during night.

An inspector may required medical examination of a young person working in a factory when he has reason to believe that a person working in the factory without certificate of fitness is a young person or a the young person working in the factory carrying certificate of fitness is no longer fit to work.

Every adult worker who has worked at least 240 days in a calendar year in a factory is allowed one day leave for every twenty days of work performed during the previous calendar year.

Every child worker who has worked at least 240 days in a calendar year in a factory is allowed one day leave for every fifteen days of work performed during the previous calendar year.

If in any factory any dangerous occurrence take place whether any bodily injury or disability is caused or not, the manager of the factory is required to send notice thereof to concerned authorities.



Every worker has right to obtain information from the occupier relating to workers health and safety at work.

Every worker has right to represent to the inspector directly or through his representative in the matter of inadequate provision for protection of his health or safety in the factory to obtain information from the occupier relating to workers health and safety at work.

If in any factory any worker contract any disease specified in the third schedule the manager of the factory is required to send notice thereof to concerned authorities.

If any workers contravenes any provision of this act or any rules or orders made thereunder he shall be punishable with fine which may extend to five hundred rupees.

Using or allowing using false certificate of fitness is punishable with imprisonment for a term which may extend to two months or with fine which may extend to one thousand rupee or with both.

A court can take cognizance of any offence under this Act only on complaint by or with the previous sanction in writing of, an inspector.

No court below that of a Presidency Magistrate or a Magistrate of the first Class shall try any offence punishable under this Act.

Central Government has power to give direction to a state Government as to the carrying into execution of any provisions of this Act.

The provisions of this Act are equally applicable to the factories of the Central/State Government unless otherwise exempted.

### 3.2 THE INDUSTRIAL DISPUTES ACT, 1947

Industrial Dispute Act, 1947 is one of the important social legislation enacted to provide mechanism for resolution of Industrial disputes, which may arise between Employer and Workmen's, Workman and Workman, Employers and Employers. Prior to enactment of this Act in 1947, Industrial disputes were being settled under the provisions of the Trade Disputes Act, 1929 that was found inadequate to settle Industrial disputes. Though the Trade Disputes Act, 1929 did impose some restraints on the right of workers and employers to declare strike or lockout in public utility service but no provision was made in the Act to render the proceedings institution able under the Act for settlement of an Industrial dispute either by reference to a Board of Conciliation or to a court of Enquiry, conclusive and binding on the parties to the dispute. This defect was overcome during the war by empowering under Rule 81A of the Defense of India Rules, the Central Government to refer Industrial dispute to adjudicators and to enforce their awards. Rule 81 A of Defense of India lapsed on 1st October 1946. The essential provisions of Rule 81A were embodied in the Act which was acceptable to both Employers and Employees.

This Act provides not only the machinery and procedures for the investigation and settlement of Industrial disputes but also to secure industrial peace so that it may result in more production and improve national economy for providing congenial Industrial relations and working conditions. This Act is applicable to every establishment or factory whether in public or private sector which falls within the definition of Industry and those employees who are covered under the definition of Workman given in the Act.

The Act envisages appointment of Conciliation officers charged with the duty of mediating in and promoting settlement of Industrial disputes, Constitution of labor courts/Industrial Tribunals.

Though the Act does not interfere with the right of Employees and Employer to declare strike or lockout but it provide due procedure for such eventualities. The Act prohibit strikes and lockout during the pendency of conciliation and adjudication proceedings of settlement reached in the course of conciliation proceedings and of awards of Industrial tribunal declared binding by the appropriate Government. It also contains detailed provisions regarding lay off, retrenchment, closures, prevention of unfair labor practices and penal provisions for violation of any provisions of this Act etc. The provisos of this Act are not applicable to Mines and Railways for which there are separate provisions.

The Act came into force with effect from 1st April 1947 and applies to the whole of India. Since then the Act has been amended several times latest being vide Industrial Disputes (Amendment) Act, 2010 which provides for establishment of Grievances Redressal Committee in every Industrial establishment employing 20 or more workmen for the resolution of disputes arising out of individual grievances. A provisions has been made for the workman/employee to make an application direct to the Labor court or Tribunal for adjudication of disputes relating to or arising out of discharge, dismissal, retrenchment or termination, after expiry of forty five days from the date he has made the application to the conciliation officer of the appropriate Government for conciliation of the dispute. This Act contains 40 sections and 5 schedules. The important concepts and sections are discussed as under.

#### 3.2.1 Objectives of the Act

The main objectives of the Act are as follows:

- (i) Securing industrial peace through-
  - (a) Preventing and settling industrial disputes between employers and employees.
  - (b) Setting up an internal Works Committee for maintaining good relations between employers and employees.
  - (c) Promoting good relations through external machineries like Conciliation, Courts of Enquiry, Industrial Tribunals, National Tribunals and Labor Courts.



- (ii) Ameliorating the condition of workmen in industry
  - (a) By redressing the grievances of workmen through statutory machinery. (b) By assuring job security.

#### **Explanation:**

The Principal objectives of the Act as analyzed by the Supreme Court of India in *Workmen of Dimackuchi Tea Estate V Management of Dimackuchi Tea Estate AIR 1958 SC 353* are follows;

- (1) The promotion of measures for securing amity and good relations between the employer and workmen
- (2) An investigation and settlement of Industrial disputes between the employers and the employees, employers and workmen or workmen and workmen with a right of representation by a registered Trade Union or Federation of Trade Unions or Association of Employers or an Association of Employers or federation of an association off employers
- (3) The prevention of illegal strikes and lockouts
- (4) Relief to workmen in the matter of layoff retrenchment and closure of an undertaking
- (5) Collective bargaining

The Industrial Dispute Act is a progressive measure of social legislation aiming at the amelioration of the conditions of Workmen in Industry (*SN Rai V Vishwanath Lal, AIR 1960 Patna 10*).

#### **3.2.2 Extent**

- (i) This Act may be called the Industrial Disputes Act, 1947.
- (ii) It extends to the whole of India.
- (iii) It shall come into force on the first day of April, 1947.

#### **3.2.3 Basic Concepts**

In this Act, unless there is anything repugnant in the subject or context,

(a) “appropriate Government” means [Sec 2(a)]

- (i) In relation to any industrial dispute concerning any industry carried on by or under the authority of the Central Government,
- (ii) Or, by a railway company or concerning any such controlled industry as may be specified in this behalf by the Central Government;
- (iii) or, in relation to an industrial dispute concerning 1a Dock Labor Board established under section 5A of the Dock Workers (Regulation of Employment) Act,(9 of 1948),
- (iv) Or, 1the Industrial Finance Corporation of India Limited formed and registered under the Companies Act, 1956 (1 of 1956),
- (v) or, the Employees’ State Insurance Corporation established under section 3 of the Employees’ State Insurance Act, 1948 (34 of 1948);
- (vi) or, the Board of Trustees constituted under section 3A of the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948 (46 of 1948), or the Central Board of Trustees and the State Boards of Trustees constituted under section 5A and section 5B, respectively, of the Employees’ Provident Fund and Miscellaneous Provisions Act, 1952 (19 of 1952),
- (vii) or, the Life Insurance Corporation of India established under section 3 of the Life Insurance Corporation Act, 1956 (31 of 1956),
- (viii) or, the Oil and Natural Gas Corporation Limited registered under the Companies Act, 1956 (1 of 1956);
- (ix) or, the Deposit Insurance and Credit Guarantee Corporation established under section 3 of the Deposit Insurance and Credit Guarantee Corporation Act, 1961 (47 of 1961), or the Central Warehousing

Corporation established under section 3 of the Warehousing Corporations Act, 1962 (58 of 1962);

- (x) or, the Unit Trust of India established under section 3 of the Unit Trust of India Act, 1963 (52 of 1963);
- (xi) or the Food Corporation of India established under section 3;
- (xii) or a Board of Management established for two or more contiguous States under section 16, of the Food Corporations Act, 1964 (37 of 1964);
- (xiii) or the Airports Authority of India constituted under section 3 of the Airports Authority of India Act, 1994 (55 of 1994);
- (xiv) or a Regional Rural Bank established under section 3 of the Regional Rural Banks Act, 1976 (21 of 1976);
- (xv) or the Export Credit and Guarantee Corporation Limited or the Industrial Reconstruction Bank of India Limited, the National Housing Bank established under section 3 of the National Housing Bank Act, 1987 (53 of 1987);
- (xvi) or an air transport service, or a banking or an insurance company, a mine, an oil field, a Cantonment Board, or a major port, any company in which not less than fifty one percent of the paid up share capital is held by the Central Government, or any corporation, not being a corporation referred to this clause, established by or under any law made by parliament or the Central public sector undertaking, subsidiary companies set up by the principal undertaking and autonomous bodies owned or controlled by the Central Government, the Central Government and
- (xvii) in relation to any other industrial dispute, including the state public sector undertaking, subsidiary companies set up by the principal undertaking and autonomous bodies owned or controlled by the State Government, the State Government :

Provided that in case of a dispute between a contractor and the Contract labor employed through the contractor in any industrial establishment where such dispute first arose, the appropriate Government shall be Central Government or the State Government as the case may be, which has control over such industrial establishment.

**Note:**

The concept of Appropriate Government is very- very important issue as the appropriate government has lot of responsibilities under this Act. Whether the appropriate Government is the Central Government or the State Government depends on the subject matter of the dispute. The general principle on which the broad classification of the Central or State Authority over the Industrial dispute is based is that in case of an Industry carried on by or under the authority of the Central Government or an industry being located in more than one State, the Appropriate Government is the Central Government so that the problem may be conveniently and uniformly dealt with.

In *Shri Shankara Allom Ltd v the State of Travancore Cochin*' AIR 1955 TC 662 it was held that merely because the manufacture of salt was carried on by the company under a licence from the Government, it can not become a Government business or one carried on under the authority of the Government.

In case of *Goa Sampling Employees Association v General Superintendent co of India Pvt. Ltd. and others* (1987) II Lab LJ217 SC it was held that in case of a dispute arising in Union Territory reference may be made by the Central Government since Central Government is the Appropriate Government in relation to Union Territory.

(aa) "arbitrator" includes an umpire;

(aaa) "average pay" means the average of the wages payable to a workman:

- (i) in the case of monthly paid workman, in the three complete calendar months,
- (ii) in the case of weekly paid workman, in the four complete weeks,
- (iii) in the case of daily paid workman, in the twelve full working days, preceding the date on which the



average pay becomes payable if the workman had worked for three complete calendar months or four complete weeks or twelve full working days, as the case may be, and where such calculation cannot be made, the average pay shall be calculated as the average of the wages payable to a workman during the period he actually worked;

(b) "award" means an interim or a final determination of any industrial dispute or of any question relating thereto by any Labor Court, Industrial Tribunal or National Industrial Tribunal and includes an arbitration award made under section 10A;

(bb) "banking company" means a banking company as defined in section 5 of the Banking Companies Act, 1949 (10 of 1949), having branches or other establishments in more than one State, and includes the Export - Import Bank of India the Industrial Reconstruction Bank of India, the Industrial Development Bank of India, the Small Industries Development Bank of India established under section 3 of the Small Industries Development Bank of India Act, 1989, the Reserve Bank of India, the State Bank of India, a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), and any subsidiary bank, as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);

(c) "Board" means a Board of Conciliation constituted under this Act;

(cc) "closure" means the permanent closing down of a place of employment or part thereof;

(d) "conciliation officer" means a conciliation officer appointed under this Act;

(e) "conciliation proceeding" means any proceeding held by a conciliation officer or Board under this Act;

(ee) "controlled industry" means any industry the control of which by the Union has been declared by any Central Act to be expedient in the public interest;

(f) "Court" means a Court of Inquiry constituted under this Act;

(g) "employer" means:

(i) in relation to any industry carried on by or under the Authority of any department of the Central Government or a State Government, the Authority prescribed in this behalf, or where no Authority is prescribed, the head of the department;

(ii) in relation to an industry carried on by or on behalf of a local Authority, the Chief Executive Officer of that Authority;

(gg) "executive", in relation to a trade union, means the body, by whatever name called, to which the management of the affairs of the trade union is entrusted;

a person shall be deemed to be "independent" for the purpose of his appointment as the Chairman or other member of a Board, Court or Tribunal, if he is unconnected with the industrial dispute referred to such Board, Court or Tribunal or with any industry directly affected by such dispute:

Provided that no person shall cease to be independent by reason only of the fact that he is a shareholder of an incorporated company which is connected with, or likely to be affected by, such industrial dispute; but in such a case, he shall disclose to the appropriate Government the nature and extent of the shares held by him in such company;

(j) "**industry**"

means any systematic activity carried on by co-operation between an employer and his workman whether such workman are employed by such employer directly or by or through any agency including a contractor for the production supply or distribution of goods or services with a view to satisfy human wants or wishes not being wants or wishes which are merely spiritual or religious in nature whether or not-

- (i) any capital has been invested for the purpose of carrying on such activity or
  - (ii) such activity is carried on with a motive to make any gain or profit and includes-
    - (a) any activity of the Dock labor Board established under section 5A of the Dock Workers(Regulation of Employment) Act,194
    - (b) such activity relating to the promotion of sales or business or both carried on by an establishment but does not include
- (1) Agricultural operations except where such agricultural operation is carried on in an integrated manner with any other activity being any such activity as is referred to in the foregoing provisions of this clause and such other activity is the predominate one

**Explanation;-** for the purpose of this sub clause, agricultural operation does not include any activity carried on in a plantation as defined in clause (f) of section 2 of the plantation labour Act, 1951 or

- (2) Hospitals / dispensaries
- (3) Educational, scientific, research or training institutions
- (4) Institutions owned or managed by organizations wholly or substantially engaged in any charitable social or philanthropic service or
- (5) Khadi/Village industries
- (6) Any activity of Government relating to sovereign functions of Government including all the activities carried on by the departments of the Central Government dealing with defense research , atomic energy and space, or
- (7) any Domestic service
- (8) any activity being a profession practiced by an individual or body of individuals, if the number of persons employed by the individuals in relation to such profession is less than ten or
- (9) any activity being an activity carried on by a co-operative society or a club or any other like body of individuals if the number of persons employed by the co-operative society , club or other like body of individuals in relation to such activity is less than ten.

**Explanation:**

In *Bhaskaran V SDO (1982) 111LLJ248Ker*;-the Kerala high court held that the Post and Telegraph is an Industry. It was further held that the Government employees who are governed by service rules fall within the purview of Industrial dispute.

In *Chief Conservator of forest & Another ve Jaganath Moruti Kondhur (1996)111LLJ1223 SC* it was held that the scheme of work undertaken by the forest Department could not be regarded as a sovereign function of the State. Therefore the forest department is not an Industry.

A place of worship Mandir where worship is done by Pujaris on a regular wage basis and where it appears from the balance sheet that there remains a large surplus in the fund after expense are paid for making Prasad, it is clear that the enterprise is of commercial nature and for this reason a Mandir is an Industry.

- (k) "industrial dispute" means any dispute or difference between employers and employees, or between employers and workmen, or between workmen and workmen, which is connected with the employment or non-employment or the terms of employment or with the conditions of labour, of any persons;

**Explanation:**

In *Workmen's of Hindustan lever Ltd ve Hinudstan lever Ltd (1984) 111LLJ 391 Sc* it was held that the demand of workmen to confirm employees employed in an acting capacity in a grade would unquestionably be an industrial dispute without anything more.



(ka) "Industrial establishment or undertaking" means an establishment or undertaking in which any industry is carried on :

Provided that where several activities are carried on in an establishment or undertaking and only one or some of such activities is or are an industry or industries, then

- (a) if any unit of such establishment or undertaking carrying on any activity, being an industry, is severable from the other unit or units of such establishment or undertaking, such unit shall be deemed to be a separate industrial establishment or undertaking;
- (b) If the predominant activity or each of the predominant activities carried on in such establishment or undertaking or any unit thereof in an industry and the other activity or each of the other activities carried on in such establishment or undertaking or unit thereof is not severable from and is, for the purpose of carrying on, or aiding the carrying on of, such predominant activity or activities, the entire establishment or undertaking or, as the case may be, unit thereof shall be deemed to be an industrial establishment or undertaking;

(KK) Insurance Company;-means an insurance company as defined in section 2 of the Insurance Act, 1938 having branches or other establishments in more than one state,

(KKa) "Khadi" has the meaning assigned to it clause (d) of the Khadi and village Industries Commission Act, 1956,

(KKb) 'Labor Court' means a labor court constituted under section 7,

Lay-off [Sec. 2(kkk)] with grammatical variations and cognate expressions- means failure, refusal or inability of an employer on account of shortage of coal, power or raw materials or the accumulation of stock or the breakdown of machinery or natural calamity or for any other connected reasons to give employment to a workmen whose name is borne on the muster rolls of his industrial establishment and who has not been retrenched.

**Explanation;-**Every workman whose name is borne on the muster rolls of the industrial establishment and who presents himself for work at the establishment at the time of appointment for the purpose during normal working hours on any day and is not given employment by the employer within two hours of his so presenting himself shall be deemed to have been laid off for that day within the meaning of this clause.

Provided that if the workmen, instead of being given employment at the commencement of any shift for any day is asked to present himself for the purpose during the second half of the shift for the day and is given employment then he shall be deemed to have been laid off only for one half of that day.

Provided further that if he is not given any such employment even after so presenting himself, he shall not be deemed to have been laid off for the second half of the shift for the day and shall be entitled to full basic wages and dearness allowance for that part of the day.

Lock-out [sec 2(l)] - It means temporary closing of a place of employment, or suspension of work or refusal by employer to continue to employ any number of persons employed by him.

**Note;-** If an employer shuts down his place of business as a means of reprisal or as an instrument of coercion or as a mode of exerting pressure on the employee or generally speaking, when his act is what may be called an act of belligerency there would be a lockout. If on the otherhand, he shuts down his work because he cannot for instance get the raw materials or the fuel or the power necessary to carry on his manufacturing or because he is unable to sell the goods he has made or because his credit is exhausted or because he is loosing money, that would not be a lockout. Sri Ramachandra Spinning Mills Pandalapakka v Province of Madras,AIR 1956 Mad 241

(1a) "major port" means a major port as defined in clause (8) of section 3 of the Indian Ports Act, 1908 (15 of 1908);

(1b) "mine" means a mine as defined in clause (j) of sub-section (1) of section 2 of the mines Act, 1952 (35 of 1952);]

- (II) "National Tribunal" means a National Industrial Tribunal constituted under section 7B;]
- (III) "office bearer", in relation to a trade union, includes any member of the executive thereof, but does not include an auditor;]
- (m) "prescribed" means prescribed by rules made under this Act;
- (n) "public utility service" means-
  - (i) any railway service or any transport service for the carriage of passengers or goods by air];
  - [(ia) any service in, or in connection with the working of , any major port or dock;]
  - (ii) any section of an industrial establishment, on the working of which the safety of the establishment or the workmen employed therein depends;
  - (iii) any postal, telegraph or telephone service;
  - (iv) any industry which supplies power, light or water to the public;
  - (v) any system of public conservancy or sanitation;
  - (vi) any industry specified in the [First Schedule] which the appropriate government may, if satisfied that public emergency or public interest so requires, by notification in the Official Gazette, declare to be a public utility service for the purposes of this Act, for such period as may be specified in the notification:  
  
Provided that the period so specified shall not, in the first instance, exceed six months but may, by a like notification, be extended from time to time, by any period not exceeding six months, at any one time if in the opinion of the appropriate government public emergency or public interest requires such extension;
- (o) "railway company" means a railway company as defined in section 3 of the Indian Railways Act, 1890 (9 of 1890);
- (oo) "retrenchments" means the termination by the employer of the service of a workman for any reason whatsoever, otherwise than as a punishment inflicted by way of disciplinary action but does not include-
  - (a) voluntary retirement of the workman; or
  - (b) retirement of the workman on reaching the age of superannuation if the contract of employment between the employer and the workman concerned contains a stipulation in that behalf; or
  - [(bb) termination of the service of the workman as a result of the non-renewal of the contract of employment between the employer and the workman concerned on its expiry or of such contract being terminated under a stipulation on that behalf contained therein; or]
  - (c) termination of the service of a workman on the ground of continued ill-health;]

**Note:** If the termination is meant to exploit an employee or to increase the bargaining power of the employer, then it has to be excluded from the ambit of the sub clause (bb) of clause (oo) and the definition of 'retrenchment' has to be given a full meaning. Chief Administrator, Haryana Urban Development Authority v Presiding officer, Industrial Tribunal-cum Labor Court, Rohtak 1994 LLR (P&H) DB

If a person is engaged for a specific period or for a the execution of a specific work and a clear stipulation is made in the contract of employment that the services shall be terminated at the expiry of the work, the workman shall not be entitled to claim that he has been retrenched or that the action is violative of the provisions of the Act; Municipal Committee v Presiding officer, labor Court, 1994 LLR 206 (P&H)

Where the workers were not project employees and were not employed for any particular project, they would not be governed by sub-clause(bb) or clause (oo) of section 2 of the Act. SM Nalijkar V Telecom District Manager, 2003 4 SCC 27



In an industrial dispute concerning insurance corporation of India the provisions of the Industrial Dispute Act, 1947 will apply, Life Insurance corporation of India v Rajeev Kumar Srivastava, 1994 LLR 573 (ALL) DB

- [(p) "settlement" means a settlement arrived at in the course of conciliation proceeding and includes a written agreement between the employer and workmen arrived at otherwise than in the course of conciliation proceeding where such agreement has been signed by the parties thereto in such manner as may be prescribed and a copy thereof has been sent to 45[an officer authorized in this behalf by] the appropriate government and the conciliation officer;]
- (q) "strike" means a cessation of work by a body of persons employed in any industry acting in combination or a concerted refusal, or a refusal, under; a common understanding of any number of persons who are or have been so employed to continue to work or to accept employment;
- (qq) "trade union" means a trade union registered under the Trade Union Act, 1926, (16 of 1926);]
- [(r) "Tribunal" means an Industrial Tribunal constituted under section 7A and includes an Industrial Tribunal constituted before the 10th day of March, 1957, under this Act;]
- [(ra) "unfair labor practice" means any of the practices specified in the Fifth Schedule;

**Note;-** It means any of the practices specified in the Fifth Schedule (introduced by Amendment Act of 1982) which declares certain labour practices as unfair on the part of employers and their trade unions and on the part of workmen and their trade union.

- (rb) "village industries" has the meaning assigned to it in clause (h) of section 2 of the Khadi and Village Industries Commission Act, 1956 (61 of 1956);]
- [(rr) "wages" means all remuneration capable of being expressed in terms of money, which would, if the terms of employment, expressed or implied, were fulfilled, be payable to a workman in respect of his employment or of work done in such employment, and includes-
  - (i) such allowances (including dearness allowance) as the workman is for the time being entitled to;
  - (ii) the value of any house accommodation, or of supply of light, water, medical attendance or other amenity or of any service or of any concessional supply of food grains or other articles;
  - (iii) any traveling concession;
  - [(iv) any commission payable on the promotion of sales or business or both;] but does not include
    - (a) any bonus;
    - (b) any contribution paid or payable by the employer to any pension fund or provident fund or for the benefit of the workman under any law for the time being in force;
    - (c) any gratuity payable on the termination of his service;]
- (s) "workman" means any person (including an apprentice employed in any industry to do any manual, unskilled, skilled, technical, operational, clerical or supervisory work for hire or reward, whether the terms of employment be express or implied, and for the purposes of any proceeding under this Act in relation to an industrial dispute, includes any such person who has been dismissed, discharged or retrenched in connection with, or as a consequence of, that dispute, or whose dismissal, discharge or retrenchment has led to that dispute, but does not include any such person-
  - (i) who is subject to the Air Force Act, 1950 (45 of 1950), or the Army Act, 1950 (46 of 1950), or the Navy Act, 1957 (62 of 1957); or
  - (ii) who is employed in the police service or as an officer or other employee of a prison; or
  - (iii) who is employed mainly in a managerial or administrative capacity; or
  - (iv) who, being employed in a supervisory capacity, draws wages exceeding ten thousand rupees per mensem or exercises, either by the nature of the duties attached to the office or by reason of the powers vested in him, function mainly of a managerial nature.]

**At a glance:**

- Industrial dispute means dispute between employers and employees or workmen's and workmen's or workmen's and employers which is connected with employment or non employment or any terms of employment or with the condition of labor of any person.
- Average is calculated on the basis of three complete calendar months, four complete weeks, twelve full working days wages in case of monthly paid, weekly paid and daily paid workmen's respectively.
- Lay off refers to failure, refusal or inability of the employer to employment to a workmen on account of shortage of raw materials, coal, power or accumulation of stocks or breakdown of machinery or natural calamity or for any other reasons.
- Lock-out refers to temporary closing of a place of employment or suspension of work or refusal by the employer to continue to employ.
- Retrenchment means termination of service for any reasons other than punishment by way of disciplinary action.
- A person who is employed in a supervisory capacity and draw wages exceeding ` 10,000 is not treated workman under this act.
- Similarly a person who is employed in a managerial or administration capacity or is subject to the Air force Act, Army Act, or Navy Act or employed in a police service or as an officer of prison or other employee of prison etc not treated as workman.
- A dispute between the employer and a workman due to employment or non employment etc will be treated an Industrial dispute even if no other workman or any union of the workmen's is a party to the dispute.
- An Industrial Establishment employing 20 or more workmen's is required to have one or more Grievances Redressal Committee to redress workmen's grievances.
- Chairmen of Grievances Redressal Committee are required to be selected from Employer and among the workmen's alternatively on rotation basis every year.
- Proceedings of Grievances Redressal Committee are required to be completed within 45 days.
- For the purpose of mediating and settlement of Industrial disputes the appropriate government may appoint such number of persons as conciliation officers.
- For the purpose of promoting settlement of an Industrial dispute the appropriate government may constitute a Board of conciliation.
- Appropriate Government may require an Industrial Establishment employing 100 or more workmen's on any day in the preceding 12 months to constitute a workmen Committee.
- Appropriate Government may constitute one or more Industrial Tribunal for adjudication of Industrial dispute relating to matters specified in any schedule.
- 2nd Schedule to the Industrial Dispute Act, 1947 enumerates the matters which fall within the jurisdiction of Labor Court.
- 3rd Schedule to the Industrial Dispute Act, 1947 enumerate the matters which fall within the jurisdiction of Industrial Tribunal.
- For adjudication of Industrial dispute of national importance the Central Government may constitute one or more National Tribunal.
- National Tribunal constitutes only one person appointed by Central Government.
- In case any Industrial dispute exist or is apprehended the employer and the workmen may agree to refer the matter to arbitration before the matter is referred to labor Court or Tribunal or National Tribunal.
- Workmen is entitled to full wages last drawn during the pendency of any proceeding in HC/SC when his order of reinstatement by a labor court or tribunal or National Tribunal is challenged by the employer.



- Person employed in any public utility service can not go on strike without giving six weeks notice and within 14 days of giving such notice.
- Person employed in any public utility service can not go on strike before the expiry of date of strike specified in the notice.
- Employer carrying on any public utility service can not declare lock out without giving six weeks notice and within 14 days of giving such notice.
- Employer carrying on any public utility service cannot declare lock out before the expiry of date of lock out specified in the notice.
- Any strike/lock-out without notice and before expiry of date specified in the notice is treated illegal.
- Unfair labor practice is punishable with imprisonment for a term which may extend to 6 month or with fine which may extend to one thousand rupees or with both.
- Any workman who commence, continues or otherwise act in furtherance of an illegal strike is liable to be punished with imprisonment for a term which may extend to six month or with fine which may extend to fifty rupees or both.
- Any Employer who commence, continues or otherwise act in furtherance of an illegal lockout is liable to be punished with imprisonment for a term which may extend to one month or with fine which may extend to one thousand rupees or both.
- Any person who instigate or incites others to take part in or otherwise act in furtherance of, a strike or lockout which is illegal is liable to be punished with imprisonment for a term which may extend to six month or with fine which may extend to one thousand rupees or both.
- Any financial aid or help in support of any illegal strike/lock out is prohibited.
- Any workmen whose name is borne on the muster roll of an industrial establishment and who has completed not less than 1 year of continuous service is entitled to wages during the period he is laid off which is 50% of the total basic wages and dearness allowance that would have been payable to him had he not been laid off.
- A workmen whose name is borne on the muster roll of an industrial establishment and completed not less than 1 yr of continuous service can be laid off only with the permission of appropriate government or such authority specified by the appropriate government unless the lay off is due to shortage of power or to any natural calamity, or fire, flood, excess of inflammable gas or explosion.
- A workmen employed in an industrial establishment and rendered not less one year service can not be retrenched without three months notice in writing indicating the reasons for retrenchment and prior permission of the appropriate government is obtained.
- Any lay off or retrenchment without permission of the appropriate government is punishable with the imprisonment for a term which may extend to one month or with fine which may extend to `1000 or both.
- Court can take cognizance of any offence punishable under this Act or of the abatement of such offence on complaint made by or under the authority of the Appropriate Government only.
- No court inferior to that of a Metropolitan Magistrate or a judicial Magistrate of the first Class can take any offence punishable under this Act.
- Appropriate Government has power to make appropriate rules for the purpose of giving effect to the provision of Industrial Dispute Act.
- Appropriate Government has power to add any industry to schedule I of the Act.
- Central Government has power to add, amend, alter schedule II,III of the Act by way of notification in the official gazette.

### 3.3 EMPLOYEES COMPENSATION ACT, 1923

#### 3.3.1 The Employees Compensation Act, 1923. (earlier known as The Workmen's Compensation Act 1923)

The growing complexity of Industry in India, with the increasing use of machinery and consequent danger to workmen, comparative poverty of workmen, non-payment of compensation by employers generally to the workmen, etc made it the government to thought of protecting the workmen as far as possible from hardship arising from accidents.

After detailed examination of the question by the Government of India, local Government was addressed in 1921 and provisional views of the Government of India were published for general information. The necessity of a separate legislation to protect the interest of workmen was accepted by great majority of local Government, Government of India, general public opinion, Employers and Workmen's Associations.

Accordingly in June, 1922 a committee was convened to consider this question. Having considered the numerous replies and opinion received by the Government of India, the Committee unanimously favored legislation and drew up detailed recommendations. The Workmen's Compensation Bill 1923 having been passed by the legislation received its assent on the 5th March 1923. It came into force with effect from 1st July, 1924 and came into the statue books as the Workmen's Compensation Act, 1923.

The Act is based on the general principle that the Compensation should ordinarily be given to workmen who sustained personal injuries by accident arising out of and in the course of their employment. Also provision has been made for payment of compensation in certain limited circumstances of diseases.

The Act has been amended from time to time. Latest amended being in 2009 raising the minimum limit of compensation in case of death to Rs120,000 and in case of permanent total disablement to Rs. 140,000. Another landmark amendment was re-christening the Act as The Employees compensations Act 1923 in place of the Workmen's Compensation Act, 1923. The passing of Workmen's Compensation Act in 1923 was the first step towards social security of Employee. The theory of this act is that "the cost of product should bear the blood of the Employee". This Act provides compensation to certain classes of workmen by their employers for injury, which may be suffered, by the workmen as result of an accident during the course of employment.

In *Sumita Devi v Avtar Singh* (2004) 104 FJR 1007 Jhar; - It was observed that "it is well settled that the Act is a piece of social security and welfare legislation. Its dominant purpose is to protect the workmen and therefore the provisions of the Act should not be interpreted too narrowly so as to debar the workman from compensation, which the parliament thought they ought to have. The intention of the legislator was to make the employer an insurer of the workmen responsible against the loss caused by the injuries or death which ought to have happened while the workman was engage in his work; This act contains 36 sections contained in four chapters and 4 schedules. Both State Governments (u/s 32) and Central Government (u/s 35 read with 36) have powers to make rules to carry out the purpose of this Act. Payment of compensation for personal injury arising out or and in the course of employment is a right of an employee and any contract or arrangement made whereby an employee relinquishes compensation from employee is null and void in so far as it purports to remove or reduce the liability of any person to pay compensation under this Act. (Sec 17)

#### 3.3.2 Object

To provide Compensation to Employee for accidental injury and occupational diseases arising during and in the course of employment.

#### 3.3.3 Applicability of Act:

It extends to whole of India

#### 3.3.4 Date of enforcement: 1st July 1923

3.3.5 Constitutional provision:-Entry no 24 list three Schedule 7 to The Constitution of India;-Both Center



Government and State Governments have power to make law thereon

### 3.3.6 Basic Concepts

“Dependent” means any of the following relatives of a deceased Employee, namely [Sec 2(d)]:-

- (i) A widow, a minor legitimate or adopted son, and unmarried legitimate or adopted daughter, or a widowed mother; and
- (ii) If wholly dependent on the earnings of the Employee at the time of his death, a son or a daughter who has attained the age of 18 years and who is infirm;
- (iii) If wholly or in part dependent on the earnings of the Employee at the time of his death,
  - (a) A widower,
  - (b) A parent other than a widowed mother,

**Explanation:** The following cases help in understanding the concept of Dependant

- (i) *Intiabji v MC Colliery AIR 1959 MP 329 MP* High court viewed that mother would be entitled to compensation even if she had remarried; provided that she can prove that she was wholly or in part dependent upon the earning of the employee.
  - (ii) In *Additional Deputy Commissioner Singhbhum v Smt Laxmibai Naidu, AIR 1945 Nagpur, Nagpur* High court held that the phrase widened mother would include an adoptive mother.
  - (iii) *Kummesin v Navia AIR 1966 Raj 36* father can claim compensation under this section provided that he can show that he was wholly or in part dependent upon the earnings of his son at the time of his death.
  - (iv) In *St Joseph's Automobile v Maria soosai AIR 1953 Mad 206* it was held that when the earnings of the deceased employee were hardly sufficient for his maintenance and no balance was left which he would contribute to the family fund the parents cannot be said to be dependant.
- (c) A minor illegitimate son, an unmarried illegitimate daughter or a daughter legitimate or illegitimate or adopted if married and a minor or if widowed and a minor,

**The following cases help in understanding the concept of Dependant**

- (i) Unmarried daughter includes a widowed daughter who is being maintained by her father during her life time. (*Soleman Bibi v East India Railway, AIR 1933 cal 358*)
  - (ii) Unmarried daughter does not include a daughter who has been divorced. *Rajban v Rahim Bux 1969 ALL LJ15*
- (d) A minor brother or an unmarried sister or a widowed sister if a minor,
- (e) A widowed daughter-in-law,
- (f) A minor child of a pre-deceased son,
- (g) A minor child of a pre-deceased daughter where no parent of the child is alive, or
- (h) A paternal grandparent if no parent of the Employee is alive.

**Explanation:** For the purposes of sub-clause (ii) and items (f) and (g) of sub-clause (iii), references to a son, daughter or child include an adopted son, daughter or child respectively;

### “Employer” [Sec 2(e)]

Includes anybody of persons whether incorporated or not, and any managing agent of an employer, and the legal representative of a deceased employer, and, when the services of a Employees are temporarily lent or let on hire to another person by the person with whom the Employee has entered into a contract of service or apprenticeship, means such other person while the Employee is working for him;

### **"Wages" [Sec2(m)]**

Includes any privilege or benefit which is capable of being estimated in money, other than a traveling allowance or the value of any traveling concession or a contribution paid by the employer a workman towards any pension or provident fund or a sum paid to a employee to cover any special expenses entailed on him by the nature of his employment;

**Note:** The term wages has different meaning under the payment of wage Act, the Factory Act and Industrial Dispute Act, Compensation to an injured person under this act is to be determined on the basis of wages of injured person under this Act and not any other acts

### **"Employee" (Section 2(dd))**

Means any person -who is -

- (i) a railway servant as defined in clause (34) of section 2 of the Railways Act, 1989 (24 of 1989), not permanently employed in any administrative, district or sub-divisional office of a railway and not employed in any such capacity as is specified in Schedule II. or
- (ii)
  - (a) a master, seaman or other member of the crew of a ship
  - (b) a captain or other members of the crew of an aircraft
  - (c) a person recruited as driver, helper, and mechanic, cleaner or in any other capacity in connection with motor vehicle
  - (d) a person recruited for work abroad by a company and who is employed outside India in any such capacity as is specified in schedule II and the ship, aircraft or motor vehicle or company, as the case may be is registered in India or
- (iii) employed in any such capacity as is specified in schedule II whether the contract of employment was made before or after the passing of this Act and whether such contract is expressed or implied, oral or in writing; but does not include any person working in the capacity of a member of Armed Forces of Union, and any reference to any employee who has been injured shall where the employee is dead, include a reference to the dependents or any of them.

### **Disablement**

Disablement means loss of capacity to work or to move. Disablement reduces a worker's earning capacity. Disablement may be partial or total. Further it may be temporary or permanent.

Partial disablement [Sec 2(g)] reduces the earning capacity of a workman as a result of some accident.

Temporary partial disablement reduces the earning capacity of a workman in the type of employment he was engaged in at the time of accident.

Permanent partial disablement reduces the earning capacity of a workman in every types of employment he was capable of at the time of accident.

### **The following case will help in understanding the concept of partial disablement:**

In upper Doaba Sugar Mills Ltd v Daulat Ram AIR 1060 ALL 493 A blacksmith lost the index and middle finger the rest of hand namely the thumb and the other two fingers could be utilized in work. The test laid down in this case to determine the nature of disablement was:"It is not enough if it is found that the employee is disable from performing his duties of a blacksmith fitter, the court should consider whether he has been incapacities from undertaking any employment and whether in that other employment the rest of hand could be utilized.)

Total disablement [Sec 2(l)] whether temporary or permanent makes a workman incapable of performing all types of work as a result accident. He becomes unfit totally and is not able to get job anywhere due to disablement. Total disablement results from every injury specified in Part I Schedule I or from combination of injuries specified in Part II where aggregate loss of earning capacity amounts to 100%.



## Main Provisions of the Act

Injury / Diseases arising out of and in course of employment are payable – The term 'arising out of and in the course of employment' means that Compensation is payable only in those injury/diseases where the employment is the immediate and proximate cause of the said injury/disease. In other words, the injury/disease would not have occurred had the employee not been employed in the particular employment.

Compensation payable – The Employees Compensation payable as per the act is as under:

### Compensation:

1. Death due to injury 50% of wages × Relevant factor OR ₹ 1, 20, 000/-, whichever is more,
2. Permanent total disablement due to injury 60% of wages × Relevant factor OR ₹140,000/-, whichever is more, Provided that the Central Government may, by notification in the Official Gazette, from time to time, enhance the amount of compensation mentioned in (1) and (2).
3. Permanent Partial disablement due to injury % of compensation as is payable in (ii) or % of compensation proportionate to loss of earning capacity,
4. Temporary Disablement: 25% of wages paid half monthly,
5. Occupational disease Occupational disease to be treated as injury by accident and compensation as applicable in the cases of injury are payable.

### Following points are to be noted in calculation of compensation:

- (a) Relevant factor are given in second column of Schedule IV of the Act,
- (b) Employee not eligible for compensation when he/she has filed a Civil Suit against the employer. Compensation not payable:

### Compensation under this Act is not payable when:-

- The employee was under the influence of drugs/alcohol at the time of accident.
- Employee willfully disobeys any safety rule.
- Employee willfully removes/disregards any safety guard/ equipments.
- Employee has filed a Civil suit against the employer for claim of compensation.
- Employee has refused to get himself medically examined cost of which is borne by the employer.

### Payment of Compensation

The Compensation payable under the Act is to be made by deposit to the Commissioner of Employee's Compensation who will distribute the same to Employee or his dependents. However, amount equal to 3 months wages can be paid directly to the dependents in cases of death of Employee, provided the said amount is less than the total compensation payable to Employee.

Report of death and serious bodily injury – should be given within 7 days of the death/ serious bodily injury to the Commissioner of Employee's Compensation.

Medical Examination –The employer should get the medical examination of the employee who has made a claim for compensation, within 3 days of receipt of claim.

Workmen's Compensation Rules, 1924:

### Object:

The objective of this Act is that in the case of an employment injury compensation be provided to the injured workman and in case of his death to his dependants.

**Employer to pay compensation:**

In case a personal injury is caused to a workman by accident arising out of and in the course of his employment, his employer is liable to pay compensation in accordance with the provision of the Act within 30 days from the date when it fell due otherwise he would also be liable to pay interest and penalty.

**When employer is not liable:**

The Compensation payable under the Act is to be made by deposit to the Commissioner of Employee's Compensation who will distribute the same to Employee or his dependents.

However, amount equal to 3 months wages can be paid directly to the dependents in cases of death of Employee, provided the said amount is less than the total compensation payable to Employee.

Report of death and serious bodily injury – should be given within 7 days of the death/ serious bodily injury to the Commissioner of Employee's Compensation.

**Amount of compensation:**

- (1) in case of death: - an amount equal to 50% of the monthly wage multiplied by the relevant factor as given in Schedule IV of the Act or ₹ 1,20,000 whichever is more.
- (2) In case of permanent total disablement, it is 60% or ₹ 1,40,000 whichever is more, and
- (3) In case of permanent partial disablement occurs then the compensation is proportionate to the disability arrived as at (2) above.

**Notice:** An injured person or his dependants have to give a notice to the employer to pay compensation.

**Claim:**

Upon the failure or refusal of an employer to give compensation, an application is to be made in Form - F to the Commissioner under the Employees Compensation Act, 1923 who is the Assistant Labor Commissioner or the Labor-cum-Conciliation Officer of the area where the accident took place or where the claimant ordinarily resides or where the employer has his registered office. After hearing both the parties, the Commissioner decides the claim.

**Contracting out:** Any contract or agreement whereby an injured person or his dependant relinquishes or reduce his right to receive compensation is null and void to that extent.

**Appeal:**

An appeal lie to the High Court against the orders of the Commissioner with regard to the awarding or refusing to award compensation, or imposing interest or penalty, or regarding distribution of compensation etc. Recovery: The amount of compensation awarded by the Commissioner is to be recovered as arrears of land revenue.

**Employer's Liability For Compensation (Sec 3)**

- (1) If personal injury is caused to an employee by accident arising out of and in the course of his employment, his employer shall be liable to pay compensation in accordance with the provisions of this Chapter:

Provided that the employer shall not be so liable—

- (a) in respect of any injury which does not result in the total or partial disablement of the employee for a period exceeding three days;
- (b) in respect of any injury, not resulting in death or permanent total disablement, caused by an accident which is directly attributable to—
  - (i) the employee having been at the time thereof under the influence of drink or drugs, or
  - (ii) the willful disobedience of the employee to an order expressly given, or to a rule expressly framed, for the purpose of securing the safety of employee, or



- (iii) the willful removal or disregard by the employee of any safety guard or other device which he knew to have been provided for the purpose of securing the safety of employee.
- (2) If a employee employed in any employment specified in Part A of Schedule III contracts any disease specified therein as an occupational disease peculiar to that employment, or if a workman, whilst in the service of an employer in whose service he has been employed for a continuous period of not less than six months (which period shall not include a period of service under any other employer in the same kind of employment) in any employment specified in Part B of Schedule III, contracts any disease specified therein as an occupational disease peculiar to that employment, or if a workman whilst in the service of one or more employers in any employment specified in Part C of Schedule III, for such continuous period as the Central Government may specify in respect of each such employment, contracts any disease specified therein as an occupational disease peculiar to that employment, the contracting of the disease shall be deemed to be an injury by accident within the meaning of this section and, unless the contrary is proved, the accident shall be deemed to have arisen out of, and in the course of, the employment :

**Provided that if it is proved,—**

- (a) that an employee whilst in the service of one or more employers in any employment specified in Part C of Schedule III has contracted a disease specified therein as an occupational disease peculiar to that employment during a continuous period which is less than the period specified under this sub- section for that employment, and
- (b) that the disease has arisen out of and in the course of the employment; the contracting of such disease shall be deemed to be an injury by accident within the meaning of this section:

Provided further that if it is proved that an employee who having served under any employer in any employment specified in Part B of Schedule III or who having served under one or more employers in any employment specified in Part C of that Schedule, for a continuous period specified under this sub-section for that employment and he has after the cessation of such service contracted any disease specified in the said Part B or the said Part C, as the case may be, as an occupational disease peculiar to the employment and that such disease arose out of the employment, the contracting of the disease shall be deemed to be an injury by accident within the meaning of this section.

- (2A) If an employee employed in any employment specified in Part C of Schedule III contract any occupational disease peculiar to that employment, the contracting whereof is deemed to be an injury by accident within the meaning of this section, and such employment was under more than one employer, all such employers shall be liable for the payment of the compensation in such proportion as the Commissioner may, in the circumstances, deem just.
- (3) The Central Government or the State Government, after giving, by notification in the Official Gazette, not less than three months' notice of its intention so to do, may, by a like notification, add any description of employment to the employments specified in Schedule III, and shall specify in the case of employments so added the diseases which shall be deemed for the purposes of this section to be occupational diseases peculiar to those employments respectively, and thereupon the provisions of sub-section (2) shall apply In the case of a notification by the Central Government, within the territories to which this Act extends or, in case of a notification by the State Government, within the State as if such diseases had been declared by this Act to be occupational diseases peculiar to those employments.
- (4) Save as provided by Sub-sections (2), (2A) and (3), no compensation shall be payable to an employee in respect of any disease unless the disease is directly attributable to a specific injury by accident arising out of and in the course of his employment.
- (5) Nothing herein contained shall be deemed to confer any right to compensation on an employee in respect of any injury if he has instituted in a Civil Court a suit for damages in respect of the injury against the employer or any other person; and no suit for damages shall be maintainable by an employee in any Court of law in respect of any injury -

- (a) If he has instituted a claim to compensation in respect of the injury before a Commissioner; or
- (b) If an agreement has been come to between the workman and his employer providing for the payment of compensation in respect of the injury in accordance with the provisions of this Act.

**Amount Of Compensation (Sec 4)**

- (1) Subject to the provisions of this Act, the amount of compensation shall be as follows, namely:—
  - (a) Where death results from the injury, an amount equal to fifty percent of the monthly wages of the deceased workman multiplied by the relevant factor; or an amount of One lakh and twenty thousand rupees, whichever is more;
  - (b) Where permanent total disablement results from the injury, an amount equal to sixty percent of the monthly wages of the injured workman multiplied by the relevant factor or an amount of One lakh forty thousand rupees, whichever is more.

Provided that the central Government may by notification in the official gazette from time to time enhance the amount of compensation mentioned in clause (a) and (b) above.

**Explanation I:** For the purposes of clause

- (a) and clause
- (b) "relevant factor", in relation to a employee means the factor specified in the second column of Schedule IV against the entry in the first column of that Schedule specifying the number of years which are the same as the completed years of the age of the workman on his last birthday immediately preceding the date on which the compensation fell due;
- (c) Where permanent partial disablement results from the injury —
  - (i) in the case of an injury specified in Part II of Schedule I, such percentage of the compensation which would have been payable in the case of permanent total disablement as is specified therein as being the percentage of the loss of earning capacity caused by that injury, and
  - (ii) In the case of an injury not specified in Schedule I, such percentage of the compensation payable in the case of permanent total disablement as is proportionate to the loss of earning capacity (as assessed by the qualified medical practitioner) permanently caused by the injury;

**Explanation I :** Where more injuries than one are caused by the same accident, the amount of compensation payable under this head shall be aggregated but not so in any case as to exceed the amount which would have been payable if permanent total disablement had resulted from the injuries;

**Explanation II :** In Assessing the loss of earning capacity for the purposes of sub-clause (ii) the qualified medical practitioner shall have due regard to the percentages of loss of earning capacity in relation to different injuries specified in Schedule I;

- (d) Where temporary a half monthly payment of the sum disablement, whether equivalent to twenty-five per cent of total or partial, results monthly wages of the employee, to from the injury be paid in accordance with the provisions of sub-section (2).
  - (1A) Notwithstanding anything contained in sub-section (1), while fixing the amount of compensation payable to a workman in respect of an accident occurred outside India, the Commissioner shall take into account the amount of compensation, if any, awarded to such workman in accordance with the law of the country in which the accident occurred and shall reduce the amount fixed by him by the amount of compensation awarded to the workman in accordance with the law of that country.
  - (1B) The Central Government may by notification in official gazette specify for the purposes of sub section
    - (1) such monthly wages in relation to an employee as it may consider necessary.



**Note;-** The Central Government Vide SO 1258(E) dated 31.05.2010 has specified Eight Thousand Rupees as the monthly wages for the purpose of this sub section.

- (2) The half-monthly payment referred to in clause (d) of sub-section (1) shall be payable on the sixteenth day—
- (i) From the date of disablement where such disablement lasts for a period of twenty-eight days or more; or
  - (ii) After the expiry of a waiting period of three days from the date of disablement where such disablement lasts for a period of less than twenty-eight days; and thereafter half-monthly during the disablement or during a period of five years, whichever period is shorter :

**Provided that—**

- (a) there shall be deducted from any lump sum or half-monthly payments to which the workman is entitled the amount of any payment or allowance which the workman has received from the employer by way of compensation during the period of disablement prior to the receipt of such lump sum or of the first half-monthly payment, as the case may be; and
- (b) No half-monthly payment shall in any case exceed the amount, if any, by which half the amount of the monthly wages of the workman before the accident exceeds half the amount of such wages which he is earning after the accident.

**Explanation:** Any payment or allowance which the workman has received from the employer towards his medical treatment shall not be deemed to be a payment or allowance received by him by way of compensation within the meaning of clause (a) of the provision.

2A. The employee shall be reimbursed the actual medical expenditure incurred by him for treatment of injuries caused during the course of employment.

(3) On the ceasing of the disablement before the date on which any half-monthly payment falls due, there shall be payable in respect of that half-month a sum proportionate to the duration of the disablement in that half-month.

(4) If the injury of the Employee results in his death, the employer shall, in addition to the compensation under sub-section (1), deposit with the Commissioner a sum of not less than five thousand rupees for payment of the same to the eldest surviving dependant of the Employee towards the expenditure of the funeral of such employee or where the employee did not have a dependant or was not living with his dependant at the time of his death to the person who actually incurred such expenditure.

Provided that the Central Government may by notification in the official gazette from time to time enhance the amount specified in this sub section.

**At a glance:**

- Workmen's Compensation Act 1923 is now renamed as Employees Compensation Act, 1923 vide the Workmen's Compensation (Amendment) Act 2009
- In the Principal Act, wherever the word Workman, workmen's are appearing they are now substituted by the word Employee and Employees.
- Employment in which the ESI is applicable are not covered by the Employees Compensation Act, 1923
- Wages includes any privileges or benefit which is capable of being estimated in money term.
- Wages excludes traveling allowance or value of any travel concession or contribution paid by the employer toward any pension or provident fund or a sum paid to an employee to cover any special expenses entailed on him by the nature of his employment.

- A person whose employment is of a casual nature and is employed otherwise than for the purpose of employer's trade or business is an employee under this Act.
- This act provides compensation to certain classes of employees by their employers for injury which may be suffered by him as a result of an accident during the course of employment.
- Disablement means loss of capacity to work or to move. It reduces an employee's earning capacity.
- A disablement is said to be temporary partial disablement if it reduces the earning capacity of an employee in the type of employment he was engaged at the time of accident.
- A disablement is said to be permanent partial disablement if it reduces the earning capacity of an employee in every type of employment he was capable of at the time of accident.
- A disablement is said to be total disablement if it incapacitates an employees' all types of work as a result of accident.
- Total disablement results from every injury specified in part I of schedule I or from combination of injuries specified in part II where the aggregate loss of earning capacity amounts to 100%
- In case of an accident resulting into death of an employee, the amount of compensation is equal to 50% monthly wages multiplied by relevant factor given in schedule IV of the Act or ₹ 120,000 whichever is more.
- In case of an accident resulting into death of an employee the amount of compensation is equal to 50% monthly wages multiplied by relevant factor given in schedule IV of the Act or ₹ 120,000 whichever is more.
- In other words in case of death the minimum compensation payable is ₹ 120,000
- In case of an accident resulting into permanent partial disablement of an employee the amount of compensation is equal to 60% monthly wages multiplied by relevant factor given in schedule IV of the Act or ₹ 140,000 whichever is more.
- In case of permanent partial disablement the compensation is proportionate to the disability.
- Any contract or agreement to the effect of the injured person or his dependent relinquishing the right of compensation or reduce the amount of compensation is null and void.
- For failure or refusal of the employer to give compensation an application in form F can be made to Assistant Labor Commissioner or labor cum conciliation officer of the area where the accident took place.
- The employee is entitled to reimbursement of actual cost of medical treatment incurred on the injury caused during the course of his employment.
- The Central Government has power to specify by notification the monthly wages for the purpose of section 4(1) of this Act.
- The Central Government Vide SO 1258(E) dated 31.05.2010 has specified Rupees eight thousand as the monthly wages for the purpose of calculating amount of compensation.
- No lump sum or half monthly payment payable under this Act in any way is capable of being assigned or charged or be liable to attachment or pass to any person other than the employee by law nor the liable to be set off against any other claim.
- Claim for compensation should be preferred before the Commissioner within 2 years of the occurrence of accident and in case of death within 2 years of death.
- In case a commissioner receive any information from any source that an employee has died as a result of an accident arising out of and in the course of employment he may require the employer to given within



- 30 days detailed report thereon.
- Compensation to be payable under this act is a first charge against the assets of the employer if he transfer his assets without paying the compensation.
- The provision of this Act shall apply to employee who are captains or other members of the crew of aircraft subject to some modification.
- Notice of accident and claim for compensation except where the person injured is the captain of the aircraft, is to be served on the captain of the aircraft But where the accident happened and disablement commenced on board the aircraft, no such notice is required to be given.
- In case of death of a captain or other members of the crew the claim for compensation is required to be made within one year after the news of the death has been received by the claimant.
- The provision of this Act shall apply to employee who are masters of ship or seamen subject to some modification.
- Notice of accident and claim for compensation except where the person injured is the master of the ship, is to be served on the master of the ship. But where the accident happened and disablement commenced on board the ship no such notice is required to be given.
- In case of death of a master or seamen the claim for compensation is required to be made within one year after the news of the death has been received by the claimant.
- The state Government has power to appoint any person to be a commissioner for Employees Compensation for such area as specified in the notification.
- Every Commissioner appointed under Section 20 of the Act is deemed to be a public servant under IPC.
- State Government has power to transfer any matter from one commissioner to another commissioner.
- No civil court has jurisdiction to settle, decide or deal with any question which is by or under this Act to be settled or decided or dealt by a commissioner or to enforce any liability incurred under this Act.
- A commissioner has power to submit any question of law for the decision of the High court.
- Commissioner has power to recover as an arrear of land revenue any amount payable by any person under this Act.

### 3.4 PAYMENT OF WAGES ACT 1936

#### Introduction

Prior to enactment of the Payment of Wages Act, 1936, the workers working in various Industries were subjected to exploitation by the employers in various ways like non timely payment of wages, non-uniformity of wage rates, imposition of fines on worker etc. The Industrial workers were forced to raise their voice against their exploitation by the Employers.

Accordingly in 1926 the Government of India ascertained from local governments with regard to the delays, which occurred in the payment of wages to person employed in Industry and the position of imposing fines upon them. Materials received from the local governments and investigations revealed existence of gross abuses by employers. The material collected was placed before the Royal Commission of Labor, which was appointed in 1929. The Commission collected further evidence on this matter and submitted report to the government. The Government of India re-examined the subject in the light of the Commission's Report and in February 1933 a bill called the Payment of Wages Bill 1933 embodying the conclusion then reached was introduced and circulated for the purpose of eliciting opinion. But the motion could not be passed and the bill elapsed. Accordingly in 1935 the Payment of Wages Bill based upon the same principles of earlier bill of 1933 but thoroughly revised was introduced in the legislative Assembly on 15th February 1935 which was further referred to the select committee. The select committee presented its report on 2nd September 1935. Incorporating the recommendations of the Select Committee, the payment of wages Bill 1935 was again introduced in the legislative Assembly. The Bill having received assent of the Legislative Assembly on 23rd April 1936 came on the Statute Books as The Payment of Wages Act, 1936.

The Ministry of Labour and Employment, Government of India vide SO 2260(E) dated 11.9.2012 specified the wage ceiling ₹ 18,000 based on the figure of the consumer expenditure survey published by the National Sample Survey Organisation. This Act contains 26 sections. The important concepts and sections of the Act are discussed as under;

#### 3.4.1 EXTENT

- (1) This Act may be called the Payment of Wages Act, 1936.
- (2) It extends to the whole of India.
- (3) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.
- (4) It applies in the first instance to the payment of wages to persons employed in any factory, to persons employed (otherwise than in a factory) upon any railway by a railway administration or either directly or through a sub-contractor by a person fulfilling a contract with a railway administration and to persons employed in an industrial or other establishment specified in sub-clauses (a) to (g) of clause (ii) of section 2.
- (5) The Appropriate Government may after giving three months' notice of its intention of so doing, by notification in the Official Gazette extend the provisions of this Act or any of them to the payment of wages to any class of persons employed in any establishment or class of establishments specified by the Appropriate Government under sub-clause (h) of clause (ii) of section 2:

Provided that in relation to any such establishment owned by the Central Government no such notification shall be issued except with the concurrence of that Government.

- (6) This act applies to wages payable to an employed person in respect of a wage period if such wages for that wages period do not exceed fifteen thousands rupees per month or such higher sum which on the basis of figures of the consumer Expenditure survey published by the National sample survey organization, the Central Government may after every five years by notification in the official gazette specify.



### Explanation:

- (A) In *Indian Statistical Institute v. State of West Bengal & others*<sup>1</sup> 1994 LLJ 75 Cal the Indian Statistical Institute employed about 2000 persons in various departments or in connection with its work. It was held that in *Osmania University case*, 1985 51 FLR 614 the Supreme Court has held that Factories Act was applicable to the press of the University. This principle applies to Indian Statistical Institute also and it will be covered by the Payment of Wages Act.
- (B) The expression 'wages' used in sub-section (6) of Section 1 would relate to the contractual wages and not to overtime allowance claimed by a worker. Section 1(6) relates to the contractual wages claimable by a workman on an average per month having regard to the fact that the wages may be payable daily or weekly or by some other wage period not exceeding one month. The overtime wages claimed do not have to be taken into account in determining the question as regards the applicability of the Payment of Wages Act in the context of Section 1(b).

**Note:** The Ministry of Labor and Employment, Government of India vide SO 1380(E) dated 08.08.2007 specified the wage ceiling ₹ 10,000 based on the figure of the consumer expenditure survey published by the National sample survey organization.

### 3.4.2 Date of applicability

8TH MARCH, 1937

### 3.4.3 Basic Concepts (Sec 2)

- (i) "Appropriate Government" means in relation to railways, air transport service, mines and oilfields the Central Government and in relation to all other cases, the State Government
- (ia) "Employed person" includes the legal representative of a deceased employed person;
- (ib) "Employer" includes the legal representative of a deceased employer;
- (ic) "Factory" means a factory as defined in clause (m) of section 2 of the Factories Act, 1948 (63 of 1948) and includes any place to which the provisions of that Act have been applied under sub-section (1) of section 85 thereof;
- (ii) "Industrial or other establishment" means any—
- (a) Tramway service or motor transport service engaged in carrying passengers or goods or both by road for hire or reward;
- (aa) Air transport service other than such service belonging to or exclusively employed in the military, naval or air forces of the Union or the Civil Aviation Department of the Government of India;
- (b) dock wharf or jetty;
- (c) inland vessel, mechanically propelled;
- (d) mine, quarry or oil-field;
- (e) plantation;
- (f) workshop or other establishment, in which articles are produced, adapted or manufactured with a view to their use, transport or sale;
- (g) establishment in which any work relating to the construction, development or maintenance of buildings, roads, bridges or canals, or relating to operations connected with navigation, irrigation or to the supply of water or relating to the generation, transmission and distribution of electricity or any other form of power is being carried on;
- (h) any other establishment or class of establishment which the appropriate Government may having regard to nature thereof, the need for protection of persons employed therein and other relevant circumstances specify by notification in the official gazette.

**Explanation:**

In the Tamil Nadu Water Supply and Drainage Board and another v. MD Vijaykumar and others 1991 1 LLJ 260 Mad, the Tamil Nadu Water Supply and Drainage Board was created for regulation and development of drinking water and drainage in the State of Tamil Nadu. It was held that in view of Clause (g) of Section 2(ii) and the statement of objects and reasons under which the Board has been created, it is clear that the Board is an establishment in which work relating to operation is connected with supply of water is being carried on and consequently it is an establishment within the meaning of Section 2(ii)(g) of the Payment of Wages Act.

- (ii) "mine" has the meaning assigned to it in clause (j) of sub-section (1) of section 2 of the Mines Act, 1952 (35 of 1952);
- (iii) "plantation" has the meaning assigned to it in clause (f) of section 2 of the Plantations Labour Act, 1951 (69 of 1951);
- (iv) "prescribed" means prescribed by rules made under this Act;
- (v) "railway administration" has the meaning assigned to it in clause (32) of section 2 of the Indian Railways Act, 1889 (24 of 1889); and
- (vi) "wages" means all remuneration (whether by way of salary allowances or otherwise) expressed in terms of money or capable of being so expressed which would, if the terms of employment, express or implied, were fulfilled, be payable to a person employed in respect of his employment, or of work done in such employment and includes—
  - (a) any remuneration payable under any award or settlement between the parties or order of a court;
  - (b) any remuneration to which the person employed is entitled in respect of overtime work or holidays or any leave period;
  - (c) any additional remuneration payable under the terms of employment (whether called a bonus or by any other name);
  - (d) any sum which by reason of the termination of employment of the person employed is payable under any law, contract or instrument which provides for the payment of such sum, whether with or without deductions, but does not provide for the time within which the payment is to be made;
  - (e) any sum to which the person employed is entitled under any scheme framed under any law for the time being in force, but does not include -
    - (1) any bonus (whether under a scheme of profit sharing or otherwise) which does not form part of the remuneration payable under the terms of employment or which is not payable under any award or settlement between the parties or order of a court;
    - (2) the value of any house-accommodation, or of the supply of light, water, medical attendance or other amenity or of any service excluded from the computation of wages by a general or special order of the State Government;
    - (3) any contribution paid by the employer to any pension or provident fund and the interest which may have accrued thereon;
    - (4) any traveling allowance or the value of any traveling concession;
    - (5) any sum paid to the employed person to defray special expenses entailed on him by the nature of his employment; or
    - (6) any gratuity payable on the termination of employment in cases other than those specified in sub- clause (d).



The following cases will help in understanding the concept of Wages under this Act:-

- (i) It was held in *State of Rajasthan and Others v. Bhawani Shankar and Another* 2005 1 LLJ 1011 Raj that remuneration payable under the Labour Court award setting aside termination of workman's service would be wages. Any claim for it was held to be maintainable under the Payment of Wages 1936. It was further held that the workman could avail remedy either under the Payment of Wages Act or the Industrial Disputes Act 1947.
- (ii) It was held in *KL Garg v. New India Assurance Co. Ltd and others* 1992 1 LLJ 190 P&H that an application for recovery of loan was not maintainable as loan did not fall within the definition of wages under Section 2(vi) of the Payment of Wages Act 1936 nor the amount claimed could be said to be a deduction as provided under Section 7 of the Act.
- (iii) In *payment of Wages Inspector v. BES & Co* AIR 1969 SC 590, the Supreme Court observed that "A workman whose service is terminated in consequence of transfer of an undertaking whether by agreement or by operation of law has a statutory right under Section 25-F of the Industrial Disputes Act 1947, to compensation unless such right is defeated under proviso to that section. The same is the position in the case of closure under Section 25-FFF of that Act. Such compensation would be wages as defined by Section 2(vi)(d) of the Payment of Wages Act 1936 as it is sum which by reason of the termination of employment of the person employed, is payable under any law .....which provides for the payment of such sum whether with or without deduction but does not provide for the time within which the payment is to be made".
- (iv) It was held in *Purshottam v. Potadar* AIR 1969 SC 590 that expression by reason of the termination of employment in sub-clause (d) of Section 2(vi) must in the context have the same meaning as the expression, 'payable' on the termination of employment which is used in sub-clause(b). In other words, gratuity which may be payable to an employee by reason of the termination of the employment would fall under sub-clause (b) provided it is shown that it is payable under any law, contract or instrument. It is true that an award made by industrial adjudication framing a scheme of gratuity becomes enforceable under Sections 18 and 19 of the Industrial Dispute Act and in that sense it is a scheme which is enforceable by virtue of the operation of law. But that would not justify the conclusion that the gratuity itself is payable under any law. It is payable under an award which is made enforceable by Section 18 of the Industrial Disputes Act. Therefore, it cannot be said that the gratuity under an award is payable under any law.
- (v) In *DP Kelkar v Ambadas* AIR 1971 Bom 124 it was held that the definition of wages is not limited to remuneration payable under an agreement or contract.
- (vi) The amount of lay off compensation under section 25 C of the industrial dispute act ,1947 does not come within the definition of wages given in this Act.(*Trichinopoly Mills Ltd v Swaminathan and others* 1956 1 LLJ 269 Mad.

#### **3.4.4 Rules For Payment Of Wages (Sec 3-6) Responsibility For Payment Of Wages (Sec 3)**

- (1) Every employer shall be responsible for the payment of all wages required to be paid under this Act to person employed by him and in case of persons employed
  - (a) in factories if a person has been named as the manager of the factory under clause (f) of sub section 7 of the Factories Act 1948
  - (b) in industrial or other establishments if there is a person responsible to the employer for the supervision and control of the industrial or other establishments;
  - (c) upon railways (otherwise than in factories) if the employer is the railway administration and the railway administration has nominated a person in this behalf for the local area concerned.

- (d) in the case of contractor a person designated by such contractor who is directly under his charge and
- (e) in any other case a person designated by the employer as a person responsible for complying with the provision of the Act

The person so named the person so responsible to the employer or the person so nominated or the person so designated as the case may be shall also be responsible for such payment.

(2) Notwithstanding anything contained in sub section (1) it shall be the responsibility of the employer to make payment of all wages required to be made under this Act in case the contractor or the person designated by the employer fails to make such payment.

#### **3.4.5 Fixation Of Wage-Periods (Sec 4)**

- (1) Every person responsible for the payment of wages under section 3 shall fix periods (in this Act referred to as wage-periods) in respect of which such wages shall be payable;
- (2) No wage-period shall exceed one month.

#### **3.4.6 Deductions Which May Be Made From Wages (Sec 7)**

- (1) Notwithstanding the provisions of Railway Act 1989 (24 of 1989) the wages of an employed person shall be paid to him without deductions of any kind except those authorised by or under this Act..

**Explanation I :** Every payment made by the employed person to the employer or his agent shall for the purposes of this Act be deemed to be a deduction from wages.

**Explanation II :** Any loss of wages resulting from the imposition, for good and sufficient cause upon a person employed of any of the following penalties namely :

- (i) the withholding of increment or promotion (including the stoppage of increment at an efficiency bar);
- (ii) the reduction to a lower post or time scale or to a lower stage in a time scale; or
- (iii) suspension;

shall not be deemed to be a deduction from wages in any case where the rules framed by the employer for the imposition of any such penalty are in conformity with the requirements, if any, which may be specified in this behalf by the State Government by notification in the Official Gazette.

- (2) Deductions from the wages of an employed person shall be made only in accordance with the provisions of this Act and may be of the following kinds only namely :
  - (a) Fines;
  - (b) Deductions for absence from duty;
  - (c) Deductions for damage to or loss of goods expressly entrusted to the employed person for custody or for loss of money for which he is required to account where such damage or loss is directly attributable to his neglect or default;
  - (d) Deductions for house-accommodation supplied by the employer or by Government or any housing board set up under any law for the time being in force (whether the Government or the Board is the employer or not) or any other Authority engaged in the business of subsidizing house-accommodation which may be specified in this behalf by the Appropriate Government by notification in the Official Gazette;
  - (e) Deductions for such amenities, services supplied by the employer as the State Government or any officer specified by it in this behalf may by general or special order authorise.

**Explanation :** The word "services" in this clause does not include the supply of tools and raw materials required for the purposes of employment;



- (f) Deductions for recovery of advances of whatever nature (including advances for travelling allowance or conveyance allowance) and the interest due in respect thereof or for adjustment of over-payments of wages;
- (ff) Deductions for recovery of loans made from any fund constituted for the welfare of labour in accordance with the rules approved by the Appropriate Government and the interest due in respect thereof;
- (fff) Deductions for recovery of loans granted for house-building or other purposes approved by the State Government and the interest due in respect thereof;
- (g) Deductions of income-tax payable by the employed person; [Sec 7(2)g]
- (h) Deductions required to be made by order of a court or other authority competent to make such order;
- (i) Deductions for subscriptions to and for repayment of advances from any provident fund to which the Provident Funds Act 1952 (19 of 1952) applies or any recognised provident funds as defined in section 38 of section 2 of the Indian Income Tax Act, 1961 (43 of 1961) or any provident fund approved in this behalf by the Appropriate Government during the continuance of such approval;
- (j) Deductions for payments to co-operative societies approved by the Appropriate Government or any officer specified by it in this behalf or to a scheme of insurance maintained by the Indian Post Office and
- (k) Deductions made with the written authorisation of the person employed for payment of any premium on his life insurance policy to the Life Insurance Corporation Act of India established under the Life Insurance Corporation 1956 (31 of 1956) or for the purchase of securities of the Government of India or of any State Government or for being deposited in any Post Office Saving Bank in furtherance of any savings scheme of any such government.
- (kk) Deductions made with the written authorisation of the employed person for the payment of his contribution to any fund constituted by the employer or a trade union registered under the Trade Union Act, 1926 (16 of 1926) for the welfare of the employed persons or the members of their families or both and approved by the Appropriate Government or any officer specified by it in this behalf during the continuance of such approval;
- (kkk) Deductions made with the written authorisation of the employed person for payment of the fees payable by him for the membership of any trade union registered under the Trade Union Act, 1926 (16 of 1926);
- (l) Deductions for payment of insurance premia on Fidelity Guarantee Bonds;
- (m) Deductions for recovery of losses sustained by a railway administration on account of acceptance by the employed person of counterfeit or base coins or mutilated or forged currency notes;
- (n) Deductions for recovery of losses sustained by a railway administration on account of the failure of the employed person to invoice to bill to collect or to account for the appropriate charges due to that administration whether in respect of fares freight demurrage wharfage and carnage or in respect of sale of food in catering establishments or in respect of sale of commodities in grain shops or otherwise;
- (o) Deductions for recovery of losses sustained by a railway administration on account of any rebates or refunds incorrectly granted by the employed person where such loss is directly attributable to his neglect or default;
- (p) Deductions made with the written authorisation of the employed person for contribution to the Prime Minister's National Relief Fund or to such other Fund as the Central Government may by notification in the Official Gazette specify;

- (q) Deductions for contributions to any insurance scheme framed by the Central Government for the benefit of its employees.

#### **3.4.7 Deductions for Absence from Duty (Sec 9)**

- (1) Deductions may be made under clause (b) of sub-section (2) of section 7 only on account of the absence of an employed person from the place or places where by the terms of his employment, he is required to work such absence being for the whole or any part of the period during which he is so required to work.
- (2) The amount of such deduction shall in no case bear to the wages payable to the employed person in respect of the wage-period for which the deduction is made in a larger proportion than the period for which he was absent bears to the total period within such wage-period during which by the terms of his employments he was required to work :

Provided that subject to any rules made in this behalf by the Appropriate Government if ten or more employed persons acting in concert absent themselves without due notice (that is to say without giving the notice which is required under the terms of their contracts of employment) and without reasonable cause such deduction from any such person may include such amount not exceeding his wages for eight days as may by any such terms be due to the employer in lieu of due notice.

**Explanation :** For the purposes of this section an employed person shall be deemed to be absent from the place where he is required to work if although present in such place he refuses in pursuance of a stay-in strike or for any other cause which is not reasonable in the circumstances to carry out his work.

#### **3.4.8 Deductions for Damage or Loss (Sec 10)**

- (1) A deduction under clause (c) or clause (o) of sub-section (2) of section 7 shall not exceed the amount of the damage or loss caused to the employer by the neglect or default of the employed person.
- (1A) A deduction shall not be made under clause (c) or clause (m) or clause (n) or clause (o) of sub-section (2) of section 7 until the employed person has been given an opportunity of showing cause against the deduction or otherwise than in accordance with such procedure as may be prescribed for the making of such deductions.
- (2) All such deductions and all realizations thereof shall be recorded in a register to be kept by the person responsible for the payment of wages under section 3 in such form as may be prescribed.

#### **3.4.9 Deductions for Services rendered (Sec 11)**

A deduction under clause (d) or clause (e) of sub-section (2) of section 7 shall not be made from the wages of an employed person, unless the house-accommodation amenity or service has been accepted by him as a term of employment or otherwise and such deduction shall not exceed an amount equivalent to the value of the house-accommodation amenity or service supplied and in the case of deduction under the said clause (e) shall be subject to such conditions as the Appropriate Government may impose.

#### **3.4.10 Deductions for Recovery of Advances (Sec 12)**

Deductions under clause (f) of sub-section (2) of section 7 shall be subject to the following conditions namely :

- (a) recovery of an advance of money given before employment began shall be made from the first payment of wages in respect of a complete wage-period, but no recovery shall be made of such advances given for traveling-expenses;
- (aa) recovery of an advance of money given after employment began shall be subject to such conditions as the Appropriate Government may impose;
- (b) recovery of advances of wages not already earned shall be subject to any rules made by the Appropriate Government regulating the extent to which such advances may be given and the installments by which they may be recovered.



### 3.4.11 Deductions for Recovery of Loans (Sec 12A)

Deductions for recovery of loans granted under clause (fff) of sub-section (2) of section 7 shall be subject to any rules made by the Appropriate Government regulating the extent to which such loans may be granted and the rate of interest payable thereon.

### 3.4.12 Deductions for Payments to Co-Operative Societies and Insurance Schemes (Sec 13)

Deductions under clause (j) and clause (k) of sub-section (2) of section 7 shall be subject to such conditions as the Appropriate Government may impose.

#### At a glance:

- Applies to persons employed in a factory, railway or Industrial establishment or other establishments.
- Appropriate empowered to extent to class of persons or class of establishment by giving three months notice of its intention by way of notification.
- Applicable only if the wages payable in respect of a wage period does not exceed 6500 or any such higher sum, which the Central Government may prescribe on the basis of NSO data.
- Presently such higher sum prescribed by the Central Government is ` 10,000.
- Wages should be paid before the expiry of 7th day of the wage period in less than 1000 persons are employed and in case of others before the expiry of 10th day.
- Every person required for payment of wages is required to fix wage period.
- Wages period cannot exceed one month.
- All wages payable under this act is required to be paid in current coins or in currency notes or both.
- Deduction from wages on account of LIC premium, purchase of government securities, post office savings, and contribution to any fund constituted by the employer or trade union, fee toward membership of trade union, PM National Relief Funds etc cannot be made without written authorisation of the employee.
- Deduction on account of payment to co-operative societies cannot be more than 75% of the wages.
- Fine can be imposed only with the approval of the appropriate Government.
- Other deductions cannot be more than 50% of wages.
- No fine can be imposed on a person who is under the age of fifteen years.
- The total amount of fine which may be imposed in any one wage period on any employed person shall not exceed an amount equal to three percent of the wages payable to him in respect of that wage period.
- An inspector of Factories appointed under the Factories Act,1948 is the inspector for the purpose of this
- Act also.
- The appropriate Government can appoint inspectors in respect of all people employed upon a Railway.
- No fine can be recovered in installments or after the expiry of 90 days from the day on which it was imposed.
- Deduction for damages or loss cannot exceed the amount of loss or damages.
- Deduction for payments to co-operative societies and Insurance Schemes shall be subject to such conditions as the State Government may impose.

- Employer required maintaining register and records showing the details of person employed, work done, wages paid and deductions from wages etc.
- Register and record so maintained is required to be preserved for 3 years after the date of last entry.
- Central Government has power to give direction to any State Government for execution of this act.
- The appropriate Government appoint inspectors for the purpose of this Act.
- Any contract or agreement between the employer and employee whereby an employee either relinquishes or reduces his right to minimum wages or any privileges or concession under this act is null and void.
- Appropriate Government has power to make rules for implementation of this act which are required to be laid before the state legislature.
- Rule made by the Central Government under this Act to be laid before each house of parliament while it is in session.



### 3.5 MINIMUM WAGES ACT, 1948

The Minimum Wages Act, 1948 is another social legislation to provide safeguard to the workers employed in unorganized sector by providing for fixation of minimum wages in certain employments. Prior to the enactment of this Act and other Act like Payment of Wages Act, 1936 the conditions of workers in general was very deplorable due to exploitation of Employers in various ways like non-payment of wages or low rates of wages.

The concept of minimum wages first evolved with reference to remuneration of workers in those Industries where the level of wages was low compared to the wages for similar types of workers in other Industries. The initiative started with the resolution placed by one Shri K.G.R. Choudhary in 1920 for setting up Boards for determination of minimum wages in each Industry. At the international level also the International Labor Conference of International organization in 1928 Convention at Geneva adopted a draft convention on minimum wages requiring the member countries to create and maintain machinery whereby minimum rates of wages could be fixed for workers employed in Industries in which wages were exceptionally low. Later on the Preparatory Asian Regional Labor Conference of International Labor Organization held in New Delhi in 1947 and then at the session of Asian Regional Labor Conference, it was decided that effort should be made to improve wage standards in Industries and occupations where they are still low. Accordingly a bill to provide machinery for fixing and periodical revision of minimum wages was prepared and discussed in the 7th session of Indian Labor Conference in November 1945. The 8th meeting of the Standing Committee recommended in 1946 to enact a separate legislation for unorganized sector including working hours, minimum wages and paid holidays.

Accordingly a Minimum Wages Bill was introduced in the Central Legislative Assembly on 11.04.46 to provide for fixation of minimum wages in certain employments. It was passed in 1946 and came into force with effect from 15.03.48. Under this Act, both Central and State Government are appropriate Government to fix, review and revise the minimum wages of the workers employed in scheduled employment under their respective jurisdiction. The appropriate Governments have also been empowered to notify any employment in the schedule where the number of employee is 1000 or more and fix the rates of minimum wages in respect of the employees employed therein. There are around 45 scheduled employed in the Central sphere and 1530 in the State Sphere. This Act does not provide for any discrimination between male and female workers or different minimum wages for them. There are two methods for fixation/revision of minimum wages;- Committee Method and Notification Method. The appropriate Government appoints Advisory Board for advising it on the matters relating to fixation/revision of rates of wages.

The Central Government appoints Central Advisory Board for advising it and the state Governments on such matters including co-coordinating the work of Advisory Board. Minimum wage and allowance are linked to the cost of living index and is to be paid in cash, though payment of wages fully in kind or partly in kind may be allowed in certain cases. The minimum rate of wages consists of a basic wage and a special allowance, known as 'Variable Dearness Allowance (VDA)' linked to the Consumer Price Index Number. The allowance is revised twice a year, once in April and then in October.

The Act also provides for revision of the Minimum rates at an appropriate interval not exceeding five years. For effective enforcement of the Act enforcement mechanism exist both at the Center as well at the State level. While in the Central Sphere, the enforcement is secured through the inspecting officers of Chief Labor Commissioner (Central), the compliance in the States is ensured through the State Enforcement Machinery, which conducts regular inspections.

This act is applicable to whole of India. It applies to the employment which are listed in the schedule to the act and in certain other cases may in the discretion of the appropriate Government be extended to any other employment.

In the case of Hindu Inter college Muzzafarnagar v Prescribed Authority (Minimum wages Act, 1948) and others it was held that this act does not apply to teachers in private educational institutions.

The Act was last amended in 1961. This Act contains 31 sections and 2 schedules.

### 3.5.1 Date of Receipt of legislature assent

15th March 1948.

### 3.5.2 Objectives of the Act

Fixing Minimum rates of wages in certain employment called scheduled employment. There are two parts to the schedule, Part I contains 21 employments whereas part II contains only one employment agriculture.

The basic concepts and provisions of the Act are discussed as under;

### 3.5.3 Basic Concepts (Section 2)

In this Act unless there is anything repugnant in the subject or context—

- (a) "Adolescent" means a person who has completed his fourteenth year of age but has not completed his eighteenth year;
- (aa) "Adult" means a person who has completed his eighteenth year of age; (b) "Appropriate government" means –
  - (i) In relation to any scheduled employment carried on by or under the authority of the Central Government or a railway administration, or in relation to a mine, oilfield or major port, or any corporation established by a Central Act, the Central Government and
  - (ii) In relation to any other scheduled employment, the State Government;
- (bb) "Child" means a person who has not completed his fourteenth year of age;
- (c) "Competent authority" means the authority appointed by the appropriate government by notification in its Official Gazette to ascertain from time to time the cost of living index number applicable to the employees employed in the scheduled employments specified in such notification;
- (d) "Cost of living index number " in relation to employees in any scheduled employment in respect of which minimum rates of wages have been fixed means the index number ascertained and declared by the competent authority by notification in the Official Gazette to be the cost of living index number applicable to employee in such employment;
- (e) "Employer" means any person who employs, whether directly or through another person, or whether on behalf of himself or any other person, one or more employees, in any scheduled employment in respect of which minimum rates of wages have been fixed under this Act and includes except in sub-section (3) of section 26 –
  - (i) In a factory where there is carried on any scheduled employment in respect of which minimum rates of wages have been fixed under this Act, any person named under clause (f) of sub-section (1) of section 7 of the Factories Act 1948 (63 of 1948) as manager of the factory;
  - (ii) In any scheduled employment under the control of any government in India in respect of which minimum rates of wages have been fixed under this Act, the person or Authority appointed by such Government for the supervision and control of employees or where no person or authority is so appointed, the head of the department;
  - (iii) In any scheduled employment under any local authority in respect of which minimum rates of wages have been fixed under this Act, the person appointed by such authority for the supervision and control of employees or where no person is so appointed, the chief executive officer of the local Authority;
  - (iv) In any other case where there is carried on any scheduled employment in respect of which minimum rates of wages have been fixed under this Act, any person responsible to the owner for the supervision and control of the employees or for the payment of wages;



- (f) "Prescribed" means prescribed by rules made under this Act;
- (g) "Schedule employment" means an employment specified in the Schedule or any process or branch of work forming part of such employment;
- (h) "Wages" means all remuneration, capable of being expressed in terms of money, which would, if the terms of the contract of employment, express or implied, were fulfilled be payable to a person employed in respect of his employment or work done in such employment and includes house rent allowance but does not include –
- (i) the value of—
    - (a) any house accommodation, supply of light, water, medical attendance, or
    - (b) any other amenity or any service excluded by general or special order of the appropriate government;
  - (ii) any contribution paid by the employer to any person fund or provident fund or under any scheme of social insurance;
  - (iii) any traveling allowance or the value of any traveling concession;
  - (iv) any sum paid to the person employed to defray special expenses entailed on him by the nature of his employment; or
  - (v) any gratuity payable on discharge;
- (i) "employee" means any person who is employed for hire or reward to do any work, skilled or unskilled, manual or clerical, in a scheduled employment in respect of which minimum rates of wages have been fixed; and includes an out-worker to whom any articles or materials are given out by another person to be made up, cleaned, washed, altered, ornamented, finished, repaired, adapted or otherwise processed for sale for the purposes of the trade or business of that other person where the process is to be carried out either in the home of the out-worker or in some other premises not being premises under the control and management of that other person; and also includes an employee declared to be an employee by the appropriate Government, but does not include any member of the Armed Forces of the Union.

#### **3.5.4 Fixing of Minimum Rates of Wages (Sec 3)**

The responsibility of fixing minimum wages lies with appropriate govt. The appropriate government shall in the manner hereinafter -

- (a) fix the minimum rates of wages payable to employees employed in an employment specified in Part I or Part II of the Schedule and in an employment added to either Part by notification under section 27 :

Provided that the appropriate government may in respect of employees employed in an employment specified in Part II of the Schedule instead of fixing minimum rates of wages under this clause for the whole State fix such rates for a part of the State or for any specified class or classes of such employment in the whole State or part thereof;

- (b) review at such intervals as it may think fit such intervals not exceeding five years the minimum rates of wages so fixed and revise the minimum rates if necessary :

Provided that where for any reason the appropriate government has not reviewed the minimum rates of wages fixed by it in respect of any scheduled employment within any interval of five years nothing contained in this clause shall be deemed to prevent it from reviewing the minimum rates after the expiry of the said period of five years and revising them if necessary and until they are so revised the minimum rates in force immediately before the expiry of the said period of five years shall continue in force.

### **3.5.5 Minimum Number of Employees [Sec 3(1A)]**

Notwithstanding anything contained in sub-section (1) the appropriate government may refrain from fixing minimum rates of wages in respect of any scheduled employment in which there are in the whole State less than one thousand employees engaged in such employment but if at any time the appropriate government comes to a finding after such inquiry as it may make or cause to be made in this behalf that the number of employees in any scheduled employment in respect of which it has refrained from fixing minimum rates of wages has risen to one thousand or more it shall fix minimum rates of wages payable to employees in such employment as soon as may be after such finding.

### **3.5.6 Minimum Rates [Sec 3(2)]**

The appropriate government may fix

- (a) A minimum rate of wages for time work (hereinafter referred to as "a minimum time rate");
- (b) A minimum rates of wages for piece work (hereinafter referred to as "a minimum piece rate");
- (c) A minimum rate of remuneration to apply in the case of employees employed on piece work for the purpose of securing to such employees a minimum rate of wages on a time work basis (hereinafter referred to as "a guaranteed time rate");
- (d) A minimum rate (whether a time rate or a piece rate) to apply in substitution for the minimum rate which would otherwise be applicable in respect of overtime work done by employees (hereinafter referred to as "overtime rate").

3(2A) Where in respect of an industrial dispute relating to the rates of wages payable to any of the employees employed in a scheduled employment any proceeding is pending before a Tribunal or National Tribunal under the Industrial Disputes Act 1947 (14 of 1947) or before any like authority under any other law for the time being in force or an award made by any Tribunal National Tribunal or such authority is in operation and a notification fixing or revising the minimum rates of wages in respect of the scheduled employment is issued during the pendency of such proceeding or the operation of the award then notwithstanding anything contained in this Act the minimum rates of wages so fixed or so revised shall not apply to those employees during the period in which the proceeding is pending and the award made therein is in operation or as the case may be where the notification is issued during the period of operation of an award during that period; and where such proceeding or award relates to the rates of wages payable to all the employees in the scheduled employment no minimum rates of wages shall be fixed or revised in respect of that employment during the said period.

#### **In fixing or revising minimum rates of wages under this section—**

- (a) Different minimum rates of wages may be fixed for—
  - (i) Different scheduled employments;
  - (ii) Different classes of work in the same scheduled employment;
  - (iii) Adults, adolescents, children and apprentices;
  - (iv) different localities;
- (b) minimum rates of wages may be fixed by any one or more of the following wage periods; namely :
  - (i) By the hour
  - (ii) By the day
  - (iii) By the month, or
  - (iv) By such other larger wage-period as may be prescribed; and, where such rates are fixed by the day or by the month the manner of calculating wages for a month, or for a day, as the case may be may be, indicated :



Provided that where any wage-periods have been fixed under section 4 of the Payment of Wages Act, 1936 (4 of 1936) minimum wages shall be fixed in accordance therewith.

**Note:-**The minimum wages payable must be paid by the employer notwithstanding the want of financial capacity. *Woolcombers of India v Workers union*, AIR 1973 SC 2758, 1973 (27) FLR 38

In order to make the wages realistic they must be commensurate with the price rise in essential commodities. The apology that the employer may be constrained to shut his business if minimum wages are to be paid is simply untenable. *Hydro Engineers Pvt Ltd v the Workmen*, 1969 (18) 1 LLJ 713

Employer's capacity to pay has no bearing in fixing the minimum rate of wages. Such a consideration is antilogous to the principles enshrined within the constitution of India. *Unichaoity(U) v State of Kerla*, 1961 (3) FLR 73 (1961) 1 LLJ 631

The cost of living index is not a strict basis for fixing the rates of minimum wages and if not strictly adhered to, it does not constitute a breach of a statutory duty. *Hikusa Yamasakshatriya v Sangmanes Akola pasluka Bidi Makgar Union*, AIR 1960 Bom 299 (1959) 11 LLJ 578

### 3.5.7 Minimum Rate of Wages (Sec 4)

- (1) Any minimum rate of wages fixed or revised by the appropriate government in respect of scheduled employments under section 3 may consist of –
  - (i) a basic rate of wages and a special allowance at a rate to be adjusted at such intervals and in such manner as the appropriate government may direct to accord as nearly as practicable with the variation in the cost of living index number applicable to such workers (hereinafter referred to as the “cost of living allowance”); or
  - (ii) a basic rate of wages with or without the cost of living allowance, and the cash value of the concessions in respect of supplies of essential commodities at concession rates, where so authorised; or
  - (iii) an all-inclusive rate allowing for the basic rate, the cost of living allowance and the cash value of the concessions, if any.
- (2) The cost of living allowance and the cash value of the concessions in respect of supplies of essential commodities at concession rate shall be computed by the competent authority at such intervals and in accordance with such directions as may be specified or given by the appropriate government.

**Note:-**Section 4 is a definite indication that basic wages is an integral part of the minimum wages. It is not correct to say that a minimum wages under this Act necessarily should consist of basic wages and dearness allowance. The language of section 4 does not lend itself to such an interpretation. On the plain terms of section 4(1) it is clear that the payment of dearness allowance would arise only if the basic wages fixed for a category of workmen fell short of the minimum wages which the State Government has to fix taking into consideration the needs of the workers family consisting of three consumption units. *Karnataka Films Chambers of Commerce, Bangalore V State of Karnatka*, 1986 Lab IC 1890 ILR Kant 2183

### 3.5.8 Procedure for Fixing and revising Minimum Wages (Sec 5)

- (1) In fixing minimum rates of wages in respect of any scheduled employment for the first time under this Act or in revising minimum rates of wages so fixed the appropriate government shall either—
  - (a) appoint as many committees and sub-committees as it considers necessary to hold enquiries and advise it in respect of such fixation or revision as the case may be, or
  - (b) by notification in the Official Gazette, publish its proposals for the information of persons likely to be affected thereby and specify a date not less than two months from the date of the notification on which the proposals will be taken into consideration.
- (2) After considering the advice of the committee or committee appointed under clause (a) of subsection (1) or as the case may be, all representations received by it before the date specified in the

notification under clause (b) of that sub-section, the appropriate government shall by notification in the Official Gazette, fix or as the case may be revise the minimum rates of wages in respect of each scheduled employment and unless such notification otherwise provides it shall come into force on the expiry of three months from the date of its issue :

Provided that where the appropriate government proposes to revise the minimum rates of wages by the mode specified in clause (b) of sub-section (1) the appropriate government shall consult the Advisory Board also.

**At a glance:**

- Extend to whole of India.
- Extended to the State of Jammu and Kashmir with effect from 1st September 1971.
- Person aged from 14 to 18 is treated Adolescent.
- Person aged less than 14 is called a child.
- The Appropriate Government appoints competent authority.
- Act not applicable to any member of Armed forces of the Union.
- Appropriate Government fixes rates of Minimum wages.
- Appropriate Government reviews the rates of Minimum wages within five years.
- There are two method of fixation of wage rates, i. Committee method and Notification method.
- Different minimum rate of wages can be fixed for different scheduled employment, different class of work in the same scheduled employment, adults, adolescents, children and apprentices and different localities.
- Minimum rates of wages may be fixed by any one or more of the following periods like by hour, day, month or such other larger wage period.
- Minimum wages is required to be paid in cash except where it is the custom to pay wages wholly or partly in kind. The appropriate government may authorise payment of wages either wholly or partly in kind.
- Appropriate Government fix minimum time rate, minimum piece rate, guaranteed time rate , overtime rate etc.
- For fixing the minimum rates of wages in respect of any scheduled employment for the first time or revising the minimum wages so fixed there are two method of fixing/revising the wage rates, Committee/ sub-committee method and Notification method.
- While revising the minimum wages rates by notification method the appropriate government consult the Advisory Board also.
- For the purpose of co-ordinating the work of Committee or sub-committees the appropriate government appoint Advisory Board.
- Wages does not include the value of any house accommodation, supply of water, light, medical facilities, any amenity, employer's contribution toward pension fund, provident fund, insurance funds, traveling expenses, gratuity etc.
- Employer required maintaining register and records showing the details of person employed, work done, wages paid and receipt given by them etc.
- As per section 22A any employer who contravenes any provision of this act or any rule or order made thereunder shall, if no other penalty is provided for such contravention by this act, is punishable with fine which may extend to five hundred rupees.



- Non-payment of minimum wages entails imprisonment of six months or fine of ₹ 500 or both.
- In case of wages payable to a disabled person, the appropriate government may direct that the provision of this act will not be applicable.
- Central Government has power to give direction to any State Government for execution of this act.
- The appropriate Government appoints inspectors for the purpose of this Act.
- Any contract or agreement between the employer and employee whereby an employee either relinquishes or reduces his right to minimum wages or any privileges or concessions under this act is null and void.
- The appropriate Government may direct that the provision of this act will not be applicable to disabled employees.
- Appropriate Government has power to direct that all or any provision of this act shall not apply to all or any class of employees employed in any scheduled employment.
- The appropriate government has power to add to either part of the schedule any employment by giving not less than three months notice of its intention.
- Appropriate Government has power to make rules for implementation of this act.
- Rule made by the Central Government under this Act to be laid before each house of parliament while it is in session.

### 3.6. THE PAYMENT OF BONUS ACT, 1965

The practice of paying bonus in India originated during first world war when certain textile mills granted 10% wages as war bonus to their workers in 1917, under Rule 81A of Defense of India Rules. Later on some Industrial disputes arose demanding payment of bonus. In 1950 a full bench of the Labor Appellate Tribunal evolved a formula for determination of bonus. A plea was made in 1959 to raise the formula. At the 2nd and 3rd meeting of 18th session of Standing Labour committee held in New Delhi in 1960 a decision was taken to appoint a commission to go into the question of bonus and evolve suitable norms. On 6th December 1960 the Government appointed a Bonus Commission.

Government of India vide Resolution no WB 20(3) 64 dated 2nd September 1964 accepted the recommendations of the commission subject to certain modifications. To implement these recommendations the Payment of Bonus Ordinance 1965 was promulgated in May 1965 which was replaced by Payment of Bonus Act, 1965 and assented on September 25, 1965. The Act provides for payment of at least minimum bonus @ 8.33% to a certain class of employees even if there is no or inadequate profit.

The Act has been amended several times latest being in 2015 when the wages ceiling for payment of bonus was raised to ₹ 21,000. This Act contains 40 sections and 4 schedules. The important concepts and provisions are discussed in this study note.

#### 3.6.1 Date of enactment of the Act

25th September 1965

#### 3.6.2 Object of the Act

- (a) To impose statutory liability upon the employer of every establishment covered by the Act to pay bonus to employees in establishment;
- (b) To provide for payment of minimum and maximum bonus and providing for set off and set on;
- (c) To define the principle of payment of bonus according to prescribed formula;
- (d) To provide for enforcement of liability for payment of bonus.

#### 3.6.3 Extent and Applicability:

- (1) This Act may be called the Payment of Bonus Act, 1965.
- (2) It extends to the whole of India.

**[Note :** The words "except the State of Jammu and Kashmir" omitted by Act 51 of 1970, Sec.2 and Schedule (w.e.f. 1st September,1971).

- (3) Save as otherwise provided in this Act, it shall apply to -
  - (a) Every factory; and
  - (b) Every other establishment in which twenty or more persons are employed on any day during an accounting year.
- (4) Save as otherwise provided in this Act, the provisions of this Act shall in relation to a factory or other establishment to which this Act applies, have effect in respect of the accounting year commencing on any day in the year 1964 and in respect of every subsequent accounting year.

Appropriate Government has power to extend the provision of this act to any establishment or class of establishment employing such number of employees less than 20 as specified in the notification but the number of persons so specified in no case be less than 10. An establishment to which this Act applies continue to be governed by this Act even if the number of person employed therein fall below 20 or such number specified by notification.



A part time employee is also an employee for the purpose of calculating the number of 20 or more under section 1(3)(b). *Automobile Karamchari Sangh v Industrial tribunal* (1976) 38 FLR 268 (All)

**Non applicability:** Certain classes of Employees as mentioned in section 32 of the Act are not covered under this act. Some of these are—

Employees employed in LIC, RBI, IFCI, UTI, National Housing Bank, IDBI, Red Cross Society of India, Universities and other educational Institutions etc.

### 3.6.4 Basic Concepts (Section 2):

Various terms and expressions used in the Act have been defined in section 2. The definition of various terms and expressions as given in section 2 are as under:-

In this Act, unless the context otherwise requires, -

- (1) "Accounting year" means -
  - (i) In relation to a corporation, the year ending on the day on which the books and accounts of the corporation are to be closed and balanced:
  - (ii) In relation to a company, the period in respect of which any profit and loss account of the company laid before it in annual general meeting is made up, whether that period is a year or not;
  - (iii) In any other case -
    - (a) The year commencing on the 1st day of April; or
    - (b) If the accounts of an establishment maintained by the employer thereof are closed and balanced on any day other than the 31st day of March, then, at the option of the employer, the year ending on the day on which its accounts are so closed and balanced :

Provided that an option once exercised by the employer under Para (b) of this sub-clause shall not again be exercised except with the previous permission in writing of the prescribed authority and upon such conditions as that authority may think fit.

- (2) "Agricultural income" shall have the same meaning as in the Income-tax Act ;
- (3) "Agricultural income-tax law" means any law for the time being in force relating to the levy of tax on agricultural income.
- (4) "Allocable surplus" means -

In relation to an employer, being a company [(Note: Ins. by Act 66 of 1980 (w.e.f. 21st August, 1980) (other than a banking company)] which has not made the arrangements prescribed under the Income-tax Act for the declaration and payment within Indian of the dividends payable out of its profits in accordance with the provisions of Sec.194 of that Act, sixty-seven per cent of the available surplus in an accounting year.

In any other case, sixty per cent of such available surplus ; (Note: Certain words omitted by Act 23 of 1976, Sec.4 (w.e.f. 25th September, 1975).

- (6) "Available surplus" means the available surplus computed under Sec.5.
- (7) "Award" means an interim or a final determination of any industrial dispute or of any question relating thereto any Labour Court, Industrial Tribunal or National Tribunal constituted under the Industrial Disputes Act, 1947 (14 of 1947), or by any other authority constituted under any corresponding law relating to investigation and settlement of industrial disputes in force in a State and includes an arbitration award made under Sec. 10-A of that Act or under that law.
- (8) "Banking company" means a banking company as defined in Sec.5 of the Banking Companies Act, 1949 (10 of 1949), and includes the State Bank of India, any subsidiary bank as defined in the State Bank of India (Subsidiary Bank) Act, 1959 (38 of 1959), and any other banking institution which may be notified in this behalf by the Central Government.

- (9) "Company" means any company as defined in Sec.3 of the Companies Act, 1956 (1 of 1956), and includes a foreign company within the meaning of Sec.591 of that Act.
- (10) "Co-operative society" means a society registered or deemed to be registered under the Co-operative Societies Act, 1912 (2 of 1912), or any other law for the time being in force in any State relating to co-operative societies.
- (11) "Corporation" means anybody corporate established by or under any Central, Provincial or State Act but does not include a company or a co-operative society .
- (12) "Direct tax" means -
- (a) Any tax chargeable under -
    - (i) The Income-tax Act;
    - (ii) The Super Profits Tax Act, 1963 (14 of 1963);
    - (iii) The Companies (Profits) Surtax Act, 1964 (7 of 1964);
    - (iv) The agricultural income-tax law; and
  - (b) Any other tax which, having regard to its nature or incidence, may be declared by the Central Government, by notification in the official Gazette to be a direct tax for the purposes of this Act;
- (13) Employee : [Sec. 2(13)] means any person (other than an apprentice) employed on salary or wage not exceeding ₹ 21,000 per month [w.e.f 1.4.2015 by Payment of Bonus (Amendment) Act, 2015] in any industry to do any skilled or unskilled, manual, supervisory, managerial, administrative, technical, or clerical work for hire or reward. It makes no difference whether terms of employment are expressed or implied.
- Where the salary or wage of an employee is more than ₹ 7,000 per month, the bonus payable to the employee u/s 10 or u/s 11 shall be calculated as if the salary is ₹ 7,000 per month or the minimum wage notified for the employment under the Minimum Wages Act, 1948 (whichever is higher). This means bonus is payable to employees getting upto ₹ 21,000 but bonus will be calculated on ₹ 7,000 or the minimum wages (whichever is higher) only.
- (14) "Employer" includes -
- (i) In relation to an establishment which is factory, the owner or occupier of the factory, including the agent of such owner or occupier, the legal representative of a deceased owner or occupier and where a person has been named as a manager of the factory under Cl. (f) of sub-section (1) of Sec.7 of the Factories Act, 1948, the person named; and
  - (ii) In relation to any other establishment, the person who, or the authority which, has the ultimate control over the affairs of the establishment and where the said affairs are entrusted to a manager, managing director or managing agent, such manager, managing director or managing agent.
- (15) "Establishment in private section" means any establishment other than an establishment in public sector.
- (16) "Establishment in public sector" means an establishment owned, controlled or managed by-
- (a) A Government company as defined in Sec. 617 of the Companies Act, 1956 (1 of 1956) ;
  - (b) A corporation in which not less than forty per cent of its capital is held (whether singly or taken together) by-
    - (i) The Government; or
    - (ii) The Reserve Bank of India; or
    - (iii) A corporation owned by the Government or the Reserve Bank of India.



- (17) "Factory" shall have the same meaning as in Cl. (m) of Sec.2 of the Factories Act, 1948 (63 of 1948).
- (18) "Gross profits" means the gross profits calculated under Sec.4 .
- (19) "Income-tax Act" means the Income-tax Act, 1961 (43 of 1961).
- (20) "Prescribed" means prescribed by rules made under this Act.
- (21) "Salary or wage" means all remuneration (other than remuneration in respect of overtime work) capable of being expressed in terms of money, which would, if the terms of employment, express or implied, were fulfilled, be payable to an employment or of work done in such employment and includes dearness allowance (that is to say, all cash payments, by whatever name called, paid to an employee on account of a rise in the cost of living, but does not include :
- (i) Any other allowance which the employee is for the time being entitled to ;
  - (ii) The value of any house accommodation or of such of light, water, medical attendance or other amenity or of any service of any concessional supply of food grains or other articles;
  - (iii) Any traveling concession ;
  - (iv) Any bonus (including incentive, production and attendance bonus) ;
  - (v) Any contribution paid or payable by the employer to any pension fund or provident fund or for the benefit of the employees under any law for the time being in force ;
  - (vi) Any retrenchment compensation or any gratuity or other retirement benefit payable to the employees or any ex gratia payment made to him ;
  - (vii) Any commission payable to the employee.
  - (viii) Deleted.

**Explanation** - Where an employee is given in lieu of the whole or part of the salary or wage payable to him, free food allowance or free food by his employer, such food allowance or the value of such food shall, for the purpose of this clause, be deemed to form part of the salary or wage of such employees.

- (22) Words and expressions used but not defined in this Act and defined in the Industrial Disputes Act, 1947 (14 of 1947), shall have the meanings respectively assigned to them in that Act.

### **3.6.5 Establishments to include Departments, Undertakings and Branches (Section 3)**

As per section 3 in case an establishment consists of different departments or undertakings or has branches all such departments or undertakings or branches are treated as parts of the same establishment for the purpose of computation of bonus under this Act . It is not material whether these different departments, undertaking or branches are situated in the same place or in different places. However there is one exception to this if for any accounting year a separate balance-sheet and profit and loss account are prepared and maintained in respect of any such department or undertaking or branch, then, such department or undertaking or branch is treated as separate establishment for the purpose of computation of bonus under this Act for that year, unless such department or undertaking or branch was immediately before the commencement of that accounting year treated as part of the establishment for the purpose of computation of bonus.

In the case of Workmen, Somaiya Organic (India) Ltd V Somaiya Organics(India) Ltd 1981 Lab IC363(All) it was held that branches of an establishment are to be treated as part of the same establishment for the purpose of computation of bonus. However, where in an accounting year, a separate balance sheet is maintained in respect of any branch then such branch shall be treated as a separate establishment.

When there is integral link and unity of management between the two divisions of a company it cannot be said as a separate undertaking although it is 60 miles away from one division. Gwalior Rayon Silk Mfg. Co. v. Industrial Tribunal 1975 Lab. I.C. 820.

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### **3.6.6 Customary Deductions/adjustment from bonus**

It is very customary these days to pay interim bonus in the form of puja bonus or other customary bonus, then the employer is entitled to deduct the amount of bonus so paid from the amount of bonus payable by him to the employee under this Act in respect of that accounting year and the employee will be entitled to receive only the balance. In addition to adjustment of interim/puja bonus, if an employee is found guilty of misconduct causing financial loss to the employer, then, the employer can deduct the amount of loss from the amount of bonus payable by him to the employee under this Act in respect of that accounting year only

If an employee has not worked for all the working days in an accounting year, the minimum bonus of one hundred rupees or, as the case may be, of sixty rupees, if such bonus is higher than 8.33 per cent of his salary or wage for the days he has worked in that accounting year, is proportionately reduced.

**3.6.7 Working days** - Words 'working day in any accounting year' - meaning of - factory working in a particular season only and not during the whole year in such a case the 'working days' only mean those days of the year during which the employee concerned is actually allowed to work. (Shakkar Mills Mazdoor Sangh v. Gwalior Sugar Co. Ltd., 1985 J LJ 294 = AIR 1985 SC 758).

In the case of Himalaya Drug Co Makali v Il Additional labor court, Bangalore-1995 I LLJ 1201 SC;- It was held that if an employee is paid puja or other customary bonus before he is found guilty of the act of misconduct, it will not be open to the employer to recover the amount on the ground that he had a right of adjustment under section 17 because the disqualification in section 9 applies to bonus receivable under the Act and not to puja or customary bonus

Claims for annual bonus are rooted in customs but qualified by negotiations/settlements held to be customary in nature and not statutory based only on settlement linked with productivity or profits(Mukund Ltd V Mukund Kamgar Union, 2003(ii)LLj410(Bomb)

Payment of any customary bonus, such as attendance bonus, festival bonus, or the like does not absolve the management from their liability to pay statutory bonus(Baidyanath Bhawan Mazdoor Union v Baidyanath Ayurvedic Bhawan Pvt Ltd 1984 lab IC 148

In the case of Landra Engineering & Foundry Works v State of Punjab (1970) 38 FJL 538 (P&H) it was held that the employee is bound to refund the excess amount of bonus.

### **3.6.8 Adjustment for other dues from employer**

On the one hand employer is entitled to adjust interim bonus/puja bonus or financial loss caused due to misconduct of the employee, at the same time the act makes provision that where any money is due to an employee by way of bonus from his employer under a settlement or an award or agreement, the employee himself, or any other person authorised by him in writing in this behalf, or in the case of the death of the employee, his assignee or heirs may, without prejudice to any other mode of recovery made an application to the appropriate Government for the recovery, of the money due to him, and if the appropriate Government or such authority as the appropriate Government may specify in this behalf is satisfied that any money is so due, it shall issue a certificate for that amount to the Collector who shall proceed to recover the same in the same manner as an arrear of land revenue Every such application is required to be made within one year from the date on which the money became due to the employee from the employer Appropriate government if satisfied by the ground may entertain any such application made after the expiry of the said period of one year.

### **3.6.9 Eligibility for Bonus (Sec 8)**

Every employee of the factory or establishment to which this Act is applicable receiving salary or wages upto ₹21,000 p.m. and engaged in any kind of work whether skilled, unskilled, managerial supervisory etc.



is entitled to bonus for every accounting year if he has worked for at least 30 working days in that year (Section 8).

In the case of JK Ginning & Pressing factory V PO 2nd labor court, 1991 62 FLR 207 Bom it was held that seasonal workers have worked for not less than 30 working days are entitled to bonus.

Workers who have option to attend to work at the factor premises are entitled to bonus(Kale Khan Mlhd Hanif v Jhansi Bidi Mazdoor Union 1980 lab IC 1973

Employees working on part time basis are eligible for bonus(Arun Mills Ltd v Dr Chandra Parshad C Trivedi(1976)32 FLR323

A probationer is entitled to bonus , Bank of Madurai ltd V Bank of Madurai employees Union, 1970 lab IC 1215

### **3.6.10 Disqualification for Bonus (Sec 9)**

Notwithstanding anything contained in this Act, an employee shall be disqualified from receiving bonus under this Act, if he is dismissed from service for—

- (a) Fraud; or
- (b) Riotous or violent behaviour while on the premises of the establishment; or
- (c) Theft, misappropriation or sabotage of any property of the establishment.

In the case of Himalaya drug co v PO 2nd Addl Labor court (1986)52 FLR 74 it was held that bonus can be forfeited under section 9 only with reference to accounting year in which the employee committed fraud, theft etc.

Similarly in the case of KLJ Plastic ltd v labor court III Hyderabad 2002(3)LLJ 619 Bom It was held that Bar of disqualification for bonus imposed under section 9 is a clear and unequivocal bar and if the wording of the provisions also is carefully gone through a distinction cannot be drawn between the bonus payable subsequent to the order of termination or prior to the order of termination and the bar is applicable to the bonus as such payable under the Act, hence awarding of bonus to workmen on facts is sustainable in law.

### **3.6.11 Minimum-Maximum Limit of Bonus - Payment of Minimum Bonus (Sec 10)**

The Act cast a statutory duty upon the employer to pay every employee every accounting year, a minimum bonus @ 8.33 per cent of the salary or wage earned by the employee during the accounting year or one hundred rupees, whichever is higher, irrespective of availability of allocable surplus in the accounting year. In case of an employee who has not completed fifteen years of age at the beginning of the Accounting year it is sixty rupees instead of one hundred rupee. However section 10 the Act put a ceiling on the maximum amount of bonus which cannot be more than 20% of the salary and wages.

Ex-gratia bonus is not a bonus under section 10 of the Act.RPC officers Association v RPC 1990 LLR 22 Raj

The minimum bonus under the act is a statutory right and shall be paid whether there are profits in the accounting year or not. After coming into force of this Act, bonus became an implied term of employment not dependent upon profits.(Gopalan v Angamati Chit fund.AIR 1977 ker 120.

In the case of Oriental Machinery & civil construction pvt ltd v the 2nd Industrial Tribunal, West Bengal 1978 Lab IC 586 Cal it was held that bonus in excess of allocable surplus cannot be claimed by employee.

#### **At a glance:**

- This act extends to whole of India including the state of Jammu and Kashmir.
- Every factory or establishment in which 20 or more person are employed on any day during an Accounting year are covered under this Act.

- Once an establishment or factory is covered under this Act, the provisions of this Act will continue to be applicable even if the number of person employed falls below 20 during an accounting year.
- All persons employed in an industry irrespective of nature of work (skilled or unskilled, manual, administrative, clerical, managerial etc) on salary or wages not exceeding ₹ 21,000 PM are covered under this Act provided he has worked at least 30 days in that accounting year.
- Where the salary and wages of an employee exceed ₹ 7,000 but is not more than ₹ 21,000 bonus is calculated on ₹ 7,000 PM or the minimum wages notified for the employment under the Minimum Wages Act, 1948 (whichever is higher) instead of actual salary or wages.
- An employee dismissed from service due to fraud, or riotous or violent behavior, theft, misappropriation or sabotage of any property of the establishment etc is not qualified for payment of bonus.
- An apprentice is not covered under this Act.
- Central Government has power to make rules for the purpose of this Act.
- Allocable surplus and available surplus are two important ingredients of this Act.
- Allocable surplus is 67% of available surplus in case of a company other than a banking company which has not made prescribed arrangement for payment of dividend within India out of profits in accordance with the provision of Income Tax Act. In case of other employers it is equal to 60% of available surplus.
- Available surplus is calculated under section 5 of the Act.
- Salary and wages means all remuneration which is capable of being expressed in terms of money terms which would be payable if the terms of employment expressed or implied are fulfilled.
- Overtime, value of house accommodation, Travel concession, supply of water, light medical facility or any other amenity or any service of any concessional supply of food grains of other articles, retrenchment compensation, gratuity, any contribution paid or payable by the employer to any pension fund or provident fund etc.
- Statutory minimum bonus is compulsorily required to be paid even if there is no profit or there is loss.
- All branches, departments, undertakings of an establishment whether in the same place or in different places are treated as part of same establishment for the purpose of computation of bonus except where in any accounting year a separate balance sheet and profit and loss account are prepared and maintained in respect of any such department or branch.
- Schedule I and Schedule II provide the manner of calculation of gross profit in case of a banking and other company respectively.
- Sums deductible from gross profit are provided in section 6 of the Act.
- Every employer is bound to pay a minimum bonus of 8.33% of salary or wages or one hundred Rupee whichever is higher whether or not the employer has allocable surplus in that accounting year.
- In case of an employee who has not completed 15 years of age at the beginning of the accounting year the minimum bonus will be ₹ 60 or 8.33% of salary or wages whichever is higher.
- Maximum limit of Bonus is 20% of salary and wages.
- In case an employee has not worked for all the working days in an accounting year the minimum bonus of ₹ 100 or 60 or 8.33% of salary and wages etc is calculated proportionately.
- The act provides for set-on and set off of allocable surplus when the allocable surplus exceeds the amount of minimum bonus or when there is no available surplus.
- Puja bonus, interim bonus or any other customary bonus can be adjusted against the amount of bonus payable under this Act.



- In disputed cases bonus must be paid within a month from the date on which the award becomes enforceable or the settlement comes into operation. In other cases within 8 months from the close of the accounting year.
- Appropriate Government has power to extend the limit of 8 months to two year on the application of the employer.
- Appropriate Government may appoint any person as inspector for the purpose of this Act.
- Inspector appointed by the Appropriate Government is deemed to be a public servant under the Indian Penal code.
- Having regards to the financial position and other relevant circumstances the appropriate government may exempt any establishment or class establishment from all or any provisions of this act.
- Any dispute between the employer and employees with respect of the bonus payable under this Act or with respect of application of this Act to an establishment in public sector, such dispute is treated as an Industrial Dispute.
- Every employer is required to maintain such registers, records and other documents in such form and such manner as prescribed by appropriate authority.
- Contravention of any provisions of this Act or rules is punishable with imprisonment of a term which may extend upto 6 month or a fine which may extend to ₹ 10,000 or both.

### 3.7 THE PAYMENT OF GRATUITY ACT, 1972

Payment of Gratuity Act, 1972 is a Central Act which came into effect with effect from 16th September 1972 and is one of the other important social legislations enacted by the Central Government from time to time. Before enactment of this Act there was no legislation to provide for payment of gratuity to the employees on their retirement or death. Though before enactment of this Act, employers used to pay gratuity to their employees either as per the terms of appointment between the employer and employee or voluntarily, but the schemes of Gratuity so introduced by the employers were too narrow in their scope and applicability that most of the establishments or workers out of the purview of the scheme of payment of Gratuity. Gratuity was treated to be gift or service or return for service. Moreover there was no uniformity in the schemes prevalent. Accordingly a need for a Central legislation was felt.

In the case of DCM Ltd. vs. their workers (1968) The Supreme court held that the object of providing gratuity scheme is to provide a retiring benefit to the workman who have rendered long and unblemished service to the employer and thereby contributed to their prosperity. In the working Journalist & Miscellaneous Provisions Act, 1955 the provision to pay the gratuity to the working journalist was made. Later on Kerala Government, West Bengal Government also enacted Payment of Gratuity Act in their states. The other states also started thinking on the same lines. The issue was discussed in the Labor Ministers conference held on 24th August 1971 and thereafter in the Indian Labor Conference held in October 1971 it was agreed that the central Legislation on the payment of gratuity should be undertaken. Accordingly the payment of Gratuity Act 1972 was enacted which was largely based on the West Bengal Legislation.

#### 3.7.1 Date of Commencement

This act came into force on 16th September 1972.

#### 3.7.2 Object of the Act

The Act provides for the payment of gratuity to workers employed in every factory, shop & establishments or educational institution employing 10 or more persons on any day of the preceding 12 months. A shop or establishment to which the Act has become applicable shall continue to be governed by the Act even if the number of persons employed falls below 10 at any subsequent stage. All the employees irrespective of status or salary are entitled to the payment of gratuity on completion of 5 years of service. In case of death or disablement there is no minimum eligibility period.

#### 3.7.3 Coverage

It extends to the whole of India; It is not applicable to Jammu & Kashmir in relations to plantation or ports.

#### 3.7.4 Applicability

- (a) every factory, mine, oilfield, plantation, port and railway company;
- (b) every shop or establishment within the meaning of any law for the time being in force in relation to shops and establishments in a State, in which ten or more persons are employed, or were employed, on any day of the preceding twelve months;
- (c) such other establishments or class of establishments, in which ten or more employees are employed, or were employed, on any day of the preceding twelve months, as the Central Government may, by notification, specify in this behalf.

A shop or establishment to which this Act has become applicable continue to be governed by this Act notwithstanding that the number of persons employed therein at any time after it has become so applicable falls below ten.



### Example:

ABC associates is an establishment employing 15 employee. All of a sudden 6 employees left the company within six months without any fresh induction of employee. Can the firm escape from the provision of Payment of Gratuity Act, 1972. As a Cost and Management Consultant how would you advise the company.

A Shop or establishment once covered by the payment of Gratuity Act, 1972 continues to be under the ambit of the Payment of Gratuity Act, even if the number of persons employed therein at any time falls below ten. ABC Ltd should comply with the provisions of Act without any default

A college run by a Society registered under the Societies Registration Act is an establishment covered under the payment of Gratuity Act, 1972 (Gurudevo Ayurvedic Mahavidyala v Mahadev (1999))

A temple is an establishment under the Payment of Gratuity Act (Adi Shri Jaganath Temple Puri v Jaganath Padhi (1992) Orissa)

### 3.7.5 Basic Concepts and Definitions

Section 2 of the Act defines various terms and expressions used in the Act which are reproduced here;

In this Act, unless the context otherwise requires,—

- (a) "appropriate Government" means,—
  - (i) in relation to an establishment —
    - (a) belonging to, or under the control of, the Central Government,
    - (b) having branches in more than one State,
    - (c) of a factory belonging to, or under the control of, the Central Government,
    - (d) of a major port, mine, oilfield or railway company, the Central Government,
  - (ii) in any other case, the State Government;
- (b) "completed year of service" means continuous service for one year;
- (c) "continuous service" means continuous service as defined in section 2A;
- (d) "controlling authority" means an authority appointed by the appropriate Government under section 3;
- (e) "Employee" means any person (other than an apprentice) who is employed for wages, whether the terms of such employment are express or implied, in any kind of work, manual or otherwise, in or in connection with the work of a factory, mine, oilfield, plantation, port, railways company, shop or other establishment to which this Act applied but does not include any such person who holds a post under the Central Government or a State Government and is governed by any other Act or by any rules providing for payment of gratuity.

**Note:** Trainee is not "employee" to be paid wages as an employee. In the absence of any statutory provisions under the Act, a trainee cannot be held entitled to gratuity, General Manager, Yellamma Cotton, Woollen and Silk Mills v Regional labor Commissioner (Central) and Appellate Authority under the payment of Gratuity Act, 1972 Bangalore 2006, LLR 1029

Any workmen engaged for work on temporary basis according to the availability of work is not an employee within the meaning of section 2(e). K Velukutty Achary V Harrisons Malayalam Ltd 1993 66 FLR 423 Ker DB

A workmen who rolls beedis for his employer but at his own house is an employee within the meaning of section 2(e) of the Act, PH Ramalal & Co V Chand Bibi 1981 1 LIC 790 (Guj)

- (f) "employer" means, in relation to any establishment, factory, mine, oilfield, plantation, port, railway company or shop—

- (i) belonging to, or under the control of, the Central Government or a State Government, a person or authority appointed by the appropriate Government for the supervision and control of employees, or where no person or authority has been so appointed, the head of the Ministry or the Department concerned,
  - (ii) belonging to, or under the control of, any local authority, the person appointed by such authority for the supervision and control of employees or where no person has been so appointed, the chief executive officer of the local authority,
  - (iii) in any other case, the person, who, or the authority which, has the ultimate control over the affairs of the establishment, factory, mine, oilfield, plantation, port, railway company or shop, and where the said affairs are entrusted to any other person, whether called a manager, managing director or by any other name, such person;
- (g) "factory" means has the meaning assigned to it in clause (m) of section 2 of the Factories Act, 1948 (63 of 1948);
- (h) "family", means in relation to an employee, shall be deemed to consist of –
- (i) in the case of a male employee, himself, his wife, his children, whether married or unmarried, his dependent parents and the dependent parents of his wife and the widow and children of his predeceased son, if any,
  - (ii) in the case of a female employee, herself, her husband, her children, whether married or unmarried, her dependent parents and the dependent parents of her husband and the widow and children of her predeceased son, if any :

**Explanation :** Where the personal law of an employee permits the adoption by him of a child, any child lawfully adopted by him shall be deemed to be included in his family, and where a child of an employee has been adopted by another person and such adoption is, under the personal law of the person making such adoption, lawful, such child shall be deemed to be excluded from the family of the employee;

- (i) "major port" has the meaning assigned to it in clause (8) of section 3 of the Indian Ports Act, 1908 (15 of 1908);
- (j) "mine" has the meaning assigned to it in clause (j) of sub-section (1) of section 2 of the Mines Act, 1952 (35 of 1952);
- (k) "notification" means a notification published in the Official Gazette;
- (l) "oilfield" has the meaning assigned to it in clause (e) of section 3 of the Oilfields (Regulation and Development) Act, 1948 (53 of 1948);
- (m) "plantation" has the meaning assigned to it in clause (f) of section 2 of the Plantations Labour Act, 1951 (69 of 1951);
- (n) "port" has the meaning assigned to it in clause (4) of section 3 of the Indian Ports Act, 1908 (15 of 1908);
- (o) "prescribed" means prescribed by rules made under this Act;
- (p) "railway company" has the meaning assigned to it in clause (5) of section 3 of the Indian Railways Act, 1890 (9 of 1890);
- (q) "retirement" means termination of the service of an employee otherwise than on superannuation;
- (r) "superannuation", in relation to an employee, means the attainment by the employee of such age as is fixed in the contract or conditions of service at the age on the attainment of which the employee shall vacate the employment;



- (s) "wages" means all emoluments which are earned by an employee while on duty or on leave in accordance with the terms and conditions of his employment and which are paid or are payable to him in cash and includes dearness allowance but does not include any bonus, commission, house rent allowance, overtime wages and any other allowance.

### 3.7.6 Continuous Service (Sec 2A)

For the purposes of this Act,—

- (1) an employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order treating the absence as break in service has been passed in accordance with the standing order, rules or regulations governing the employees of the establishment), lay off, strike or a lock-out or cessation of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or after the commencement of this Act.
- (2) where an employee (not being an employee employed in a seasonal establishment) is not in continuous service within the meaning of clause (1), for any period of one year or six months, he shall be deemed to be in continuous service under the employer -
  - (a) for the said period of one year, if the employee during the period of twelve calendar months preceding the date with reference to which calculation is to be made, has actually worked under the employer for not less than—
    - (i) one hundred and ninety days, in the case of an employee employed below the ground in a mine or in an establishment which works for less than six days in a week; and
    - (ii) two hundred and forty days, in any other case;
  - (b) for the said period of six months, if the employee during the period of six calendar months preceding the date with reference to which the calculation is to be made, has actually worked under the employer for not less than—
    - (i) ninety-five days, in the case of an employee employed below the ground in a mine or in an establishment which works for less than six days in a week; and
    - (ii) one hundred and twenty days, in any other case;

**Explanation:** For the purpose of clause (2), the number of days on which an employee has actually worked under an employer shall include the days on which -

- (i) he has been laid-off under an agreement or as permitted by standing orders made under the Industrial Employment (Standing Order's) Act, 1946 (20 of 1946), or under the Industrial Disputes Act, 1947 (14 of 1947), or under any other law applicable to the establishment;
  - (ii) he has been on leave with full wages, earned in the previous year;
  - (iii) he has been absent due to temporary disablement caused by accident arising out of and in the course of his employment; and
  - (iv) in the case of a female, she has been on maternity leave; so, however, that the total period of such maternity leave does not exceed twelve weeks.
- (3) Where an employee employed in a seasonal establishment, is not in continuous service within the meaning of clause (1), for any period of one year or six months, he shall be deemed to be in continuous service under the employer for such period if he has actually worked for not less than seventy-five per cent of the number of days on which the establishment was in operation during such period.

### 3.7.7 Controlling Authority (Sec 3)

The appropriate Government may, by notification, appoint any officer to be a controlling authority, who shall be responsible for the administration of this Act and different controlling authorities may be appointed for different areas.

### 3.7.8 Payment of Gratuity (Sec 4)

(1) Gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years,—

- (a) on his superannuation, or
- (b) on his retirement or
- (c) resignation, or
- (d) on his death or disablement due to accident or disease :

Provided that the completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement;

Provided further that in the case of death of the employee, gratuity payable to him shall be paid to his nominee or, if no nomination has been made, to his heirs, and where any such nominees or heirs is a minor, the share of such minor, shall be deposited with the controlling authority who shall invest the same for the benefit of such minor in such bank or other financial institution, as may be prescribed, until such minor attains majority.

**Explanation :** For the purposes of this section, disablement means such disablement as incapacitates an employee for the work which he was capable of performing before the accident or disease resulting in such disablement.

(2) **Method of Calculation of Gratuity :** Payable at the rate of fifteen days' wages based on the rate of wages last drawn by the employee concerned for every completed year of service or part thereof in excess of six months (Section 4(2)).

In the case of a monthly rated employee, the fifteen days' wages is calculated by dividing the monthly rate of wages last drawn by him by twenty-six and multiplying the quotient by fifteen. While, in the case of a piece-rated employee, daily wages is computed on the average of the total wages received by him for a period of three months immediately preceding the termination of his employment, and, for this purpose, the wages paid for any overtime work is not taken into account. The amount of gratuity payable to an employee cannot exceed ₹ 10 lakh

For the purpose of computing the gratuity payable to an employee who is employed, after his disablement, on reduced wages, his wages for the period preceding his disablement shall be taken to be the wages received by him during that period, and his wages for the period subsequent to his disablement shall be taken to be the reduced wages.

In the case of an employee who is employed in a seasonal establishment and who is not so employed throughout the year, the employer shall pay the gratuity at the rate of seven days' wages for each season.

In the case of a monthly rated employee, the fifteen days' wages is to be calculated by dividing the monthly rate of wages last drawn by him by twenty-six and multiplying the quotient by fifteen.

#### **Example:**

In the case of *DS Purwar v Elphinstone Spinning and Weaving Mills*, it was held that where an employee claims gratuity on the basis of an agreement, such claim is outside the scope of adjudication under the payment of Gratuity Act.



In another case of Duncan Agro Industries Ltd v Subanna B, the question of whether services rendered prior to commencement of Payment of Gratuity Act, 1972 will be counted for the purpose of calculation of continuous service of 5 yrs. It was held that workmen should be entitled to gratuity for the period of services rendered whether rendered prior to or after commencement of the Act.

(3) The amount of gratuity payable to an employee shall not exceed ₹ 10 lakh.

(4) For the purpose of computing the gratuity payable to an employee who is employed, after his disablement, on reduced wages, his wages for the period preceding his disablement shall be taken to be the wages received by him during that period, and his wages for the period subsequent to his disablement shall be taken to be the wages as so reduced.

(5) Nothing in this section shall affect the right of an employee to receive better terms of gratuity under any award or agreement or contract with the employer.

(6) Notwithstanding anything contained in sub-section (1),—

- (a) the gratuity of an employee, whose services have been terminated for any act, willful omission or negligence causing any damage or loss to, or destruction of, property belonging to the employer, shall be forfeited to the extent of the damage or loss so caused.
- (b) the gratuity payable to an employee may be wholly or partially forfeited—
  - (i) if the services of such employee have been terminated for his riotous or disorderly conduct or any other act of violence on his part, or
  - (ii) if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment.

### 3.7.8.1 Mode of payment of gratuity

As per rule 8 of the Payment of Gratuity Rules (Central) 1972, the gratuity payable under the Act shall be paid in cash or, if so desired by the payee, in Demand Draft or bank cheque to the eligible employee, nominee or legal heir, as the case may be:

In case the eligible employee, nominee or legal heir, as the case may be, so desires and the amount of gratuity payable is less than one Thousand rupees, payment may be made by postal money order after deducting the postal money order commission therefore from the amount payable:

### 3.7.8.2 Forfeiture of Gratuity

The gratuity of an employee, whose services have been terminated for any act, willful omission or negligence causing any damage or loss to, or destruction of, property belonging to the employer, can be forfeited to the extent of the damage or loss so caused. The gratuity payable to an employee may be wholly or partially forfeited:- (i) if the services of such employee have been terminated for his riotous or disorderly conduct or any other act of violence on his part; or (ii) if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment.

**Note:-** Badli Employees are not covered by the substantive part of the definition of continuous service and are not entitled to payment of gratuity for badli period. General Manager, Yelamma Cotton, Woollen and Silk Mills v Regional labor Commissioner, Bangalore 2006 LLR 1029

Mere absence cannot be said to result in breach of continuity of service for the purpose of the Act. Kothari Industrial corporation v Aappellate Authority (Deputy Commissioner of Labor) Karnool, 1998 LLR 223

Non acceptance of the resignation is no hurdle in the way of an employee to claim gratuity. Mettur Spinning Mills V Deputy Commissioner of Labor, 1983 II LLJ 188

A retrenched employee is entitled to gratuity, State of Punjab v labor Court 1980 1 SCR 953

Termination of service for any causes enumerated in section 4(6) is imperative. So forfeiture of gratuity by order of disciplinary authority after retirement of the petitioner was not proper and valid; *Jaswant Singh Gill v Bharat Coking coal Ltd*, 2007(112) FCLR 196

Refusal of the employees to surrender land belonging to the employer is not a ground to withhold gratuity. *Travancore Plywood industries Ltd v Regional Joint labor Commissioner*, (1996) IL LLJ 85 Ker

Employees employed in a temple are entitled to gratuity, *Administrator , Shree Jaganath Temple* 1992 65 FLR 946 Orissa

### **3.7.9 Recovery of Gratuity (Sec 8)**

If the amount of gratuity payable under this Act is not paid by the employer, within the prescribed time, to the person entitled thereto, the controlling authority shall, on an application made to it in this behalf by the aggrieved person, issue a certificate for that amount to the Collector, who shall recover the same, together with compound interest thereon at such rate as the Central Government may, by notification, specify, from the date of expiry of the prescribed time, as arrears of land revenue and pay the same to the person entitled thereto :

Provided that the controlling authority shall, before issuing a certificate under this section, give the employer a reasonable opportunity of showing cause against the issue of such certificate:

Provided further that the amount of interest payable under this section shall, in no case exceed the amount of gratuity payable under this Act.

**Note :** If gratuity is not paid , it must be paid with compound interest at the rate of interest prescribed under section 8 of the Act calculating till the date of payment, *Nagar palika v Controlling Authority*, (1988) 57 FLR 425 All

### **3.7.10 Penalties (Sec 9)**

- (1) Whoever, for the purpose of avoiding any payment to be made by himself under this Act or of enabling any other person to avoid such payment, knowingly makes or causes to be made any false statement or false representation shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees or with both.
- (2) An employer who contravenes, or makes default in complying with, any of the provisions of this Act or any rule or order made thereunder shall be punishable with imprisonment for a term which shall not be less than three months but which may extend to one year, or with fine which shall not be less than ten thousand rupees but which may extend to twenty thousand rupees, or with both :

Provided that where the offence relates to non-payment of any gratuity payable under this Act, the employer shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to two years unless the court trying the offence, for reasons to be recorded by it in writing, is of opinion that a lesser term of imprisonment or the imposition of a fine would meet the ends of justice.

### **3.7.11 Exemption of Employer from liability in certain cases(Sec 10)**

Where an employer is charged with an offence punishable under this Act, he shall be entitled, upon complaint duly made by him and on giving to the complainant not less than three clear days' notice in writing of his intention to do so, to have any other person whom he charges as the actual offender brought before the court at the time appointed for hearing the charge; and if, after the commission of the offence has been proved, the employer proves to the satisfaction of the court –

- (a) that he has used due diligence to enforce the execution of this Act, and
- (b) that the said other person committed the offence in question without his knowledge, consent or connivance, that other person shall be convicted of the offence and shall be liable to the like punishment as if he were the employer and the employer shall be discharged from any liability under this Act in respect of such offence :



Provided that in seeking to prove as aforesaid, the employer may be examined on oath and his evidence and that of any witness whom he calls in his support shall be subject to cross-examination on behalf of the person he charges as the actual offender and by the prosecutor;

Provided further that, if the person charged as the actual offender by the employer cannot be brought before the court at the time appointed for hearing the charge, the court shall adjourn the hearing from time to time for a period not exceeding three months and if by the end of the said period the person charged as the actual offender cannot still be brought before the court, the court shall proceed to hear the charge against the employer and shall, if the offence be proved, convict the employer.

### 3.7.12 Protection of Gratuity (Sec 13)

No gratuity payable under this Act and no gratuity payable to an employee employed in any establishment, factory, mine, oilfield, plantation, port, railway company or shop exempted under section 5 shall be liable to attachment in execution of any decree or order of any civil, revenue or criminal court.

Section 13A. Notwithstanding anything contained in any judgment, decree or order of any court, for the period commencing on and from the 3rd day of April 1997 and ending on the day on which the Payment of Gratuity (Amendment) Act 2009 receives the assent of the president, the gratuity shall be payable to an employee in pursuance of this notification of the Government of India in the Ministry of Labor and Employment vide SO 1080 dated the 3rd day of April 1997 and the said notification shall be valid and shall be deemed always to have been valid as if the payment of gratuity (Amendment) Act 2009 had been in force at all material times and the gratuity shall be payable accordingly.

Provided that nothing contained in this section shall extend or be construed to extend to affect any person with any punishment or penalty whatsoever by reason of the non employment by him of the gratuity during the period specified in this section which shall become due in pursuance of the said notification.

**Note:** Amount of gratuity is not liable to be adjusted towards any amount drawn by the employee as personal loan or housing loan, *yada laxmi v AP State Cooperative Bank Hyderabad*, 2006 LLR 451 2006(108) FLR 1178 Gratuity cannot be attached, *Chrisostom V Federal Bank Ltd*, 1993 1 LLj 422 Ker

#### At a glance:

- The maximum ceiling on gratuity payable is Rs. 10 lakh.
- Although this act is applicable to whole of India including the state of Jammu and Kashmir but in relation to plantation or ports it is not applicable to the State of Jammu and Kashmir.
- For every completed year of service or part thereof in excess of six months, gratuity payable is 15 days wages based on rate of wages last drawn by the employee.
- If in any shop or establishment 10 or more persons are/were employed on any day of the preceding twelve months, this act is applicable to it.
- Central Government is the appropriate government in case of an establishment belonging to or under the control of Central Government, factory, major port, mines, oil fields, railway company belonging or under the control of Central Government or establishment having branches in more than one States. State Government is the appropriate Government in case of other establishment.
- Completed year of service means continuous service of one year.
- Controlling authority is appointed by the Appropriate Government.
- Gratuity is payable to an employee on termination of his employment after rendering not less than 5 years continuous service.
- The condition of completion of 5 years continuous service is not applicable when the termination of the employment is due to death or disablement.

- The appropriate government has power to exempt any establishment, factory, mine, oil field, plantation, port, railway company, shop from the provision of this Act if the appropriate government is of the opinion that such shop, establishment etc has gratuity or pensioner benefit scheme which is not less favorable than the benefit available under this Act.
- Every employer other than an establishment belonging to or under the control of the Central Government or State Government is required to obtain insurance cover from LIC or any other prescribed insurer.
- Every employee who has completed one year of service is required to make a nomination.
- Appropriate Government has power to appoint as many inspectors as it deems fit for the purpose of this Act.
- Though an employee can make nomination in favor of any person but acquiring family such nomination made in favor of any person is invalid and he is required to make fresh nomination in favor of one or more members of his family.
- The employer is required to pay the gratuity within 30 days from the date it becomes payable.
- If gratuity is not paid within 30 days from the date it becomes payable simple interest @10% pa is payable on the expiry of said period.
- For non-payment of gratuity within the time period on application made by the aggrieved person, the controlling authority can issue a certificate to the collector, who shall recover the same as arrears of land revenue.
- Gratuity can be forfeited if service has been terminated for any act, willful omission or negligence causing damage or destruction to the property belonging to the employer, for any act which constitutes an offence involving moral turpitude.
- False statement for the purpose of avoiding any payment of gratuity is punishable with imprisonment for a term which may extend to six month or fine which may extend to Rs. 10,000 or both.
- Court can take cognizance of any offence punishable under this Act only on a complaint made by or under the authority of the appropriate government.
- No court inferior to that of a Metropolitan or a Judicial Magistrate of the first class can try any offence punishable under this Act.
- Gratuity payable under this Act is not liable to attachment in execution of any decree or order of any civil, revenue or criminal court.



### 3.8 EMPLOYEES' STATE INSURANCE ACT, 1948

The Employees State Insurance Act is a social welfare legislation aimed at bringing about social and economic justice to workers employed in the factories and establishment to which this Act applies. It aims at securing maximum labor welfare through various welfare schemes like providing certain benefits to employees in case of sickness, maternity, disablement and death due to employment injury to workers and to make provisions for certain other matters in relation thereto.

The need for a comprehensive legislation for providing social security to workers was felt immediately after World War II. Workman Compensation Act, 1923, though passed in 1923 designed to protect and safeguard the interest of labor was basically in the nature of social assistance legislation rather than a social insurance. Accordingly a need of a legislation providing some social security in the form of Insurance against some contingencies like sickness, maternity, employment injury and death etc was pleaded at various forms.

In 1943 Government of India appointed Prof BP Adarkar as a special officer to report on health insurance of the Industrial workers in India. The report submitted by Dr Adarkar in August 1944 contained comprehensive contributory scheme of social insurance.

Further some improvements in the above scheme were made by Ms Maurice Stack and Mr. Raghunath Rao, members of ILO who examined it at the invitation of the Government of India. The Report of Prof Adarkar and suggestions made by Mr. Rao and Maurice Stack were discussed in labor conference held in October 1944 and by the standing labor Committee in March 1945. The following Recommendations were made:

- (i) the Central Government should proceed with the preparation of a scheme of health insurance applicable to all perennial factories and covering employment injuries and maternity benefits if possible and
- (ii) That the scheme should be circulated to provincial Government and association of Employers and workers before the bill is drafted.

Accordingly based on the recommendation of Labor Conference and Standing Committee the Employees State Insurance Bill providing for compulsory sickness, maternity and employment injury benefits for workers in perennial factories was introduced in the Central Legislature on 6th November 1946 and passed in 1948.

#### 3.8.1 Coverage of the Act

It extends to the whole of India.

#### 3.8.2 Date of Enforcement

It came into effect with effect from-19th April 1948, though Central Government may appoint different dates for different provisions of the Act and for different States or for different part thereof.

#### 3.8.3 Applicability of the Act

In the first instance, to all factories (including factories belonging to the government) other than seasonal factories.

The Act contains an enabling provision under which the appropriate Government is empowered to extend the provision of the Act to other establishment-industrial, commercial, agricultural or otherwise.

In pursuance of the enabling provisions most of the State Governments have extended the provision to new classes of establishments namely shops ,hotels, restaurants, Cinema Halls including PVR, Road Motor Transport undertaking and Newspaper establishments employing 20 or more coverable employees.

The employees have been extended to Educational Institution employing twenty or more employees in most of the States. As of now, employees of factories/establishments mentioned above in the implemented areas and drawing wages excluding overtime not exceeding ₹ 15,000 per month are covered under the Act.

**Example:**

XYZ is a factory 15 employees and is governed by the ESI Act, 1948 since 2009. Due to resignation and termination of service of 6 employees during 2010, the number of employee fell to 9 employees on 01.1.2011. The company claims that it is not required to comply with the provisions of ESI Act, now in view of reduction in number of employees below the prescribed limit. As a Cost and Management Accountant advice of the company.

As per proviso of sub section 6 of section 1 of the Act a factory or establishment to which this Act applied once governed by this Act, continue to be governed by the act even if its number of employees falls below the limit prescribed in the Act. Accordingly the company should comply with provisions of ESI Act.

The above legal position was also confirmed in the case cited below;

In the case of kuriacan v ESI Corporation (1988) 2CLR 301 Ker- it was once that once the Act has become applicable to a factory or an establishment, its application will be continuous.

**3.8.4 Saving provision:**

This act is not applicable to a factory or establishment belonging to or under the control of the government whose employees are otherwise in receipt of benefits substantially similar or superior to the benefits provided under this Act

**3.8.5 Constitutional Provision:**

The Subject Employees insurance is included in list III at entry no 23 Schedule 7 of Constitution of India. Both State Government and State Governments have power to make legislative enactment for this purpose.

**3.8.6 Concepts and Definitions:**

Terms and expressions used in this act have been defined in section 2. Definition of various terms as given in the Act is as under:-

In this Act, unless there is anything repugnant in the subject or context,-

- (1) "Appropriate government" means, in respect of establishments under the control of the Central Government or a railway administration] or a major port or a mine or oilfield, the Central Government, and in all other cases, the State Government;
  - (3) "confinement" means labour resulting in the issue of a living child or labour after twenty-six weeks of pregnancy resulting in the issue of a child whether alive or dead;
  - (4) "contribution" means the sum of money payable to the Corporation by the principal employer in respect of an employee and includes any amount payable by or on behalf of the employee in accordance with the provisions of this Act;
  - (6) "Corporation" means the Employees' State Insurance Corporation set up under this Act;
- [(6A)] "dependant" means any of the following relatives of a deceased insured person, namely,-
- (i) A widow, a legitimate or adopted son who has not attained the age of twenty-five years, an unmarried legitimate or adopted daughter.  
[i(a) a widowed mother].
  - (ii) if wholly dependent on the earnings of the insured person at the time of his death, a legitimate or adopted son or daughter who has attained the age of twenty five years and is infirm;
  - (iii) if wholly or in part dependent on the earnings of the insured person at the time of his death,-
    - (a) parent other than a widowed mother,
    - (b) a minor illegitimate son, an unmarried illegitimate daughter or a daughter legitimate or adopted or illegitimate if married and a minor or if widowed and a minor,
    - (c) a minor brother or an unmarried sister or a widowed sister if a minor,



- (d) a widowed daughter-in-law,
  - (e) a minor child of a pre-deceased son,
  - (f) a minor child of a pre-deceased daughter where no parent of the child is alive, or
  - (g) a paternal grand-parent if no parent of the insured person is alive
- (7) "duly appointed" means appointed in accordance with the provisions of this Act or with the rules or regulations made there under;
- (8) "employment injury" means a personal injury to an employee caused by accident or an occupational disease arising out of and in the course of his employment, being an insurable employment, whether the accident occurs or the occupational disease is contracted within or outside the territorial limits of India;]
- (9) "employee" means any person employed for wages in or in connection with the work of a factory or establishment to which this Act applies and-
- (i) who is directly employed by the principal employer on any work of, or incidental or preliminary to or connected with the work of, the factory or establishment whether such work is done by the employee in the factory or establishment or elsewhere; or
  - (ii) who is employed by or through an immediate employer on the premises of the factory or establishment or under the supervision of the principal employer or his agent on work which is ordinarily part of the work of the factory or establishment or which is preliminary to the work carried on in or incidental to the purpose of the factory or establishment; or
  - (iii) whose services are temporarily lent or let on hire to the principal employer by the person with whom the person whose services are so lent or let on hire has entered into a contract of service; and includes any person employed for wages on any work connected with the administration of the factory or establishment or any part, department or branch thereof or with the purchase of raw materials for, or the distribution or sale of the products of, the factory or establishment or any person engaged as an apprentice, not being an apprentice engaged under the Apprentices Act, 1961 or under the standing orders of the establishment but does not includes:
    - (a) any member of the Indian naval, military or air forces; or
    - [(b) any person so employed whose wages excluding remuneration for overtime work) exceed such wages as may be prescribed by the Central Government a month:  
Provided that an employee whose wages excluding remuneration for overtime work) exceed such wages as may be prescribed by the Central Government at any time after and not before the beginning of the contribution period, shall continue to be an employee until the end of that period  
The wage ceiling for coverage of employees under the ESI Act 1948 has been enhanced from ₹ 10,000 to ₹ 15,000 per month w.e.f. 1.5.2010.
- (10) "exempted employee" means an employee who is not liable under this Act to pay the employee's contribution;
- (11) "family" means all or any of the following relatives of an insured person, namely,-
- (i) a spouse;
  - (ii) a minor legitimate or adopted child dependent upon the insured person;
  - (iii) a child who is wholly dependent on the earnings of the insured person and who is-
    - (a) receiving education, till he or she attains the age of twenty-one years,
    - (b) an unmarried daughter;

- (iv) a child who is infirm by reason of any physical or mental abnormality or injury and is wholly dependent on the earnings of the insured person, so long as the infirmity continues;
  - (v) dependent parents whose income from all sources does not exceed such income as may be prescribed by the central Government
  - (vi) in case the insured person is unmarried and his or her parents are not alive a minor brother or sister wholly dependent upon the earnings of the insured person
- (12) "factory" means any premises including the precincts thereof- whereon ten or more persons are employe or were employed on any day of the preceding twelve months, and in any part of which a manufacturing process is being carried on or is ordinarily so carried on, but does not include a mine subject to the operation of the Mines Act, 1952 or a railway running shed.
- (13) "immediate employer", in relation to employees employed by or through him, means a person who has undertaken the execution, on the premises of a factory, or an establishment to which this Act applies or under the supervision of the principal employer or his agent, of the whole or any part of any work which is ordinarily part of the work of the factory or establishment of the principal employer or is preliminary to the work carried on in, or incidental to the purpose of, any such factory or establishment, and includes a person by whom the services of an employee who has entered into a contract of service with him are temporarily lent or let on hire to the principal employer and includes a contractor;
- (13A) "insurable employment" means an employment in a factory or establishment to which this Act applies;]
- (14) "insured person" means a person who is or was an employee in respect of whom contributions are or were payable under this Act and who is, by reason thereof, entitled to any of the benefits provided by this Act;
- (14A) "managing agent" means any person appointed or acting as the representative of another person for the purpose of carrying on such other person's trade or business, but does not include an individual manager subordinate to an employer;]
- (14AA) "manufacturing process" shall have the meaning assigned to it in the Factories Act, 1948;]
- (14B) "mis-carrriage" means expulsion of the contents of a pregnant uterus at any period prior to or during the twenty-sixth week of pregnancy but does not include any mis-carrriage, the causing of which is punishable under the Indian Penal Code;]
- (15) "occupier" of the factory shall have the meaning assigned to it in the Factories Act, 1948;]
- [(15A) "permanent partial disablement" means such disablement of a permanent nature, as reduces the earning capacity of an employee in every employment which he was capable of undertaking at the time of the accident resulting in the disablement:
- PROVIDED that every injury specified in Part II of the Second Schedule shall be deemed to result in permanent partial disablement;
- (15B) "permanent total disablement" means such disablement of a permanent nature as incapacitates an employee for all work which he was capable of performing at the time of the accident resulting in such disablement:
- PROVIDED that permanent total disablement shall be deemed to result from every injury specified in Part I of the Second Schedule or from any combination of injuries specified in Part II thereof where the aggregate percentage of the loss of earning capacity, as specified in the said Part II against those injuries, amounts to one hundred per cent or more;]



- (15C) "power" shall have the meaning assigned to it in the Factories Act, 1948;]
- (16) "prescribed" means prescribed by rules under this Act;
- (17) "principal employer" means-
- (i) in a factory, the owner or occupier of the factory, and includes the managing agent of such owner or occupier, the legal representative of a deceased owner or occupier, and where a person has been named as the manager of the factory under 20[the Factories Act, 1948]; the person so named;
  - (i) in any establishment under the control of any department of any government in India, the authority appointed by such government in this behalf or where no authority is so appointed, the head of the department;
  - (ii) in any other establishment, any person responsible for the supervision and control of the establishment;
- "regulation" means a regulation by the Corporation;
- (19) "Schedule" means a Schedule to this Act;
- (19A) "seasonal factory" means a factory which is exclusively engaged in one or more of the following manufacturing processes, namely, cotton ginning, cotton or jute pressing, decortications of groundnuts, the manufacture of coffee, indigo, lac, rubber, sugar (including gur) or tea or any manufacturing process which is incidental to or connected with any of the aforesaid processes and includes a factory which is engaged for a period not exceeding seven months in a year-
- (a) in any process of blending, packing or repacking of tea or coffee; or
  - (b) in such other manufacturing process as the Central Government may, by notification in the Official Gazette, specify;]
- (20) "sickness" means a condition which requires medical treatment and attendance and necessitates abstention from work on medical grounds;
- (21) "temporary disablement" means a condition resulting from an employment injury which requires medical treatment and renders an employee, as a result of such injury, temporarily incapable of 21 [doing the work which he was doing prior to or at the time of the injury];
- (22) "wages" means all remuneration paid or payable, in cash to an employee, if the terms of the contract of employment, express or implied, were fulfilled and includes any payment to an employee in respect of any period of authorised leave, lock-out, strike which is not illegal or lay -off and other additional remuneration, if any, paid at intervals not exceeding two months, but does not include-
- (a) any contribution paid by the employer to any pension fund or provident fund, or under this Act;
  - (b) any travelling allowance or the value of any travelling concession;  
any sum paid to the person employed to defray special expenses entailed on him by the nature of his employment; or
  - (c) any gratuity payable on discharge.
- [(23) "wage period" in relation to an employee means the period in respect of which wages are ordinarily payable to him whether in terms of the contract of employment, express or implied or otherwise.]
- [(24) all other words and expressions used but not defined in this Act and defined in the Industrial Disputes Act, 1947, shall have the meanings respectively assigned to them in that Act.]

**Note:** Canteen workers are employee. Employee State Insurance corporation v Shri Ram Chemical Industries (1978)2LLN 227 (Raj).

Employees who are working in a showroom or sales office of a concern are "employee" Bhopal Motors (pvt) Ltd ESI Corporation, (1982) 2 LLN 827 MP.

Workers employed in a hospital attached to a factory are coverable under this Act.

Regional Director, ESI Corporation V Manager, Associated cement co ltd, AIR 1979 NOC 145 Karm.

A partner is not "Employee" Regional Director, ESI Corporation V Ramanaju Match Industries, AIR 1965 SC 278.

An apprentice who is a mere trainee for a particular period for a distinct purpose is not employee. ESI Corporation v Tata Engineering & Locomotive Co Ltd AIR 1976 SC 66.

### **3.8.7 Compulsory Registration**

In order to ensure the compliance of the provisions of this Act, every factory or establishment to which this Act applies is required to get itself registered [Sec 2-A].

Note:-The term "working on the premises of the establishment" can not mean the situation of casual or occasional presence or entry of person in a factory. Liability of payment of contribution cannot be fastened for these persons. BOC India Ltd Calcutta v Asst Regional Director, ESI Corporation, Hyderabad, 2005 LLR 4

### **3.8.8 Who is an insurable employee?**

Every employee of a factory or establishment to which the Act applies is an insurable person. Section 38 states that subject to provisions of the Act, all employees in factories or establishments to which this Act applies shall be insured in manner as provided in Act. However the following persons are not insurable and Act does not provide any benefit to them:

(a) Workers in mines subject to Mines Act, 1952 [Sec 2(12)]

(b) Workers in a railway running shed [Sec 2(12)]

(c) Any member of [the Indian] naval, military or air forces [Sec 2(9)]

(d) Any person so employed whose wages (excluding remuneration for overtime work)

exceed [such wages as may be prescribed by the Central Government]:

### **3.8.9 Compulsory Insurance**

It is compulsory to get all the employees in a factory or establishment to which this Act apply insured in the manner provided by this Act. For an employee to be insured two conditions must be fulfilled (a) he must be employed in a factory or establishment to which this act applies (b) contribution must be either paid or payable.

In Hyderabad Asbestos v Employees Insurance court (Air) 1978 SC 356 the Supreme court held that the words all employees in factories do not mean the person employed in factories only but also include persons employed in connection with the work of the factory. The employees that are required to be insured are not restricted to only those employed in factories defined under section 2(19) of the Act.

In case of Transport corporation of India V Employees' State Insurance Corporation, AIR SC 328, and Supreme court held that the Employees State Insurance Act is aimed at conferring benefits on employees in case of sickness, maternity and employment injury. Section 38 of the Act mandates that all the employees in the factory or establishment shall be insured. The initial and vital endeavour should be to identify the beneficiaries or the employees for insurance.

### **3.8.10 Contribution to Employees State Insurance Fund:**

**The provisions relating to contribution to Employees Provident funds are enumerated in Chapter IV of the Act.**

**As per section 38** all employees in factories or establishments to which this Act applies are to be insured by



the employer. The contribution payable under this Act in respect of an employee comprise contribution payable by the employer called as the employer's contribution and contribution payable by the employee called as the employee's contribution and shall be paid to the Corporation. Rate of contribution are prescribed by the Central Government. Presently the rate of Employer's contribution is 4.75% and Employees' contribution is 1.75% of the wages.

### 3.8.11 Benefits under this Act

Benefits available to the insured persons under the Act are provided in Chapter V section 46.

These benefits are as follows:

- (i) Sickness Benefit.
- (ii) Maternity Benefit.
- (iii) Disablement Benefit.
- (iv) Dependants' Benefit.
- (v) Medical Benefit.
- (vi) Funeral Expenses.

All these benefits except medical benefit are monetary benefits. The rules regarding benefits are contained in Secs 46 to 58 and Rules 55 to 58.

As per section 46 the insured persons, their dependants or the persons hereinafter mentioned, as the case may be is entitled to the following benefits, namely,-

- (a) **Medical Benefit** : Full medical care is provided to an Insured person and his family members from the day he enters insurable employment. There is no ceiling on expenditure on the treatment of an Insured Person or his family member. Medical care is also provided to retired and permanently disabled insured persons and their spouses on payment of a token annual premium of ₹ 120.
- (b) **Sickness Benefit (SB)** : Sickness Benefit in the form of cash compensation at the rate of 70 per cent of wages is payable to insured workers during the periods of certified sickness for a maximum of 91 days in a year. In order to qualify for sickness benefit the insured worker is required to contribute for 78 days in a contribution period of 6 months.
  1. **Extended Sickness Benefit (ESB)** : SB extendable upto two years in the case of 34 malignant and long-term diseases at an enhanced rate of 80 per cent of wages.
  2. **Enhanced Sickness Benefit** : Enhanced Sickness Benefit equal to full wage is payable to insured persons undergoing sterilization for 7 days/14 days for male and female workers respectively.
- (c) **Maternity Benefit(MB)** : Maternity Benefit for confinement/pregnancy is payable for three months, which is extendable by further one month on medical advice at the rate of full wage subject to contribution for 70 days in the preceding year
- (d) **Disablement Benefit**
  1. **Temporary disablement benefit (TDB)** : From day one of entering insurable employment & irrespective of having paid any contribution in case of employment injury. Temporary Disablement Benefit at the rate of 90% of wage is payable so long as disability continues.
  2. **Permanent disablement benefit (PDB)** : The benefit is paid at the rate of 90% of wage in the form of monthly payment depending upon the extent of loss of earning capacity as certified by a Medical Board
- (e) **Dependants' Benefit (DB)** : DB paid at the rate of 90% of wage in the form of monthly payment to the dependants of a deceased Insured person in cases where death occurs due to employment injury or occupational hazards.

**(f) Other Benefits:**

- Funeral Expenses: An amount of ₹ 10, 000/- is payable to the dependents or to the person who performs last rites from day one of entering insurable employment.
- Confinement Expenses: An Insured Women or an I.P.in respect of his wife in case confinement occurs at a place where necessary medical facilities under ESI Scheme are not available. In addition, the scheme also provides some other need based benefits to insured workers.
- Vocational Rehabilitation: To permanently disabled Insured Person for undergoing VR Training at VRS.
- Physical Rehabilitation: In case of physical disablement due to employment injury.
- Old Age Medical Care: For Insured Person retiring on attaining the age of superannuation or under VRS/ERS and person having to leave service due to permanent disability insured person & spouse on payment of ₹ 120/- per annum.
- Rajiv Gandhi Shramik Kalyan Yojana - This scheme of Unemployment allowance was introduced w.e.f. 01-04-2005. An Insured Person who become unemployed after being insured three or more years, due to closure of factory/establishment, retrenchment or permanent invalidity are entitled to :-
  - Unemployment Allowance equal to 50% of wage for a maximum period of upto one year.
  - Medical care for self and family from ESI Hospitals/Dispensaries during the period IP receives unemployment allowance.
  - Vocational Training provided for upgrading skills - Expenditure on fee/travelling allowance borne by ESIC.

An interesting feature of the ESI Scheme is that the contributions are related to the paying capacity as a fixed percentage of the workers' wages, whereas, they are provided social security benefits according to individual needs without distinction. Cash Benefits are disbursed by the Corporation through its Branch Offices (BOs) / Pay Offices (POs), subject to certain contributory conditions.

The Corporation at the request of the appropriate government may extend the medical benefit to the family of an insured person.

**Benefit cannot be an assigned/attached.**

As per section 60 the right to receive any payment of any benefit under this Act cannot be transferable or assignable. Similarly no cash benefit payable under this Act can be liable to attachment or sale in execution of any decree or order of any Court.

**Similar benefits under any other laws not allowed.**

If an insured person entitled to claim any benefit under this act has claimed any benefit he cannot claim similar benefits available under any other law for the time being in force.

**3.8.12 Employer not to reduce any payment or benefits under this Act**

Quite possible the employer directly or indirectly recovers the employer's contribution from the wages or benefits given under this Act. Section 85 prohibits such unethical practice on the part of employer. No employer by reason only of his liability for any contributions payable under this Act can, directly or indirectly, reduce the wages of any employee, or except as provided by the regulations, discontinue or reduce benefits payable to him under the conditions of his service which are similar to the benefits conferred by this Act.

**3.8.13 Penalties**

Penal provisions for false statement for the purpose of avoiding any payment or benefit or increasing any payment or benefit under this Act or not paying contribution are contained in Chapter VII of the Act. As per section 84 any person knowingly makes or cause to make a false statement or false representation for the purpose of causing any increase in payment or benefit or causing any payment or benefit not authorized under this Act or for the purpose of avoiding any payment or benefits to be made under this Act shall be punishable with imprisonment for a term which may extend to six months, or with fine not exceeding two thousand rupees, or with both.



Section 85 imposes fine or penalties and both for not paying employers contribution, or recovering whole or part of employers contribution from the salary or wages of the employee or reducing salary or wages or any benefit of the employee on account of employer contribution shall be punishable for a term which may extend to three years but

- (a) which shall not be less than one year, in case of failure to pay the employee's contribution which has been deducted by him from the employee's wages and shall also be liable to fine of ten thousand rupees;
- (b) Which shall not be less than six months, in any other case and shall also be liable to fine of five thousand rupees: for failure to deposit contribution. If the offence relates to recover of employers contribution from salary and wages of the employee or reduction any benefit or payment, with imprisonment for a term which may extend to one year or with fine which may extend to four thousand rupees, or with both.

### 3.8.14 Penalty for repeated violation

In order to discourage repeated violations of the provision of this Act, stringent provisions have been made in section 85 A. As per section 85A whoever having been convicted by a court of an offence punishable under this Act, commits the same offence shall, for every such subsequent offence, be punishable with imprisonment for a term which may extend to two years and with fine of five thousand rupees In case such subsequent offence is for failure by the employer to pay any contribution which under this Act he is liable to pay, he shall, for every such subsequent offence, be punishable with imprisonment for a term which may extend to five years but which shall not be less than two years and shall also be liable to fine of twenty-five thousand rupees.

Where an employer is convicted of an offence for failure to pay any contribution payable under this Act, the Court may, in addition to awarding any punishment by order, in writing require him within a period specified in the order to pay the amount of contribution in respect of which the offence was committed, and to furnish the return relating to such contributions. In such a case the employer shall not be liable under this Act in respect of the continuation of the offence during the period or extended period, if any, allowed by the Court, but if, on the expiry of such period or extended period, as the case may be, the order of the Court has not been fully complied with, the employer shall be deemed to have committed a further offence and shall be punishable with imprisonment in respect thereof under section 85 and shall also be liable to pay fine which may extend to one thousand rupees for every day after such expiry on which the order has not been complied with.

**Note:** Offence on the part of the employer for non-compliance of the provisions of the Act does not get wiped off with the belated payments; Sub-Regional office, ESI Corporation v Krishnachan Shetty, 2005 LLR 853.

As a partner of the firm owing the factory, he is liable to be prosecuted for non-distribution of the identity/contribution cards. Shankar Bhattacharjee v Bholanath Ghosh (1987) 1CLR 413 cal

### 3.8.15 Exemption of a Factory or Establishment or Class of Factories or Establishments

Appropriate government has been given power under section 87 of the Act to exempt any factory or establishment or class of factories or establishments in any specified area from the operation of this Act for a period not exceeding one year and may from time to time by like notification renew any such exemption for periods not exceeding one year at a time. Similarly the appropriate government may, exempt any person or class of persons employed in any factory or establishment, or class of factories or establishments to which this Act applies from the operation of the Act. Such exemption orders will be issued by the appropriate government only after giving reasonable opportunity of being heard to the Corporation. Such exemption may be with or without any conditions which may be specified in such notification.

The appropriate government may, with the consent of the Corporation, by notification in the Official Gazette, exempt any employees or class of employees in any factory or establishment or class of factories or establishments from one or more of the provisions relating to the benefits provided under this Act.

With regard to the factories or establishments belonging to government or any local authority, the appropriate government may, after consultation with the Corporation, by notification in the Official Gazette and subject

to such conditions as may be specified in the notification, exempt any factory or establishment belonging to any local authority, from the operation of the Act], if the employees in any such factory or establishment are otherwise in receipt of benefits substantially similar or superior to the benefits provided under this Act. It may further be noted that the exemption notifications issued by the appropriate government can be prospective as well retrospective.

**Note:** Exempting persons or class of persons from coverage under ESI Act Should not be in a mechanical manner hence an employer, seeking exemption under ESI Act, has to prove that medical facilities and other benefits as extended to employees are better than those under the ESI Act, Lark laboratories (India) ltd v Government of NCT of Delhi 2006 LLR 1093 2007(1)LLJ 72 (Del)HC

### **3.8.16 Power to Disentitle Benefit to Insured Person**

In order to prevent misuse of the benefits available under this Act If the Central Government is satisfied that the benefits under this Act are being misused by insured persons in a factory or establishment, that Government may disentitle such persons from such of the benefits as it thinks fit: Before passing such order a reasonable opportunity of being heard is given to the concerned factory or establishment, insured persons and the trade unions registered under the Trade Unions Act, 1926 having members in the factory or establishment.

### **3.8.17 Power of Corporation to make regulations [ Sec.97]**

The E.S.I. Corporation, subject to certain conditions, can prescribe regulations and rules for the administration of the affairs of the Corporation and for carrying into effect the provisions of this Act.

#### **At a glance:**

- The Employees State Insurance Act is a social welfare legislation aimed at bringing about social and economic justice to workers employed in the factories and establishment to which this Act applies.
- The Act is applicable in the first instance, to all factories (including factories belonging to the government) other than seasonal factories.
- This act is not applicable to a factory or establishment belonging to or under the control of the government whose employees are otherwise in receipt of benefits substantially similar or superior to the benefits provided under this Act
- Every employee of a factory or establishment to which the Act applies is an insurable person.
- The ESI scheme is administered by The Employees' State Insurance Corporation.
- Employee State Insurance corporation a corporate body having perpetual existence and common seal has been set up by the Central Government by virtue power conferred upon it vide section 3 of the Act.
- A Standing Committee is constituted from among the members of the ESI Corporation to act as an executive body for administration of the scheme under general supervision of ESI corporation [Sec 8 and 18].
- It is compulsory to get all the employees in a factory or establishment to which this Act apply insured in the manner provided by this Act.
- The insurance fund is mainly derived from contribution from employers and employees.
- Benefits available to the insured persons under the Act are provided in Chapter V section 46.
- These benefits are as follows:
  - (i) Sickness Benefit.
  - (ii) Maternity Benefit.
  - (iii) Disablement Benefit.
  - (iv) Dependants' Benefit.
  - (v) Medical Benefit.
  - (vi) Funeral Expenses.



### 3.9. EMPLOYEES' PROVIDENT FUNDS AND MISCELLANEOUS PROVISIONS ACT, 1952

The Employees' Provident Fund & MP Act, 1952 is an important piece of Labor Welfare legislation enacted by the Parliament to provide social security benefits to the workers by making provision for future of Industrial workers and their dependents in case of their retirement and in the event of their premature death. By gradual extension of the scope and coverage of the Act, the benefit are being made applicable to a wide range of employees working in factories, mines, plantations, construction industries, educational institution and other classes of establishment in a short period.. At present, the Act and the Schemes framed there under provides for three types of benefits-Contributory Provident Fund, Pensioner benefits to the employees/ family members and the insurance cover to the members of the Provident Fund. The EPF scheme take care of the following needs of its members(i) Retirement (ii) Medical care (iii) Housing (iv) Family obligation (v) Education of children (vi) Financing of insurance scheme.

The object of the Act in 1952 was the institution of the compulsory contributory Provident Fund to the employees to which both the employee and the employer would contribute. The Employees' Provident Fund Scheme was accordingly framed under the Act and it came into effect from 1-11-1952. Initially the title of the Act, was, "The Provident Fund Act, 1952".

On a review of the working of the scheme over the years, it was found that in the event of the premature death of the employees the accumulation in the Provident Fund were too meager to the family of the deceased .Thus another social security benefit of providing Family Pension through the Employees' Family Pension Fund Scheme, 1971 was introduced by amending the Act. At this stage, the Act was renamed as "The Employees' Provident Fund & Family Pension Act, 1952" and the Employees' Family Pension Scheme came into force on 1-3-1971.

The Act was further amended in the year 1976 to introduce another social security benefit to provide an insurance cover to the members of the Provident Fund in covered establishment. The Employees' Deposit Linked Insurance Scheme, 1976 came into force from 1-8-1976. The name of the Act was then changed to the present one i.e. 'The Employees' Provident Fund & MP Act, 1952'. From 16-11-1995, the Employees' Pension Scheme has come into force which provides pension to retiring employees on reaching 50/60 years of age, widow pension, children pension and nominee pension on death of the member to his eligible family members. This replaces the Employees' Family Pension Scheme, 1971.

The provisions of the Employees' Provident Fund & MP Act, 1952 extends to whole of India except the State of Jammu & Kashmir and also the State of Sikkim where it has not been notified so far after its annexation with the Union of India.

Originally the various schemes under this Act were applicable only to Indian Workers, which have employed 50, or more, which was subsequently reduced to 20 and above employee with effect from 31.12.1960. A special provision has been made in respect of Cinema theatres employing 5 or more employees on any day in a year. Now the Government of India Vide notification dated 1st October 2008, has broadened the scope of the Employees Provident fund Scheme,1952 and the Employees Pension Scheme, 1995 to include separate category of Indian Employees working outside India and employees other than Indian Employees, holding other than Indian Passport and working for the establishment in India. A new category of International workers has been introduced under the provisions of the amended provident fund scheme. This Act contains 23 sections and 4 schedules.

The State Government of Jammu & Kashmir have instituted a separate Provident Fund Scheme w.e.f. 1-6-1961.The important terms used and salient features of the three schemes under the Act are discussed as under;

#### 3.9.1 Constitutional provision

Entry No 24 list III of schedule 7 to Constitution of India. Both Central and State Governments have power to legislation.

### 3.9.2 Coverage

Whole of India except the state of Jammu & Kashmir which has instituted a separate Provident fund scheme

### 3.9.3 Applicability

Subject to the provisions contained in section 16, it applies—

- (a) To every establishment which is a factory engaged in any industry specified in Schedule I and in which twenty or more persons are employed, and
- (b) To any other establishment employing twenty or more persons or class of such establishments which the Central Government may, by notification in the Official Gazette, specify in this behalf:
- (c) The Central Government may, after giving not less than two months' notice of its intention so to do, by notification in the Official Gazette, apply the provisions of this Act to any establishment employing such number of persons less than twenty as may be specified in the notification.

Notwithstanding anything contained in sub-section (3) of section 1 or sub-section (1) of section 16, if Central Provident Fund Commissioner feels, whether on an application made to him in this behalf or otherwise, that the employer and the majority of employees in relation to any establishment have agreed that the provisions of this Act should be made applicable to the establishment, he may, by notification in the Official Gazette, apply the provisions of this Act to that establishment on and from the date of such agreement or from any subsequent date specified in such agreement.

An establishment to which this Act once applies continues to be governed by this Act notwithstanding that the number of persons employed therein at any time falls below twenty.

#### Non Applicable to:

The Act does not apply to certain establishments as specified under Section 16 of the Act. As per section 16 of the Act, the act is not applicable to:

- (a) Any establishment registered under the co-operative societies Act 1912 or under any other law for the time being in force in any state relating to co-operative societies employing less than 50 persons and working without the aid of power or
- (b) to any establishment belonging to or under the Control of the Central Government or a State Government and whose employees are entitled to the benefit of CPF or old age pension. Or
- (c) Any other establishment set up under any Central Provincial or State Act and whose employees are entitled to any Contributory provident fund or old age pension.
- (d) Any newly setup establishment (less than 3 years).

Central Government having regard to the financial position of any class of establishment or other circumstances of the case may exempt that class of establishment from the operation of this Act for such period as specified in the notification issued for this purpose.

### 3.9.4 Definitions

Section 2 of the Act defines various terms and expressions used in the act, which are given below:

In this Act, unless the context otherwise requires,—

[(a) "appropriate Government" means—

- (i) in relation to an establishment belonging to, or under the control of, the Central Government or in relation to an establishment connected with a railway company, a major port, a mine or an oil field or a controlled industry, or in relation to an establishment having departments or branches in more than one State, the Central Government; and
- (ii) in relation to any other establishment, the State Government;]



(aa "authorised officer" means the Central Provident Fund Commissioner, Additional Central Provident Fund Commissioner, Deputy Provident Fund Commissioner, Regional Provident Fund Commissioner or such other officer as may be authorised by the Central Government, by notification in the Official Gazette;

It was held in PGT Components Pvt. Ltd Noida and other v Assistant PP Commissioner (2003) 1 LLJ 1033 ALL that the provident fund commissioner while discharging the duties under this act was not a court

- (b) "basic wages" means all emoluments which are earned by an employee while on duty or on leave or on holidays with wages in either case] in accordance with the terms of the contract of employment and which are paid or payable in cash to him, but does not include—
- (i) the cash value of any food concession ;
  - (ii) any dearness allowance (that is to say, all cash payments by whatever name called paid to an employee on account of a rise in the cost of living), house-rent allowance, overtime allowance, bonus, commission or any other similar allowance payable to the employee in respect of his employment or of work done in such employment;
  - (iii) any presents made by the employer;

**Note:**

- (i) In Regional Commissioner EPF, Tamil Nadu V Management of South Alloys Foundaries (P) Ltd 19821 LLJ 21 Mad It was held that special allowance paid to the employees as a result of an agreement cannot be treated basic wages for the purpose of computation of employer's contribution
  - (ii) In Manipal Academy of Higher education v Provident fund commissioner, 2008 II LLJ 666 SC, it was held that the amount received by encashing earned leave is not part of basic wages under this act.
  - (iii) In Prantiya Vidhyut Mandal Mazdoor federation etc v Rajasthan State Electricity Board and others 1993 1 LLJ 222 SC it was held that arrears earned by the employees under award is wages and contribution would be paid on such arrears also.
- (c) "contribution" means a contribution payable in respect of a member under a Scheme [or the contribution payable in respect of an employee to whom the Insurance Scheme applies];
- (d) "controlled industry" means any industry the control of which by the Union has been declared by a Central Act to be expedient in the public interest;
- (e) "employer" means—
- (i) in relation to an establishment which is a factory, the owner or occupier of the factory, including the agent of such owner or occupier, the legal representative of a deceased owner or occupier and, where a person has been named as a manager of the factory under clause (f) of sub-section (1) of section 7 of the Factories Act, 1948 (63 of 1948), the person so named; and
  - (ii) in relation to any other establishment, the person who, or the authority which, has the ultimate control over the affairs of the establishment, and where the said affairs are entrusted to a manager, managing director or managing agent, such manager, managing director or managing agent;
- (f) "employee" means any person who is employed for wages in any kind of work, manual or otherwise, in or in connection with the work of [an establishment], and who gets his wages directly or indirectly from the employer, and includes any person—
- (i) employed by or through a contractor in or in connection with the work of the establishment;
  - (ii) engaged as an apprentice, not being an apprentice engaged under the Apprentices Act, 1961 or under the standing orders of the establishment

**Note:**

Before a person can be said to be an employee there must be proof

- (i) that he is employed
- (ii) that he is employed for wages
- (iii) that he is employed in work, manual or otherwise
- (iv) that the work is in connection with the work of factory or establishment and
- (v) that he gets his wages directly or indirectly from the employer.

In *Mohamad Ali V Union of India* 1963 II LLJ 536 it was argued that the Act was intended by parliament to apply to employees who were mere wage earners and not to the salaries servants, This contention was rejected by the SC on the following grounds. "It is a little difficult to appreciate the distinction sought to be made Both salary and wages are emoluments paid to an employee by way of recompensate for his labor. The Act itself has not made any distinction between wages and salary. Both may be paid weekly, fortnightly or monthly through remuneration for the day's work is not ordinary termed salary. Simply that wages for the month run into hundreds as they very often do now, it would not mean that the employees is not earning wages properly so called.-----It is therefore not established that the Act was not intended to apply to salaries employees if by salary is meant fortnightly or monthly wages running into hundreds per month.

- (ff) "exempted employee" means an employee to whom a Scheme or the Insurance Scheme, as the case may be, would, but for the exemption granted under [\*\*\*] section 17 have. applied;
- (fff) "exempted establishment" means [an establishment] in respect of which an exemption has been granted under section 17 from the operation of all or any of the provisions of any Scheme [or the Insurance Scheme, as the case may be,] whether such exemption has been granted to the establishment as such or to any person or class of persons employed therein;
- (g) "factory" means any premises, including the precincts thereof, in any part of which a manufacturing process is being carried on or is ordinarily so carried on, whether with the aid of power or without the aid of power;

**Note:**

- (i) In *Pragnarrain v Crown*, AIR 1928 Lah 78 it was held that factory means premises where anything is done towards making or finishing of an article upto the stage when it is ready to be sold or is in a suitable condition to be put in the market.
- (ii) In *State V Jograj* AIR 1961 ALL 556 it was held a company engaged in manufacturing grinding wheels and transporting them for sale is a factory within the meaning of section 2(g) of the Act because when grinding wheels are being prepared and transported for sale it would be a manufacturing process.
- (h) "Fund" means the provident fund established under a Scheme;
- (i) "industry" means any industry specified in Schedule I, and includes any other industry added to the Schedule by notification under section 4;
  - (ia) "Insurance Fund" means the Deposit-linked Insurance Fund established under sub-section (2) of section 6C;
  - (ib) "Insurance Scheme" means the Employees' Deposit-linked Insurance Scheme framed under sub-section (1) of section 6C;
  - (ic) "manufacture" or "manufacturing process" means any process for making, altering, repairing, ornamenting, finishing, packing, oiling, washing, cleaning, breaking up, demolishing or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery or disposal;



**Note:**

In case of owner v Cottingham Sanctuary co Ltd, 1970 74 JP 219 it was held that the worlds manufacturing process do not necessarily refer to something produced but to the particular business carried on. It was further held that where a laundry was being carried on for the purpose of gain and in which mechanical power was used for driving machines used in aid of the work of washing clothes it was held to be a factory

- (j) "member" means a member of the Fund;
- (k) "occupier of a factory" means the person who has ultimate control over the affairs of the factory, and, where the said affairs are entrusted to a managing agent, such agent shall be deemed to be the occupier of the factory;
- (ka) "Pension Fund" means the Employees' Pension Fund established under sub-section (2) of section 6A;
- (kb) "Pension Scheme" 'means the Employees' Pension Scheme framed under sub-section (1) of section 6A;
- (kc) "prescribed" means prescribed by rules made under this Act;
- (kd) "Recovery Officer" means any officer of the Central Government, State Government or the Board of Trustees constituted under section 5A, who may be authorised by the Central Government, by notification in the Official Gazette, to exercise the powers of a Recovery Officer under this Act;
- (l) "Scheme" means the Employees' Provident Fund Scheme framed under section 5;
- (ll) "superannuation", in relation to an employee, who is the member of the Pension Scheme means the attainment, by the said employee, of the age of fifty-eight years;
- (m) "Tribunal" means the Employees' Provident Funds Appellate Tribunal constituted under section 7D;

**Note:** Under the Employees Provident funds scheme, the retired employees from Railway cannot be treated as excluded employees. Central Provided Fund commissioner V Modern Transportation consultancy service ltd 2009 LLR 324 SN Cal HC

- (ii) A school covered under the Provident fund Act, will not be liable for payment of contributions of the employees such a drivers, conductors as engaged by the transport contractor for providing transport facilities. Springdales School V Regional Provident Fund Commissioner, 2006 LLR 47
- (iii) A partner of a firm having a status of beneficiary will not be an employee either to be covered or counted under the Act, Prakash D, Shah v Union of India 2004 LLR 218 Bombay
- (iv) Contribution towards provident fund can only be on basic wages, it is not at all necessary that the workmen must actually be on duty and should actually have worked; Changdeo Sugar Mills v Union of India 2001 LR 188 SC

Payment of bonus cannot be of a fixed or proven nature having no nexus with the quantity of extra output produced by workers; Daily Partap v Regional Provident Fund Commissioner; AIR 1999 SC 2015

**Sec. 2A. Establishment to include all departments and branches.**

For the removal of doubts, it is hereby declared that where an establishment consists of different departments or has branches, whether situate in the same place or in different places, all such departments or branches shall be treated as parts of the same establishment.

**Note:** An establishment will include all departments and branches and if two units are put together as a single establishment, the Act will be applicable and otherwise not; Noor Niwas Nursery Public school v Regional Provident F und Commissioner, 2001 LLR 99SC

To determine whether different units of an employer constitute one establishment or separate establishment various tests will have to be applied. But it is not possible to lay down one test as absolute and invariable test of all cases; Wipro Ltd Tunkur v Regional Provident Fund Commissioner Karnataka 1995 LLJ 120 Karn HC.

### **Sec.5. Employees' Provident Fund Schemes.**

- (l) The Central Government may, by notification in the Official Gazette, frame a Scheme to be called the Employees' Provident Fund Scheme for the establishment of provident funds under this Act for employees or for any class of employees and specify the establishments or class of establishments to which the said Scheme shall apply and there shall be established, as soon as may be after the framing of the Scheme, a Fund in accordance with the provisions of this Act and the Scheme.
- (1A) The Fund shall vest in, and be administered by, the Central Board constituted under section 5A.
- (1B) Subject to the provisions of this Act, a Scheme framed under sub-section (1) may provide for all or any of the matters specified in Schedule II.
- (2) A Scheme framed under sub-section (1) may provide that any of its provisions shall take effect either prospectively or retrospectively on such date as may be specified in this behalf in the Scheme.

The Employeee, member of Employee's provident fund Scheme is a consumer and facilities provided by provident fund scheme are services ;Regional Provident Fund Commissioner v Shiv Kumar Joshi, AIR 2000 SC 331

### **Sec. 6A. Employees' Pension Scheme**

- (1) The Central Government may, by notification in the Official Gazette, frame a Scheme to be called the Employees' Pension Scheme for the purpose of providing for—
  - (a) superannuation pension, retiring pension or permanent total disablement pension to the employees of any establishment or class of establishments to which this Act applies; and
  - (b) widow or widower's pension, children pension or orphan pension payable to the beneficiaries of such employees.
- (2) Notwithstanding anything contained in section 6, there shall be established, as soon as may be after framing of the Pension Scheme, a pension fund into which there shall be paid, from time to time, in respect of every employee who is a member of the Pension Scheme,—
  - (a) such sums from the employer's contribution under section 6, not exceeding eight and one-third per cent of the basic wages, dearness allowance and retaining allowance, if any, of the concerned employees, as may be specified in the Pension Scheme;
  - (b) such sums as are payable by the employers of exempted establishments under sub-section (6) of section 17;
  - (c) the net assets of the Employees' Family Pension Fund as on the date of the establishment of the Pension Fund;
  - (d) such sums as the Central Government may, after due appropriation by Parliament by law in this behalf, specify.
- (3) On the establishment of the Pension Fund, the Family Pension Scheme (hereinafter referred to as the ceased scheme) shall cease to operate and all assets of the ceased scheme shall vest in and shall stand transferred to, and all liabilities under the ceased scheme shall be enforceable against, the Pension Fund and the beneficiaries under the ceased scheme shall be entitled to draw the benefits, not less than the benefits they were entitled to under the ceased scheme, from the Pension Fund.
- (4) The Pension Fund shall vest in and be administered by the Central Board in such manner as may be specified in the Pension Scheme.
- (5) Subject to the provisions of this Act, the Pension Scheme may provide for all or any of the matters specified in Schedule III.
- (6) The Pension Scheme may provide that all or any of its provisions shall take effect either prospectively or retrospectively on such date as may be specified in that behalf in that Scheme.



- (7) A Pension Scheme, framed under sub-section (1), shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the scheme or both Houses agree that the Scheme should not be made, the Scheme shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that Scheme.]

**Note:** Once an employee has opted for the employee provident fund scheme and had withdrawn the entire amount, then such employee cannot be permitted to switch over to the Employee's pension scheme; *Ram Sing v State of Uttar Pradesh*, 2005 LLR 349 AL.

### **Sec. 6C. Employees' Deposit-linked Insurance Scheme.**

- (1) The Central Government may, by notification in the Official Gazette, frame a scheme to be called the Employees' Deposit-linked Insurance Scheme for the purpose of providing life insurance benefits to the employees of any establishment or class of establishments to which this Act applies.
- (2) There shall be established, as soon as may be after the framing of the Insurance Scheme, a Deposit-linked Insurance Fund into which shall be paid by the employer from time to time in respect of every such employee in relation to whom he is the employer, such amount, not being more than one percent of the aggregate of the basic wages, dearness allowance and retaining allowance (if any) for the time being payable in relation to such employee as the Central Government may, by notification in the Official Gazette, specify.

**Explanation:** For the purposes of this sub-section, the expressions "dearness allowance" and "retaining allowance" have the same meanings as in section 6.

- (4) (a) The employer shall pay into the Insurance Fund such further sums of money, not exceeding one-fourth of the contribution which he is required to make under sub-section (2), as the Central Government may, from time to time, determine to meet all the expenses in connection with the administration of the Insurance Scheme other than that expenses towards the cost of any benefits provided by or under that scheme.
- (5) The Insurance Fund shall vest in the Central Board and be administered by it in such manner as may be specified in the Insurance Scheme.
- (6) The Insurance Scheme may provide for all or any of the matters specified in Schedule IV.
- (7) The Insurance Scheme may provide that any of its provisions shall take effect either prospectively or retrospectively on such date as may be specified in this behalf in that Scheme.

#### **At a glance:**

- This act is applicable to every establishment which is a factory engaged in any industry mentioned in schedule 1 of the Act and employing 20 or more persons.
- An establishment once government by this act continues to be governed by this act even if the number of person employed falls below 20 subsequently.
- Central Government has power to apply the provision of this Act to any other establishment employing less than 20 persons.
- The provision of this Act has been extended to Cinema theater employing 5 or more persons.
- This act was initially known as Provident fund Act.
- This act is not applicable to the State of Jammu and Kashmir and Sikkim.

- Only employee getting not more than ₹ 15,000 monthly salary and wages are covered by this Act.
- Employee includes any person employed by or through a contractor in or in connection with the work of an establishment including an apprentice but not under Apprentice Act, 1961 or under standing order of the establishment.
- Basic wages excludes cash value of any food concession, any dearness allowance or any other allowance like HRA, OTA, Bonus and commission.
- Recently new class of workers called International workers has also been covered under Employees Provident fund scheme.
- An employee who had been member of the fund but withdraw the full accumulated amount in the fund after retirement is not covered under this act.
- Employers contribution under this Act is 12% or 10% as the case may be of the basic wages, dearness allowance including and food concession and retaining allowance.
- In case of sick industrial co, establishment having accumulated loss equal to entire paid up capital, establishment in jute industry, Beedi Industry, brick Industry, Coir industry, Gaur Gum factories the employer contribution is only 10%.
- 8.33% of basic wages, dearness allowance including retaining allowance goes towards employee's pension scheme, remaining 1.67%/3.67% towards provident fund.
- Employer contributes 0.5% of wages, dearness allowance, retaining allowance towards Employees Deposit linked insurance scheme.
- The required contribution under this act must be paid within 15 days from the close of every month with the provident fund commissioner.
- Non-payment of contribution entails damages in addition to criminal prosecution.
- On death of a member the family member or nominee can claim Employee Linked Deposit Insurance (ELDI) benefit.
- The amount of ELDI is higher of 20 times of last twelve months average monthly wages or amount of benefit as per Para 22(1) of EDLI Scheme 1976.
- The maximum amount of insurance payable on death of an employee is Rs130,000
- Within in 15 days from the date of applicability of this Act the employer is required to send the particulars of all branches, departments, owners, occupiers, directors, partners or any other person in charge of and responsible for the conduct of business, in form 5A in duplicate to the Commissioner of Provident fund.
- Any change in the above particulars also needs to be intimated to the Regional Commissioner within 15 days thereof..
- A monthly return of contribution in the prescribed form 6 is required to be filed with the Commissioner within 25 days of the close of the month.
- Annual return of contribution in form 6A in respect of each employee is to be submitted within one month of the close of the period of currency to the Commissioner.



### 3.10. THE CHILD LABOUR (PROHIBITION AND REGULATION) ACT, 1986

Children have always been subject to exploitation, inhuman treatment and abuse everywhere since long. Almost in every country there are various social legislations aimed at protection of children from any form of exploitation and misuse. In our country also from time to time various enactments namely “ The Protection of Children from Sexual Offences Act ,2012, The Commission for Protection of Child Rights Act,2005, the prohibition of child Marriage Act ,2006, The Juvenile Justice (Care and protection of Children) Act,2000, etc have been made. Still the children especially from the poor and uneducated families are not free from one or exploitation. Employment of child as a bonded labor or otherwise in factories, road side Dhabas, Restaurant, Motor-car Workshops etc is common. There are a number of Acts which prohibit the employment of children below 14 yrs of age and 15 years in certain specified employment. However, there is no procedure laid down in any law for deciding in which employment, occupations or process the employment of children should be prohibited. There is also no law to regulate the working of conditions of children in most employments where they are not prohibited from working and working under various exploitative conditions.

Child is a future not only of his family but also of a nation. The framers of Indian constitution also thought it prudent to ensure at least the minimum rights to children which they considered is essential for proper development of human being. Indian Constitution accorded some fundamental rights to children. Right to Education Act, Child Labour(Prohibition & Regulation) Act, 1986 are in the spirit of the constitutional duty cast upon the state.

Article 24 of the Indian Constitution prohibits employment of children below 14 years of age in any factory or mine or other hazardous employment. Accordingly the social as well constitutional validity of the Child Labour(Prohibition and Regulation) Act, 1986 though enacted belatedly after more than 35 years of coming into force of Indian Constitution cannot be questioned.

This Act outlines the area where and how children can work and also the area where they cannot work. Though complete ban on employment of children in any employment has neither been made not practicable due to implementation problems and wide spread poverty, so the act outlines the conditions in which children may work in occupations/processes not listed in the schedule. The list of occupations and processes included in schedule to the Act is dynamic as from time to time new occupations and process are being added by the Central Government at the advice of Central Child labor Advisory Committee.

#### 3.10.1 Object of the Act

The basic objective of the Child Labor (Prohibition & Regulation) Act, 1986 is to prohibit the engagement of children in certain employment's and to regulate the conditions of work or children in certain other employment's. The objective of the Act can be summarized as under:

- (i) To ban the employment of children in specified occupations and processes
- (ii) To lay down a procedure to decide modification to the schedule of banned occupations and processes.
- (iii) To regulate the conditions of work of children in employments where they are not prohibited from working
- (iv) To lay down enhanced penalties for employment of children in violation of the provisions of this Act and other Acts which forbid the employment of children.

#### 3.10.2 Definitions

Various terms and expressions used in this Act have been defined in section 2. The expressions used and so defined in the Act are as under:

In this Act, unless the context otherwise requires:-

- (i) Appropriate Government means, in relation to an establishment under the control of Central

Government or a railway administration or a major port or a mine or oilfield, the Central Government and in all other cases, the State Government.

- (ii) Child: Child means a person who has not completed his fourteen years of age.
- (iii) Day means a period of twenty four hours beginning at mid night
- (iv) Establishment includes a shop, commercial establishment, workshop, farm, residential hotel, eating house, theatre or other place of public amusement or entertainment.  
It may be noted that definition of the term "Child," "Appropriate Government" under this Act is same as in the Minimum wages Act, 1948
- (v) Family in relation to an occupier, means the individual, the wife or husband, as the case may be, of such individuals and their children, brothers or sisters of such individuals
- (vi) occupier in relation to an establishment or a workshop, means the person who has the ultimate control over the affairs of the establishment or workshop
- (vii) port authority means any authority administering a port
- (ix) week means a period of seven days beginning at midnight on Saturday night or such other night as may be approved in writing for a particular area by the inspector
- (x) workshop means any premises (including the precincts thereof) wherein any industrial process is carried on, but does not include any premises to which the provisions of section 67 of the factories Act, 1948 for the time being apply.

**Note:**

It may be noted that definition of the term "Child," "Appropriate Government" under this Act is same as in the Minimum wages Act, 1948. This act has changed definition of child to one who has not completed the age of fourteen years of age by repealing the erstwhile The Employment of Children Act, 1938. At the same time the age of child in other Acts like The Minimum Wages Act, 1948, The Plantation labor Act, 1951, The Merchant Shipping Act, 1958, and the Motor Transport Act, 1961.

However, the Factories Act, 1948 define child a person who has not completed his fifteenth year of age which is different from the definition of child in other Acts as mentioned above.

**3.10.3 Applicability**

The Act extends to the whole of India. The Act contains 4 parts and one schedule which again is in two parts A and B. Provisions contained in Part III of the Act for regulating conditions of work of Children came into effect with effect from 26th May 1993, whereas for other provisions of the Act, the central Government has power to appoint different dates for different states and for different class of establishments,

**3.10.4 Prohibition of employment of children in certain occupations and processes**

Part II of the Act through section 3 prohibit employment of children in the occupations set forth in part A of the schedule and processes set forth in part B of the schedule. This restriction is not applicable if in any workshop any process is carried on by the occupier with the aid of his family or to any school stabled by or receiving any assistance or recognition from Government.

**Note:** The prohibition of employment of children is not applicable to any workshop wherein an y process is carried on by the occupier with the aid of his family or to any school established by or receiving any assistance or recognition from Government.

Children can be employed in the process of packing but packing should be done in any area away from the place of manufacturing to avoid exposure to accident. MC Mehta vs. State of Tamil Nadu, AIR 1991 SC 417.

Central Government has been empowered under section 4 to add any occupation or processes to the schedule after giving not less than three months notice.



In the exercise of the power so conferred upon the Central Government, the Central Government is assisted by an advisory committee called “**The Child Labour Technical Advisory Committee**’ to advise for the purpose of addition of any occupation or processes to the schedule ( Sec 5)

- The Committee shall consist of a Chairman and such other members not exceeding ten, as may be appointed by the Central Government.
- The Committee shall meet as often as it may consider necessary and shall have power to regulate its own procedure.
- The Committee may, if it deems it necessary so to do, constitute one or more sub-committees and may appoint to any such sub-committee, whether generally or for the consideration of any particular matter, any person who is not a member of the Committee.
- The term of office of, the manner of filling casual vacancies in the office of, and the allowance, if any, payable to, the Chairman and other members of the Committee, and the conditions and restrictions subject to which the Committee may appoint any person who is not a member of the Committee as a member of any of its sub-committees shall be such as may be prescribed.

In case of MC Mehta V State of Tamil Nadu, AIR 1991 SC 417 it was held that children can be employed in the process of packing but packing should be done in any area away from the place of manufacture to avoid exposure to accident.

### **3.10.5 REGULATION OF CONDITIONS OF WORK OF CHILDREN**

#### **(A) Hours and period of work(Sec7)**

- (1) No child shall be required or permitted to work in any establishment in excess of such number of hours, as may be prescribed for such establishment or class of establishments.
- (2) The period of work on each day shall be so fixed that no period shall exceed three hours and that no child shall work for more than three hours before he has had an interval for rest for at least one hour.
- (3) The period of work of a child shall be so arranged that inclusive of his interval for rest, under sub-section (2), it shall not be spread over more than six hours, including the time spent in waiting for work on any day.
- (4) No child shall be permitted or required to work between 7 p.m. and 8 a.m.
- (5) No child shall be required or permitted to work overtime.
- (6) No child shall be required or permitted to work in, any establishment on any day on which he has already been working in another establishment.

#### **Comments:**

This section stipulates that no child shall work for more than 3 hours before he has had an interval for rest for at least one hour. The double employment of a child is banned.

#### **(B) Weekly holidays (Sec 8)**

Every child employed in an establishment shall be allowed in each week, a holiday of one whole day, which day shall be specified by the occupier in a notice permanently exhibited in a conspicuous place in the establishment and the day so specified shall not be altered by the occupier more than once in three months.

#### **Comments:**

The child employed in an establishment is entitled for a holiday of one whole day in each week.

**(C) Health and Safety (Sec 13)**

- (1) The appropriate Government may, by notification in the official Gazette, make rules for the health and safety of the children employed or permitted to work in any establishment or class of establishments.
- (2) Without prejudice to the generality of the foregoing provisions, the said rules may provide for all or any of the following matters, namely :
  - (a) cleanliness in the place of work and its freedom from nuisance;
  - (b) disposal of wastes and effluents;
  - (c) ventilation and temperature;
  - (d) dust and fume;
  - (e) artificial humidification;
  - (f) lighting;
  - (g) drinking water;
  - (h) latrine and urinals;
  - (i) spittoons;
  - (j) fencing of machinery;
  - (k) work at or near machinery in motion;
  - (l) employment of children on dangerous machines;
  - (m) instructions, training and supervision in relation to employment of children on dangerous machines;
  - (n) device for cutting off power;
  - (o) self-acting machines;
  - (p) easing of new machinery;
  - (q) floor, stairs and means of access;
  - (r) pits, sumps, openings in floors, etc.;
  - (s) excessive weights;
  - (t) protection of eyes;
  - (u) explosive or inflammable dust, gas, etc.;
  - (v) precautions in case of fire;
  - (w) maintenance of buildings; and
  - (x) safety of buildings and machinery.

**Comments:**

The appropriate Government is empowered to make rules in such matters as cleanliness, disposal of wastes, dust, lighting, precaution against fire, protection of eyes, spittoons and ventilations, etc., in any establishment for the health and safety of the children employed or permitted to work.

**3.10.6 Penalty for violation of any Provision of this Act (Sec 14)**

In a non-prohibited process/occupations the working hours of child labor cannot exceed the hours prescribed. Children can work only in non-hazardous processes/occupations. Any person contravening the provision of this act is liable for imprisonment for a term which may range from 3 months to one year or fine ranging between ₹10,000-20,000 or both.. Who commit the same offence again is liable for imprisonment ranging from 6 month to 2 yrs.



In order to prosecute an employer under section 14 of the Act, the age of the child must be proved to be less than 14 years of age and onus lies upon the prosecution. In *Ram Chander V State of UP* (2002) 1 LLJ907 (All) the petitioner was prosecuted under this Act for having employed a person below 12 years in his carpet loom.

(VIII) Where to make complaint

Any person can make a complaint for the commission of any offence under this Act. All offences under this Act are tried by a court not inferior to that of a Metropolitan Magistrate or a Magistrate of first Class.

### **3.10.7 Prohibited Occupations:**

**Occupations listed in Part A of Schedule I are prohibited occupations. Detail of such occupation is as under:**

- (1) Transport of passengers, goods; or mails by railway
- (2) Cinder picking, clearing of an ash pit or building operation in the railway premise.
- (3) Work in a catering establishment at a railway station, involving the movement of vendor or any other employee of the establishment from one platform to another or into or out of a moving train.
- (4) Work relating to the construction of railway station or with any other work where such work is done in close proximity to or between the railway lines.
- (5) The port authority within the limits of any port.
- (6) Work relating to selling of crackers and fireworks in shops with temporary licenses
- (7) Abattoirs/slaughter Houses
- (8) Automobile workshops and garages.
- (9) Foundries
- (10) Handling of taxies or inflammable substance or explosives
- (11) Handloom and power loom industry
- (12) Mines (underground and under water) and collieries
- (13) Plastic units and Fiber glass workshop
- (14) Employment of children as domestic workers or servant
- (15) Employment of children in dhabas, restaurants, hotels, motels, tea shops, resorts, spas or other recreational centers
- (16) Diving
- (17) Circus
- (18) Caring of Elephants

### **Prohibited Proceses:**

**Process included in part B of schedule 1 are prohibited process Details of Processes mentioned in Part B are as under;**

*In any workshop wherein any of the following processes is carried on.*

- (1) Beedi making
- (2) Carpet Weaving
- (3) Cement manufacture including bagging of cement.
- (4) Cloth printing, dyeing and weaving.
- (5) Manufacture of matches, explosive and fireworks.
- (6) Mica cutting and splitting.

- (7) Shellac manufacture
- (8) Soap manufacture
- (9) Tanning.
- (10) Wool cleaning
- (11) Building and construction industry
- (12) Manufacture of slate pencils (including packing)
- (13) Manufacture of products of agate
- (14) Manufacturing processes using toxic metals and substances such as lead, mercury, manganese, chromium, cadmium, benzene, pesticides and asbestos (Section-3)
- (15) All Hazardous process as defined in section 2( cb) and dangerous operations as notified in ruler made under section 87 of the factories Act 1948
- (16) Printing (as defined in section 2(k) of the factories Act 1948
- (17) Cashew and cashew nut descaling and processing
- (18) Soldering process in electronic industries
- (19) Agarbathi manufacturing
- (20) Automobile repairs and maintenance (namely welding lather work, dent beating and printing)
- (21) Brick kilns and Roof files units
- (22) Cotton ginning and processing and production of hosiery goods
- (23) Detergent manufacturing
- (24) Fabrication workshop (ferrous and non-ferrous)
- (25) Gem cutting and polishing
- (26) Handling of chromites and manganese ores
- (27) Jute textile manufacture and of coir making
- (28) Lime kilns and manufacture of lime
- (29) Lock making
- (30) Manufacturing process having exposure to lead such as primary and secondary smelting, welding etc. ( See item 30 of part B process)
- (31) Manufacture of glass, glass ware including bangles fluorescent tubes bulbs and other similar glass products
- (32) Manufacturing of cement pipes, cement products, and other related work.
- (33) Manufacture of dyes and dye stuff
- (34) Manufacturing or handling of pesticides and insecticides
- (35) Manufacturing or processing and handling of corrosive and toxic substances, metal cleaning and photo enlarging and soldering processes in electronic industry
- (36) Manufacturing of buring coal and coal briquette
- (37) Manufacturing of sports goods involving to synthetic materials, chemicals and leather
- (38) Moulding and processing of fiberglass and plastics
- (39) Oil expelling and refinery
- (40) Paper making
- (41) Potteries and ceramic industry



- (42) Polishing, moulding, cutting welding and manufacture of brass goods in all forms.
- (43) Process in agriculture where tractors, threshing and harvesting machines are used and chaff cutting
- (44) Saw mill all process
- (45) Sericulture processing
- (46) Skinning dyeing and process for manufacturing of leather and leather products
- (47) Stone breaking and stone crushing
- (48) Tobacco processing including manufacturing of tobacco, tobacco paste and handling of tobacco in any form
- (49) Tyre making repairing, re-trading and graphite beneficiation
- (50) Utensils making polishing and metal buffing
- (51) Zari Making (all process)
- (52) Electroplating
- (53) Graphite powdering and incidental processing.
- (54) Grinding or glazing of metals
- (55) Diamond cutting and polishing
- (56) Extraction of slate from mines
- (57) Rag picking and scavenging
- (58) Processes involving exposure to excessive heat and cold
- (59) Mechanised finishing
- (60) Food processing
- (61) Beverage Industry
- (62) Timber handling and loading
- (63) Mechanical lumbering
- (64) Warehousing
- (65) Processes involving exposure to free silica such as slate, pencil industry, stone grinding, slate stone mining, stone quarries, agate industry.

**At a glance:**

- The basic objective of the Child Labor ( Prohibition & Regulation) Act, 1986 is to prohibit the engagement of children in certain employment's and to regulate the conditions of work or children in certain other employment.
- Part II of the Act through section 3 prohibit employment of children in the occupations set forth in part A of the schedule and processes set forth in part B of the schedule.
- No child shall be required or permitted to work in any establishment in excess of such number of hours, as may be prescribed for such establishment or class of establishments.
- This section stipulates that no child shall work for more than 3 hours before he has had an interval for rest for at least one hour. The double employment of a child is banned.
- The appropriate Government may, by notification in the official Gazette, make rules for the health and safety of the children employed or permitted to work in any establishment or class of establishments.



# Study Note - 4

## THE NEGOTIABLE INSTRUMENTS ACT, 1881



### This Study Note includes

- 4.1 Concepts and Definitions
- 4.2 Acceptance and Negotiation
- 4.3 Liabilities of Parties
- 4.4 Dishonour of a Negotiable Instrument
- 4.5 Discharge of a Negotiable Instrument
- 4.6 Hundis
- 4.7 Bankers and Customers
- 4.8 International Law Relating to Foreign Negotiable Instruments

### 4. THE NEGOTIABLE INSTRUMENTS ACT, 1881 - INTRODUCTION

The Negotiable Instrument are the most commonly used credit instrument in modern business to facilitate trade and commerce when it is not possible to settle all business and commercial transactions in money terms. Considering the value and volume of transactions it is not possible to settle all the transactions in cash. Beside there are some disadvantages associated with settlement of business transactions in cash due to Taxation provisions. Accordingly businessmen adopt a new method of exchanging documents like Bill of exchange, Cheque, Drafts etc, in place of actual currency for their day to day business transactions. Such documents which are used in place of money to facilitate business and commercial transactions are known as Negotiable Instrument.

Negotiable Instrument Act, 1881 primarily contains the law relating to negotiable instruments. The term 'negotiable' means transferable and the term 'instrument' means 'any written document creating a right in favour of some person.' Thus by negotiable instrument we mean a written document by which a right is given to a person and which is transferable in accordance with provisions of Negotiable Instrument Act, 1881. Bill of exchange, promissory note etc are included in schedule 7 list 1 entry no 46. Central Government has power to make enactment on "promissory note, Bill of exchange and Cheque etc.

Negotiable Instruments are money/cash equivalents. These can be converted into liquid cash subject to certain conditions. They play an important role in the economy in settlement of debts and claims. Law regulates the transactions involving the Negotiable Instruments in our country and the framework of the Statute, which governs the transaction of these instruments, is known as the Negotiable Instruments Act, 1881. This act was framed in our country in the year 1881 when the British ruled our country. Prior to 1881 the transactions governing Negotiable Instruments were regulated under the cover of the Indian Contract Act 1872. This act has been amended as many as 23 times to meet the needs of the time. The last amendment was made in 2002.

#### The RBI Act, 1934

The Negotiable Instrument Act does not affect the provisions of section 31 and 32 of the RBI Act, 1934. According to section 31 of the RBI Act, 1934 no person other than the RBI or Central Government can draw, accept or make or issue any bill of exchange or promissory note payable to bearer on demand. Further section 31 of the RBI Act, 1934 says that no person other than the RBI or Central Government can make or issue any promissory note, payable to the bearer of the Instrument. Section 32 of the RBI Act provides that

if a person issues bills or notes payable to bearer on demand or a note payable to the bearer shall be punishable with fine. In common parlance a negotiable instrument can be understood as a piece of paper which entitles to a sum of money and which is transferable from one person to another merely by delivery or by endorsement and delivery. The person to whom it is so transferred becomes entitled to the sum mentioned therein and also to the right to further transfer it. Though there is a general principle that no one can become owner of any property unless the person who sold the property to him is the true owner of the said property, yet this rule is not applicable in the case of Negotiable instrument.

## 4.1 CONCEPTS & DEFINITIONS

### 4.1.1 Definition of a Negotiable Instrument:

The word negotiable means transferable by delivery and the instrument means a written document by which a right is created in favor of some person.

Sec. 13 defines a negotiable instrument as 'a promissory note, bill of exchange or cheque payable either to order or to bearer.'

#### Explanations:

- (i) A promissory note, bill of exchange or cheque is payable to the order to which it is expressed to be payable or which is expressed to be payable to a particular person, and does not contain words, prohibiting transfer or indicating an intention that it shall not be transferable.
- (ii) A promissory note, bill of exchange or a cheque, either originally which is expressed to be so payable or on which the only or last endorsement is an endorsement in blank.
- (iii) Where a promissory note, bill of exchange or cheque, either originally or by endorsement, is expressed to be payable to the order of a specified person and not to him or his order, it is nevertheless payable to him or his order at his option.

A negotiable instrument may be payable to two or more persons jointly or it may be made payable in the alternative to one of two or one or some of several payees.

The above definition of the term "Negotiable Instrument" given in section 13 of the Act, mention of three instruments namely promissory note, bill of exchange or a cheque payable either to order or to bearer'

The above definition of a negotiable instrument appears to be incomplete as it does not throw any light on the essential features and characteristic of a Negotiable Instrument and does not say about any other instrument other than the three mentioned therein which are equally negotiable

Can we say that there are only the above three types of instruments which fall within the definition of the Negotiable Instrument? It is not so, in fact every document can act as a negotiable instrument if it possesses the characteristic of a negotiable instrument. In fact every document, which entitles a person a sum of money mentioned therein and is transferable by delivery, is called a negotiable instrument.

Justice Wills defines a negotiable instrument as "A negotiable instrument is one, the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any defect in the title of the person from whom he took it." Though section 13 of the Negotiable Instrument does not mention of any other instrument to be called but at the same time it also does not prohibit any instrument from being treated as a Negotiable Instrument provided it posse s the characteristic of a negotiable instrument.

Judge Wills is of the opinion that a negotiable instrument is "one the property in which is acquired by one who takes it bonafide and for value notwithstanding any defects in the title of the person from whom he took it.

In Smith's leading case it is said "Where an instrument is by the custom of trade transferable in this country like cash, by delivery and is capable of being sued upon by the person holding it pro-tempore (for the time being) there it is entitled to the name negotiable instrument and the endorsement must be genuine".

## > 4.2 | LAWS, ETHICS AND GOVERNANCE



Thomas defines it in his book "Commerce, Its theory and Practice" "A negotiable instrument is one which is, by a legally recognized custom of trade or by law, transferable by 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."

#### 4.1.2 Characteristics of a Negotiable Instrument

Any instrument may be negotiable either by (a) statute or (b) by usage

Promissory notes, Bills of exchange and cheque are negotiable instrument by virtue of section 13 of the Act but Bank notes, Bank drafts, share warrants, bearer debentures, dividend warrant, scripts and treasury bills are negotiable by usage.

Accordingly an instrument to be called a Negotiable Instrument must have the following characteristics:

- (1) **Freely transferable:** If a negotiable instrument is payable to bearer, it is transferred by mere delivery and if payable to order, then by endorsement and delivery.
- (2) **Holder's title is free from all defects:** A transferee taking an instrument bonafide and for value gets the instrument free from all defects in the title of the previous holder. The transferee is known as the holder in due course. So the doctrine of nemo dat quod non-habet (no one can transfer a better title than he himself has) is not applicable in cases of a Negotiable Instrument provided the holder is bonafide holder and get it for value paid.

#### Example:

In *Raepheal V Bank of England*, it was found that some bank notes of the Bank of England were stolen in a robbery. The Bank of England distributed list of such stolen notes to various agencies/parties. Raepheal, the plaintiff who was a money changer in Paris also received on such list so circulated by the bank. After around 12 months a man came to the plaintiff to exchange a Bank of England currency note which was stolen from the bank. The plaintiff exchanged the note and paid for it without knowing that the same was stolen for which notice had already been issued by the Bank of England. Since the plaintiff Mr. Raepheal had taken the same in good faith and also paid for it, was entitled to its payment despite his negligence.

- (3) The holder in due course can sue on the instrument in his own name and for this purpose notice of transfer need not be given. This will be discussed subsequently
- (4) A negotiable instrument is subject to certain presumptions (**Sec 118 and 119**):

(a) **Consideration:** Every negotiable instrument is presumed to be made, accepted, endorsed, negotiated or transferred for certain consideration [Sec 118 a)].

In *Marimuthu Kounder v radhakrishnan and others* AIR 1991 ker 39 the Kerala High court observed that the presumption as to existence of consideration for negotiable instrument is not irrefutable. When once the court finds that the defendant has executed the promissory note, then the burden is on the defendant to prove that there is no consideration. True the initial burden lies on the plaintiff who has to prove that the promise note is executed by the defendant. If there is an admission by the defendant certainly there is burden on the plaintiff to prove the execution of the promissory note. Further the court observed that where execution is admitted or provided a presumption is raised in favor of the consideration having been passed and the burden to prove lack of the considerations is then on the defendant.

- (b) **Date:** Every negotiable instrument bears the date on which it was drawn or made [Sec 118 (b)].
- (c) **Time of acceptance:** Every negotiable instrument is deemed to have been accepted within a reasonable time after the date mentioned on it and before its maturity [sec 118 (c)].
- (d) **Time of transfer:** It is presumed to have been transferred before maturity [(sec 118 (d)].

- (e) **Order of endorsements:** The endorsement made is deemed to have been made in the order they appear on the instrument [118 (e)].
- (f) **Holder in due course:** Every holder is presumed to be the holder in due course [sec 118 (g)].
- (g) **Stamped:** In case an instrument is lost, it is presumed that the instrument was duly stamped [sec 118 (f)].
- (h) **Proof of protest.** In case of dishonour of an instrument, if a suit is filed, the court shall on proof of protest presume the fact of dishonour, unless it is disproved [sec 119].

#### **Instruments which are not negotiable Instruments.**

As we have already discussed one of the characteristic of negotiable instrument is its transferability by mere delivery or endorsement and delivery. Some instruments are negotiable instrument by Act and some others are negotiable by customs and usages. Similarly there are certain instruments and documents of title which do not have the characteristics of negotiable instruments and are accordingly not treated negotiable instruments. These are (i) Money order and postal orders, deposit receipts (ii) share certificates, dock warrants, bill of lading, railway receipts, wharfinger certificate. Some of these are transferable by endorsement or delivery but they lack one of the main characteristics of negotiable instrument i.e. better title. The transferee of such documents does not get a better title than that of a transferor. For this reason these documents are also called quasi negotiable instruments".

IOU is not a negotiable instrument because it is merely an acknowledgement of debt without any promise to pay. This type of instrument can be transferred by assignment under the Transfer of Property Act and not by negotiation. However if certain words are added to IOU which may make it negotiable instrument. For example in *Books v Erikins 1936 2 M&W 734* a document ran " IOU \$20 to be paid on 22<sup>nd</sup> and it was held to be a promissory note and hence a negotiable instrument.

#### **4.1.3 Types of Negotiable Instrument:**

Negotiable Instruments are of two types:

- i) **Negotiable by statute** – Section 13 of the Act, provide that a negotiable Instrument include promissory note, bill of exchange and cheque, whether payable to bearer or order.
- ii) **Negotiable by custom or usage** – Though the Act speaks of only three types of Negotiable Instrument, but it does not prohibit other kinds of instruments from being treated as a negotiable instrument provided they possess the characteristics of a negotiable instruments. Accordingly certain other instruments takes the character of negotiable instruments by custom or usage-dividend warrant, share certificates, circular notes, bearer debentures are some of them though they are not specifically mentioned in the Act.

#### **The following rule of estoppels are applicable to a negotiable Instrument:**

- (1) **Estoppels against denying original validity of instrument:** The maker of the note and drawer of the bill of exchange or cheque are directly responsible for the bringing into existence of the instrument and, thus, cannot be allowed afterwards to deny the validity of the instrument (Section 120).
- (2) **Estoppels against denying capacity of the payee to endorse:** The maker of a promissory note or an acceptor of a bill shall not, in a suit by holder in due course, be allowed to deny the capacity of the payee to endorse the bill (Section 121).
- (3) **Estoppels against denying signature or capacity of prior party:** An endorser of a negotiable instrument shall, in a suit thereon by the subsequent holder, be allowed to deny the signature or capacity to contract of any prior party to the instrument.



## Payee in a Negotiable Instrument

All three kinds of negotiable instruments mentioned under section 13 of the Act could be made payable in any of the following ways –

- Payable to bearer; or
- Payable to order.

**Payable to bearer:** The expression “*bearer instrument*” signifies an instrument, be it promissory note, bill of exchange or a cheque, which is expressed to be so payable or on which the last endorsement is in blank. This character of the instrument can be altered subsequently e.g. an endorsee can convert an ‘*Endorsement in blank*’ into an ‘*Endorsement in full*’. In such a case, the holder of the instrument would not be able to negotiate the instrument by mere delivery. He will be required to endorse the instrument before delivering it.

**Payable to order:** An instrument is payable to order when it is payable to:

- (i) the order of a specified person, or
- (ii) a specified person or his order, or
- (iii) a specified person without the addition of the words “*or his order*” and does not contain words prohibiting transfer or indicating an intention that it should not be transferable.

When an instrument is not payable to bearer, the payee must be indicated with reasonable certainty.

### 4.1.4 Classification of Negotiable Instruments

#### (1) Bearer and order instruments

A negotiable instrument is said to be payable to bearer when (i) it is expressed to be so payable (ii) only or last endorsement is a blank endorsement.

A negotiable instrument is said to be payable to order when (i) it is expressed to be so payable (ii) expressed to be payable to a particular person with restricting its transferability.

#### (2) Inland and foreign instruments

A bill, promissory note or cheque if both drawn and payable in India or drawn on a person resident in India is said to be an inland bill.

A bill which is not an inland bill is deemed to be a foreign bill. Foreign bill must be protested for dishonour if such protest is required by the law of the place where it was drawn, this is not case with Inland bills where protest for non payment is optional as per section 104 of the Act.

#### (3) Demand and time instruments

An instrument is payable on demand when it is expressed to be so payable or when no time is specified on it. A cheque is always payable on demand as discussed earlier.

A note or bill if payable after a specified period or happening of a specified event which is certain, it is a time instrument. If a promissory note or bill of exchange bears the expression “*at sight*” and “*on presentation*” mean on demand (section 21). The words “*on demand*” are usually found in a promissory note, where the words “*at sight*” are found in a bill of exchange.

#### (4) Genuine, accommodation and fictitious bill

When a bill is drawn, accepted, or endorsed for consideration it is a genuine bill. When it is drawn, accepted, or endorsed without consideration it is accommodation bill. When drawer or payee or both are fictitious the bill is called fictitious bill. If both drawer and payee of a bill is fictitious person,

the acceptor is liable to a holder in due course, if the holder in due course can show that the signature of the supposed drawer and that of first payee are in the same handwriting.

**Example 1:**

X purchased goods worth ₹ 10,000 from Y. In lieu of cash payment X accept of a bill of exchange of ₹ 10,000 to be payable after three months. This is a genuine trade bill.

**Example 2:**

S is in need of some money urgently. He approaches his friend T for necessary funds, who too have no funds for the time being but do enjoy some credibility in market He advice S to draw a bill of exchange on him for three months which he will accept. Accoringly S draw a bill of exchange of ₹ 10,000 for three months on T which T accepts. S can either it or get is discounted with Bank. On the maturity date S refunded the money to T so that he can make payment to the bank or to the person to whom the bill was endorsed by S. This is an accommodation bill drawn to accommodate the person in needs of temporary financial accommodation.

In the above case X is called the accommodated party and Y the accommodating party.

**Example 3:**

X draw a bill of exchange on Y for ₹ 10,000 to be payable to Z after three months. There is no person in the name of Z and the bill has been made payable to a dummy person. This is a fictitious bill of exchange.

A fictitious bill, payable to the order of the drawee, and accepted by a genuine person becomes a good bill in the hands of a holder in due course. The holder in due course is entitled to payment from the acceptor if he can show that the first endorsement on the bill and the signature of the supposed drawer are in the same handwriting. If the holder knew that the drawer's name is fictitious, he cannot claim the money because in this case, he is not a holder in due course.

It may be noted that the Negotiable Instruments Act lays down the following rules regarding accommodation bills:

- (a) An accommodation bill can be negotiated after maturity.
- (b) The accommodation party is liable to pay the money due on the instrument to any holder for value,
- (c) The accommodated party cannot demand the money from the accommodation party if he holds the bill till maturity.
- (d) Non-presentment of an accommodation bill to the acceptor for payment does not discharge the drawer.
- (e) Failure to give notice of dishonour does not discharge the liability of the prior parties as it does in the case of other bills.

**(5) Clean and documentary bill**

When no documents relating to goods are annexed to the bill ,it is clean bill. When documents of title or other documents relating to goods are attached ,it is documentary bill.

**(6) Ambiguous instrument**

When an instrument due to faulty drafting may be interpreted either as bill or note, it is an ambiguous instrument. It is for holder to decide how he wants the bill to be treated. Ambiguity may also arise when the amount is stated differently in words and figures. In such case the amount stated in words will be taken into account.

Section 17 provides that, "where an instrument may be construed either as a promissory note or bill of exchange the holder may at his election treat it as either and the instrument shall be henceforth treated accordingly"

In the following cases an instrument is treated as ambiguous:

- Where in a bill the drawer and drawee are the same person;
- Where the drawee is a fictitious person; or
- Where drawee is a person not having capacity to contract.

#### **Illustrations**

- A bill is drawn by an agent acting within the scope of his authority upon principal. The instrument is ambiguous as the drawer and drawee are the same person.
- A draws a bill on Y, a fictitious person; and negotiates it. The holder may treat it as a note made by A.
- The holder may treat an ambiguous instrument as a bill of exchange or a promissory note, but once he has made his choice he must abide by it, and cannot afterwards fall back and treat the instrument of the other kind.

### **(7) Inchoate instrument**

An instrument incomplete in some respect is known as inchoate instrument. When a person signs and delivers to another a blank or incomplete stamped paper, he authorizes the other person to make or complete upon it a negotiable instrument for any amount not exceeding the amount covered by the stamp. The effect of such signing is that the person signing the instrument is liable upon such instrument in the capacity in which he signed it to holder in due course of the instrument.

### **(9) Escrow Instrument**

When an instrument is drawn conditionally or for a special purpose as a collateral security and not for the purpose of transferring property therein, it is called Escrow instrument. The liability to pay in case of an Escrow instrument does not arise if the conditions agreed upon are not fulfilled or the purpose for which the instrument was delivered is not achieved.

#### **4.1.5 Capacity to Become a Party to a Negotiable Instrument**

A person competent to contract can become a party to a negotiable instrument. If a party who makes, draws, endorses, or negotiates a negotiable instrument is incompetent to do so, the agreement is void as against him. But the contract is still valid against the other parties competent to contract. The following entities cannot bind themselves by becoming a party to a negotiable instrument:

##### **Minor**

A minor person is not competent to contract; therefore he can not bind himself by becoming a party to a negotiable instrument. But mere presence of a minor as one of the party in a negotiable instrument does not make it invalid. A minor a draw, indorse, deliver and negotiate an instrument so as to bind all parties except himself.

##### **Example:**

A, B and C a minor executed a promissory note in favor of P. Held C immunity from liability did not absolve A and B, other joint promisors, from liability. [*Sulochana v Pandiyan Bank Ltd AIR(1975)Mad70*]

A minor is not personally liable on a bill or note given by him for necessaries supplied to him. It is only his estate which is liable for such a bill or note.

When an instrument is signed both by an adult and a minor jointly, the minor is not liable but the adult person signed the instrument cannot escape from his liability. A minor can take minority as a defence even though he made false representation of his age or concealed his true age. Similarly if a minor is a payee in an instrument, he can enforce payment thereof to him.

### **Corporation**

Corporation can be a party to a negotiable instrument if authorized by its Article of Association, otherwise it is ultra vires.

### **Agent**

As per section 27 an agent can bind his principal by acting on his behalf only in the manner in which he is duly authorized to become a party to a negotiable instrument. The agent is required to make it clear that he is acting in representative capacity which must be evidenced by the manner he sign such document. The form of signature must show that he does not intend to incur personal liability. Otherwise he becomes personally liable.

In order to enable an agent to make, draw or endorse a negotiable instrument, the authority to execute an instrument must be given specifically as a simple general authority to act an agent does not include the authority to negotiate an instrument. Similarly an authority to draw a bill of exchange does not by itself means an authority to endorse an bill of exchange too.

However, to exclude personal liability the agent must indicate his intention of signing such instrument as an agent by using the words like 'for and on behalf of' or "per pro" which is short for of " per procuracionem"

#### **Example 1:**

A manager of ABC Ltd accepted a bill of exchange and signed as a manager. It was held that A was personally liable. [*Iverpool bank v Walker (1859)4DeG&J.24*]

#### **Example 2:**

A manager of ABC Ltd accepted a bill of exchange and signed as for ABC Ltd a manager. It was held that A was not personally liable. [*Alexander vsizer (1869) LR4 Ex192*]

### **Legal Representative**

As per section 30 a legal representative of a deceased person who signs his name to a negotiable instrument incurs personal liability unless by clear words he limits his liability to the extent of the assets of the deceased received by him as legal representative.

If a legal representative does not use the words restricting his personal liability he becomes personally liable to that extent. If a person endorses a negotiable instrument payable to order but dies before he can deliver the instrument to the endorsee his legal representative cannot complete the transaction by delivering the instrument to the party intended to receive it. He should re-indorse the instrument, signing it as the legal representative and then deliver it.

### **Hindu Undivided family:**

The Karta of a Joint Hindu family can bind the other members by executing a negotiable instrument provided the transaction is for the benefit of the family or is for the legal necessity. The other members of the Joint Hindu family are bound to the extent of their shares in the Joint family property but are not liable personally.

### **Lunatic, Idiot and Drunken Person:**

The legal position of these persons to make, draw and endorse a negotiable instrument is same that of a minor person. However, a lunatic person can, however, bind himself by a negotiable instrument if he signs it during a lucid interval.

### **Insolvent person:**

Once a person is adjudicated as an insolvent person his properties vest in the Official Assignee or the official Receiver, so in that case he cannot be party to a negotiable instrument. However, a bill drawn upon the insolvent person before he becomes insolvent may be presented to the Official Assignee



for acceptance. Similarly an instrument executed in favour of the insolvent person, vests in the Official Assignee or the Official Receiver only.

#### 4.1.6 Promissory Notes

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

There are two parties to it: the maker and the payee.

##### Example 1:

D signs an instrument stating, 'I promise to pay F or order ₹ 1,000'. This is a promissory note.

##### Example 2:

I acknowledge myself to be indebted to B in ₹ 5,000 to be paid on demand, for value received. This is also a promissory note;

Let take a few more examples and see whether these are promissory note or not.

- (i) A sign a document like (i) "Mr. C I O U ₹ 1,000.
- (ii) I promise to pay B ₹ 1,000 and interest thereon.
- (iii) I promise to pay B ₹ 1,000 and all other sum which shall be due to him.
- (iv) I promise to pay B ₹ 1,000 as soon as possible.
- (v) I promise to pay B ₹ 1,000 if I win my case.
- (vi) I promise to repay the amount due to B ₹ 1,000 by sending him two Kg dry fruits (equivalent value).

None of them are promissory notes. Let us find out why they are not promissory notes.

Example (i)-This is a mere acknowledgement or statement without any promise to pay.

Example (ii) There is a promise but the sum is not certain.

Example (iii) Again amount is not certain

Example (iv) Amount not certain

Example (v) Conditional on winning a case

Example (vi) Being paid other than in money term.

#### Specimen Promissory Note

	Kolkata
	10 <sup>th</sup> March, 2012
₹ 5,000/-	
On demand I promise to pay Mr. Z or order the sum of rupees five thousand with interest at 5% per annum for value received.	
	Stamp
	Mr X(sd on stamp)
To	
Mr. Z	
Kolkata.	

From the above examples we can easily discern the essential characteristics of promissory note.

Thus essential elements of a promissory note are:

- (i) Must be in writing. Writing includes print and typewriting.
- (ii) Must contain an express promise or undertaking to pay. A mere acknowledgement of debt is not a promissory note. A mere receipt of money is not a promissory note even though it may contain the term of repayment.

A negotiable instrument was written as "This receipt is hereby executed by B- ₹ 43,000-received from A. The amount to be payable after two year. Interest at the rate of ₹ 5.4.0 per cent to be charged"(Akbar Khan V Attar Singh). It was held by the privy council that " the instrument is not a promissory note within the definition of section 4. It is a receipt for money containing the terms on which it is to be repaid. Being primarily a receipt, even if coupled with a promise to pay, it is not a promissory note and is not negotiable. Receipt are generally not intended to be negotiable" Hence to make a promissory note' there must be an express undertaking to pay the amount mentioned. A mere implied undertaking is not sufficient.

In *Raff v Webb 1974 Esp 129* it was held that where there is an express promise to pay a promissory note it will still be a promissory note even if it contains expression of politeness or gratitude The following had been held to be good promissory notes:

- (i) Acknowledge myself to be indebted to B in ₹ 1000 to be paid on demand for value received" [*Casborne V Dutton 1727 Sel NP 13<sup>th</sup> edition ist vol 329*]
- (ii) ₹ 1000 balance due to you I am still indebted and do promise to pay" [*Chadwick v Allen 1725 1 Stra 706*]
- (iii) We shall order the borrowed money to be repaid" [*Sri Yerruganti Chinna v Kota Egiri 1913 MWN 1005*]

**Example:**

We have received a sum of ₹ 21, 000 from X. This amount will be repaid on demand. We have received this amount in cash" This is a valid promissory note.

However, note that the use of the word "I promise" is not essential to constitute an instrument as a promissory note.

- (iii) The promise must be definite and unconditional. The instrument payable on performance or non performance of a particular act or the happening or non happening of an event is not promissory notes.

**Example1:**

I promise to pay B ₹ 5000 provided I have sufficient balance in my bank account after meeting all mandatory payments. This is not a promissory note.

**Example 2:**

I promise to pay B ₹ 5000 one month after his marriage. This is also not a promissory note.

In the above two examples given above the note executed by the parties is not a promissory note. In the first one there is no guarantee that a person will have sufficient balance in his bank account after meeting his mandatory payment. Similarly in example 2, B may never marry either during his life time or during the life time of A. So in both the cases the promise will never be fulfilled and the amount promised to be paid by the promise never become payable.

The reasons why conditional instruments are not permitted to come into circulation was explained in *Carlos v Fancourt (1794) 2 RR 647*."Certainty is a great object in commercial instruments. On this ground bills of exchange which are only payable on a contingency are not negotiable, because it does not appear on the fact of them whether or not they will even be paid it does not appear on the face of them whether or not they will ever be paid.



In one case Lord Kenyon observed "It would perplex the commercial transaction of mankind, if paper securities of this kind were issued out into the world, encumbered with conditions and contingencies and if the persons to whom they were offered in negotiation were obliged to inquire when these uncertain events would probably be reduced to certainty."

In *Palmer v Pratt* a bill of exchange made payable at thirty days after arrival of the ship 'paragon' at Kolkata was held to be bad, the court saying " so that if the ship did not arrive the bill would never be paid" Similarly, in another case, a note payable to the payee "when he is twenty one years old" was held not negotiable. It was said " The payment was to be made when the payee would attain his majority might never happen and therefore, money was not certainly and at all events payable."

But where the instrument is payable on the death of a person it is a perfectly valid promissory note as death is a certain to happen but its timing is uncertain. But where the instrument is contingent upon happening of an event which is not certain to happen, the instrument is not a promissory note. The reason for this that the certainty is one of the main object in commercial instruments. Thus negotiable instrument is a carrier without luggage. An undertaking to repay the amount only when demanded is not a conditional promise to pay. [*Balmukund v Munna Lal Ramki Lal, AIR 1970 Punj 516*] A letter requesting a loan stating that the amount lent will be repaid is not a promissory note as the repayment is dependent on the advance being made [*Dhond Bhai v Annaram, 13 Bomb 669*]

From the examples and cases discussed above it is clear that un-conditionality is one of the important essential characteristic of a valid promissory note.

**(iv)** The instrument must be signed by the maker: A promissory note is incomplete till it is so signed. Since the signature is intended to authenticate the instrument it can be on any part of the instrument.

Two or more persons may make a promissory note and they may be liable thereon jointly or severally (*Joint family of MR Bhagwandas V. State Bank of Hyderabad 1971 SC 449*). It must be clearly understood, however, that the two makers cannot be liable in alternate.

Where a pronote was shown to have been executed by two persons and later it was found that signature of one of the persons were forged, the person whose signature was forged cannot be held liable. The other person will, however, be liable.

**(v)** The parties –maker & payee must be certain. Both maker and payee must be indicated with certainty on the face of the instrument. However, it is not necessary that name of payee must be specifically mentioned provided on reading of the document as a whole there is no doubt as to the person who is the payee. The following example will make it clear:

In *Brij Raj Sharan V Sah Raghunandan Sharan* a letter addressed to X contained the following statement.

In your account Rs4668 are due from my son Mahesh, I shall pay the amount by Dec 1948. You rest assured'

It was contended that it should not be treated a promissory note because the name of the payee is not indicated. The above contention was not accepted and the instrument was treated a promissory note as the letter is addressed to X from which it was clear that X was intended to be the Payee.

**(vi)** The promise should be to pay certain sum of money only. If the promise is to pay something other than money or something more in addition to money, it will not be treated a promissory note. Similarly the amount to be paid must be certain. If the amount to be paid is not certain it cannot be treated a promissory note.

#### **Example1:**

I promise to pay to XY the sum of \$100 with lawful interest for the same, three months after date and also all other sums which may be due to him, is not promise note (*Smith v Nightingale*) as the amount to be paid is not certain.

### Example 2

I promise to pay B ₹ 5000 and also deliver him a Car is not a promissory note.

### Example 3:

I promise to pay B ₹ 500, first deducting any sum which he may owe to me.

The sum of money payable must also be certain. Negotiable instruments are meant for free circulation and if their value is not apparent on their face, their circulation would be materially impeded. It may be noted that the act simply requires certainty of the amount promised to be paid, but it does not insist upon the amount to be mentioned both in words and figures. But generally the instrument is written both in words and figures. Section 18 says that wherever there is discrepancy in both words and figures, the amount mentioned in words will hold good.

In *Lakshminath v Benaras Bank Ltd AIR 1929 Pat 136* an instrument payable with ten percent interest per annum with quarterly rests was held to be a valid promissory note.

**(vii)** Must bear necessary stamp as per Indian Stamp Act, 1899. It means that the stamps of the requisite amount must have been affixed on the instrument and duly cancelled either before or at the time of execution. A promissory note which is not stamped is a nullity.

In *Nanga V Dhannalal AIR 1962 Raj 68* it was held that the proper amount of stamp duty required for an instrument to be determined according to the law in force at the time of the execution of the instrument and not when it is tendered in evidence.

**(viii)** It cannot be made payable to bearer on demand. RBI Act, 1934 prohibits issue of such promissory note except by RBI or Central Government itself.

**(ix)** Bank note or currency note is not a promissory note because bank note or currency note itself is a money.

**(x) Other points:** The following points shall also be remembered in connection with promissory notes:

- (i) Consideration need not be mentioned.
- (ii) Place and date of making it need not be mentioned. A promissory note on which date is not mentioned is deemed to have been drawn on the date of its delivery.
- (iii) An ante-dated or post dated instrument is not invalid.
- (iv) Place of payment also need not be mentioned in the promissory note. However, it can be made payable at any specified place.
- (v) It may be made payable on demand or after a certain time. A demand promissory note becomes time barred on expiry of three years from the date it bears.
- (vi) A promissory note cannot be made payable to the maker himself. Such a note is nullity. But, if it is endorsed by the maker to some other person, or endorsed in blank, it becomes a valid promissory note [*Gay V. Landal (1848) LT CP 286*].
- (vii) Where two or more persons sign the promissory note, their liabilities will be joint as well as several. A note cannot be signed in alternative.
- (viii) It is usual to mention in a promissory note the words '*for value received*', but such a statement is not essential for the validity of the note, because the note is presumed to be for consideration unless contrary proved.
- (ix) A promissory note is not invalid by reason only that it contains any matter in addition to promise to pay e.g. a recital that the maker has deposited the title deeds with the payee as a collateral security.



### Parties to a Promissory note:

- (a) The maker: the person who makes the note promising to pay the amount stated therein;
- (b) the payee: is the person to whom the amount of the note is payable;
- (c) the holder: is either the original payee or any other person in whose favor the note has been endorsed;
- (d) the endorser: the person who endorses the note in favor of another person;
- (e) the endorsee: the person in whose favor the note is negotiated by the endorsement.

### 4.1.7 Bill of Exchange

A Bill of Exchange is defined in section 5 of the Act "as an instrument in writing containing an unconditional order signed by 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". There are three parties to a bill, namely drawer, drawee and payee. The person who gives order to pay or who make the bill is called drawer, the person who accept or who is directed to pay is called drawee and the person who actually receive the payment is called payee. When in the bill or in any endorsement thereon the name of any person is given in addition to the drawee , such a person is called drawee in case of need. The resort to drawee in need arise only when the bill is returned dishonored due to non acceptance or non payment.

A signs an instrument directing B 'Pay C or order a sum of ₹ 1,000 only, 3 months after date'. This is BOE.

### Specimen Bill of Exchange:

	Kolkata 11 <sup>th</sup> March 2012
₹ 12,000	
Three months after date pay to bearer the sum of rupees twelve thousand for value received.	
Stamp	
	Mr. Y (Sd. on stamp)
To Mr. X Allahabad	

Following special benefits associated with the Bill of Exchange:

1. A Bill of Exchange is a double secured instrument i.e. where the drawee fails to honour the order, the holder of the instrument may look to the drawer for payment.
2. In case of immediate requirement a Bill may be discounted with a bank.
3. The drawer or any endorser thereof may mention a person as 'drawee in case of need' to be resorted to for payment by the payee in case of dishonour of the bill by the drawee.

### Essential features of a bill of exchange are:

- (i) Must be in writing
- (ii) Must contain an unconditional order. to pay and not a promise or request. Words like Please Pay ₹ 1,000 to A on demand and oblige, or May I request you to pay ₹ 1,000 to me etc do not constitute the instrument a bill of exchange.

The instrument must contain an order to pay the money at all events and not merely authorise the other to pay the money. In *Hamilton v Spottiswood (1849) 80 RR 519* an Instrument was made like "To Alexander Spottiswood, Dear Sir, We hereby authorise you on our account, to the order of William Gentle the sum of six thousand pounds" The instrument was held not be a bill of exchange.

It may also be noted that the drawee need not be expressed by the word "Pay but any other word conveying the idea of payment eg 'credit in cash" will be sufficient [*Edison v Colingridge (1850) 19 LJCP 268*]. A mere request to pay to an account does not amount to an order.

- (iii) The order must be to pay money only.
- (iv) The amount must be certain .
- (v) Requires three parties.-Drawers, Drawee and the payee. However one person may assume the role of two parties. A drawer of a bill of exchange can draw it in his own favor so he becomes payee also. But he cannot be drawee also in that case it will become a promissory note.
- (vi) The parties must be certain .
- (vii) It should be signed by drawer.
- (viii) Necessary stamp must be affixed.

A bill as originally drawn can not be made payable to bearer on demand.

#### **Stamp duty, attestation and Registration of promissory note and a bill of exchange.**

A promissory note as well as a bill of exchange is liable to stamp duty. However, an endorsement of a negotiable instrument is exempt from any stamp duty . Neither a promissory note, nor a bill of exchange is to be attested or registered.

#### **Parties to Bill of Exchange**

There are generally three parties to a bill of exchange: (i) the drawer, (ii) the drawee, and (iii) the payee. Section 7 says that the maker of a bill of exchange or cheque is called the "drawer", the person thereby directed to pay is called the "drawee", "payee" is the person named in the instrument , to whom or to whose order the money is by the instrument directed to be paid. Apart from these parties, however, there may be other parties to a bill of exchange which are as follows:

- **Drawee in case of need:** When in the bill or any indorsement thereon the name of any person is given in addition to the drawee to be resorted to in case of need. Such person is called a "drawee in case of need".
- **Acceptor:** After the drawee of a bill has signed his assent upon the bill or if there are more parts thereof than one, upon one of such parts, and delivered the same, or given notice of such signing to the holder or to some person on his behalf, he is called the "acceptor".
- **Acceptor for honour:** When a bill of exchange has been noted or protested for non-acceptance or for better security, and any person accepts it supra protest for honour of the drawer or of any one of the indorsers, such person is called the acceptor for honour.
- **Holder:** The "holder" of a promissory note, bill of exchange or cheque means any person entitled in his own name to possession thereof and to receive or recover the amount due thereon from the parties thereto. He is either the original payee or any other person to whom the instrument has been negotiated.
- **Indorser:** When the holder of a negotiable instrument indorses the instrument to any other person, he becomes the indorser.
- **Indorsee:** The person to whom the negotiable instrument is indorsed, is called the indorsee.
- **Payment for honour:** When a bill of exchange has been noted or protested for non-payment, any person may pay the same for the honour of any party liable to pay the same: provided that the person so paying or his agent in that behalf has previously declared before a notary public the party for whose honour he pays, and that such declaration has been recorded by any such notary public.



#### 4.1.8 Cheque

A Cheque is the usual method of withdrawal of money from bank both from the Saving Bank Account and Current Account. A cheque is in essence an order by the customer of the bank directing the bank to pay on demand the sum specified therein to or to the order of the person named therein or to the bearer. Section 6 of the Negotiable instrument defines a cheque. The Amendment Act of 2002 has substituted a new definition for cheque'-

As per section 6 A Cheque is a bill of exchange drawn on a specified banker payable on demand. Further the expression includes the electronic image of a truncated cheque or a cheque in electronic form.

“ The definition of cheque was broadened in 2002 to include the electronic image of a truncated cheque and a cheque in electronic form to bring the definition of cheque in time with the Information of Technology Act 2000. 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 (paying or collecting) immediately on generation of electronic image of the cheque, substituting the further movement of the cheque. In such a process, a cheque will be scanned and the electronic image of the cheque instead of the physical cheque will be transmitted in the clearing cycle. An electronic cheque is a cheque in electronic form as against the usual paper instrument in writing generated, written and signed with the use of digital signature (with or without biometric signature and asymmetric crypto system)

As cheque in Electronic form are vulnerable to misutilisation accordingly for safe handling of electronic cheque by various persons involved in the transactions, some amendments were made in section 64,81,89 and 131 of the Negotiation Instrument Act,1881 by the Negotiation Instrument(Amendment) Act,2002.

All cheques are bills of exchange but all bills of exchange are not cheques. A cheque is required to possess all essential features of a bill of exchange. In the case of *Col v Milson* a document was drawn absolutely in the form of a cheque. It was made payable to cash or order. A question on the validity of the cheque was raised. Section 5 of the Indian Act and section 3(1) of the English Act, require that a bill of exchange must be made payable to or to the order of a specified person or to bearer. Since the instant cheque was made payable to cash or order. Hence it was not payable to any person or to bearer and therefore was not a bill of exchange and accordingly could not be treated as cheque.

A cheque must satisfy the requirement of a valid bill of exchange in addition to the requirement of section 6 of the Act. In the first instance it must be drawn upon a banker and secondly it must be payable on demand.

#### Comparative analysis of Promissory Note, Bill of Exchange and Cheque

Particulars	Promissory Note	Bill of Exchange	Cheque
Parties	2 parties-maker & payee.	3 parties-drawer, drawee & Payee.	3 parties - drawer, banker, and payee.
Nature	Contains an unconditional promise by maker to pay the Payee.	Contains an unconditional order to the drawee to pay the payee.	Drawn on specified banker to pay on demand.
Acceptance	Not necessary.	Necessary if the bill is payable after sight.	Not necessary.
Liability	Liability of maker is primary and absolute.	Liability of drawer is conditional and secondary upon nonpayment by drawee.	Liability of drawer is conditional and secondary upon nonpayment by banker.
Notice of dishonor	Not necessary.	Necessary.	Not necessary.

Particulars	Promissory Note	Bill of Exchange	Cheque
Payable	On demand or after a specified time. Cannot be made payable to bearer on demand or even after certain period	On demand or after a specified time. Cannot be made payable to bearer on demand.	On demand even to bearer if so made.
Crossing	Not possible.	Not possible.	Can be crossed.
Noting and protesting in case of dishonour	Not required.	Required to establish the fact of dishonour.	Not required.
Grace period	Available if payable after specified time.	Available if payable after specified time (usance bill)	Not available.
Other features	Number, date, place not essential. Must be stamped.	Number, date, place not essential. Must be stamped.	Number, date, place, essential. Need not be stamped.

**Requisite of a valid cheque: A cheque has the following features:**

**(a) Cheque contains an unconditional order**

Every cheque contains an unconditional order issued by the customer to his bank. It does not contain a request for payment. The Bank dishonours a cheque containing conditional orders. Generally the order to bank is expressed as 'Pay to' - If the words like please precedes "pay" the document will not be regarded invalid merely on this ground provided other requirement of a valid cheque are met.

**(b) Must be in writing:**

A cheque must be an instrument in writing . Regarding the manner of writing the act is silent. It may be hand written or typewritten or printed. Only condition is that there should not be mismatch between the amount as per words and amount in figures. Now a days some banks are not honoring multi colored cheques, i.e. cheques filled up in different inks.

**(c) Cheque is drawn by a customer on his bank:**

A cheque is always drawn on a specific bank mentioned therein. Cheque drawn by stranger is of no meaning. Cheque book facility is made available only to account holder who are supposed to maintain certain minimum balance in the account.  
To avoid any mistake the name and address of the banker should be specified.

**(d) Cheque must be signed by customer:**

A cheque must be signed by customer (Account holder) . Unsigned cheques or signed by persons other than customers are not regarded as cheque and returned by the bank unpaid.

**(e) Cheque must be payable on demand:**

A cheque when presented for payment must be paid on demand. If cheque is made payable after the expiry of certain period of times then it will not be a cheque. Use of the words like on demand or equivalent thereof is not necessary

**(f) Cheque must mention exact amount to be paid.**

**(g) Cheque must be for money only:**

The amount to be paid by the banker must be certain. It must be written in words and figures. The amount of cheque must agree both in words and figures. If there is disagreement the banker may return the cheque.



**(h) Payee must be certain to whom payment is made:**

The payee of the cheque should be certain whom the payment of a cheque is to be made i.e. either real person or artificial person like joint stock company. The name of the payee must be written on the cheque or it can be made payable to bearer.

**(i) Cheque must be duly dated by customer of bank:**

A cheque must be duly dated by the customer of bank. The cheque must indicate clearly the date, month and the year. A cheque is valid for a period of six months from the date of issue.

**(j) Cheque has 3 parties: Drawer, Drawee & Payee:**

Drawer: A drawer is a person, who draws a cheque.

Drawee: A drawee is a bank on whom a cheque is drawn.

Payee: A payee is a person in whose favour a cheque is drawn

**Out dated or stale or overdue cheques:**

The paying bank is bound to pay only those cheques as are presented to him for payment within a reasonable time of issue. Usually the cheque presented after six months of the date mentioned thereon are considered stale and hence are returned to the banker for their reconfirmation. Now days the maturity of bank cheques has been reduced to three months. Reserve Bank of India (RBI) with effect from 1<sup>st</sup> April 2012 has reduced the validity of Cheques/bank draft/Banker cheques from existing 6 months to 3 months. Accordingly Banks are returning cheque presented after more than 3 months from the date of issue unpaid.

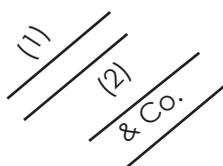
Section 84 provides that if the holder fails to present the cheque for payment within a reasonable time of its issue and in the meanwhile the bank fails causing damage to the drawer the later is then discharged as against the holder to the extent of the actual damages suffered by him. The Limitation Act provides that a cheque become time barred after three years from its date of issue.

**Crossing of Cheque**

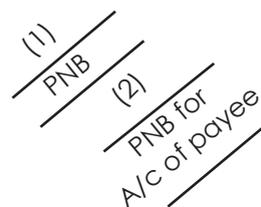
Cheques are of two types-open and crossed. When a cheque is payable in cash across the counter of a bank ,it is said to be open .A crossed cheque is one on which two parallel transverse lines with or without the words '&Co.' are drawn. Crossing a cheque implies directing the drawee banker to pay the amount only to a banker or a particular banker so that the party getting payment can be easily traced.

Crossing is a unique feature associated with a cheque affecting to a certain extent the obligations of the paying banker and also its negotiable character. It is a peculiar method of modifying the instrument to the banker for payment of cheque. Crossing on cheque is a direction to the paying banker by the drawer that the payment should not be made across the counter. The payment of such crossed cheques can be made only through a banker and not over the counter. A cheque may be crossed by the drawer, holder, or banker. Crossing may be of two types –general and special. Specimens are shown below:

**General Crossing**



**Special Crossing**



In addition to above two crossing prescribed in the Act, there is another type of crossing known as

restrictive crossing developed out of business usages. In this type of crossing the word account payee are added to general or special crossing. The effect of making the cheque account payee is to give direction to the bank to credit the amount to the account of the payee. Account payee cheque despite being crossed is fully negotiable.

### **What does Not Constitute Crossing**

- (i) When a cheque bears the words 'Not Negotiable' or 'A/c payee' without two parallel lines or the name of the bank it not treated as crossed.
- (ii) If a cheque bears single line across its face or simply an 'X' mark, the cheque is not treated as crossed cheque. Note that the inclusion of any other word/words within two parallel lines is irrelevant and the cheque is still deemed to be a crossed cheque.

### **Liability of the Paying Banker**

Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker. And where a cheque is crossed specially, the banker on whom it is drawn shall not pay it other wise than to the banker to whom it is crossed or his agent for collection (Section 126).

Any banker paying a cheque crossed generally, otherwise than to a banker, or a cheque crossed specially, otherwise than to the banker to whom the same is crossed, or his agent for collection being banker, shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid [Sec.129].

1. Liability to the True Owner of the cheque.
2. Liability to the Drawer

### **Not-Negotiable crossing**

At times the cheques are marked "not –negotiable". The effect of such marking is that the transferee does not get title better than that of the transferor. Any one who takes a cheque marked Not-negotiable takes it on his own risk and cost

A person taking a cheque crossed generally or specially bearing in either case the words 'not negotiable' shall not have and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had [Sec.130].

The effect of the words 'not negotiable' in the crossing will be clear from the following examples:

- (1) A draws a crossed cheque on his banker in favour of 'B' without the words not negotiable therein C steals it from the house of B and endorses it to D who receives it for value and in good faith from C (i.e. without the knowledge of the fact that C had no title to the cheque). D will be its holder in due course and will have valid title, though his transferor (endorser) had no title thereto.
- (2) In the above example, if the cheque bears the words "NOT NEGOTIABLE" then 'D' will not have a valid title even if all the above circumstances are satisfied.

### **Collection of Third Party Crossed bearer cheques**

In trade circles it is observed that as per practice the crossed bearer cheques were circulated and exchanged freely for trade transactions. They were in the past collected by bank through the instrument issued in the name of third parties and were presented by the customers of the bank for credit to their account without endorsement on the reverse of the instrument. The issue, whether collecting banker can get protection under Section 131 of the NI Act 1881 in such cases had been examined and it is opined that the negotiability of a bearer cheque is not affected by the crossing. Under section 47 of the Act, a cheque payable to bearer is negotiable even by a mere delivery and section 47 does not exempt (forbid) crossed cheques. As such, it is permissible to negotiate crossed bearer cheques by delivery thereof without endorsement.



There are some important judgment on liability of bank on this issue which are reproduced as under;

- (i) When customer's signature is forged there is no mandate to the bank to pay. As such the bank is not entitled to debit customers account on such forged note cheque. [*Canara Bank vs. Canara Sales Corporation & others 1987, SC*]
- (ii) In a joint account if one of the signatures is forged then there is no mandate and banker cannot make payment. [*Bihta Coop. Development and Cane Marketing Union Ltd. vs. Bank of Bihar, SC*]
- (iii) Payment should be made in due course to seek protection under Sec. 85 [*Bank of Bihar vs. Mahabir Lal 1964, SC*]
- (iv) Where there are no circumstances which afforded any reasonable ground for believing that the payee was not entitled to receive payment of the cheques, the bank is deemed to have made payment in due course. [*Bhutoria Trading Co. vs. Allahabad Bank 1977, Calcutta HC*]
- (v) Payment made to a liquidator against the cheques presented across the counter was not payment in due course. [*Madras Provincial Coop. Bank Ltd. vs. Official Liquidator, South Indian Match Factory Ltd. 1945, Madras HC*]
- (vi) Bank is protected if payment was made in good faith without negligence of a cheque on which alteration was not apparent. [*Bank of Maharashtra vs. M/s Automotive Engineering Co. 1993, SC*]
- (vii) The bank is liable where payment was made on cheques on which alterations were authenticated by not all but some of the drawers. [*Brahma Shumshere Jung Bahadur vs. Chartered Bank of India, Australia & China 1956 Calcutta HC*]

Under Section 131 a collecting bank is protected if following conditions are met:

- (a) The collecting banker should have acted in good faith.
- (b) He should have acted without negligence.
- (c) He should receive payment for customer.
- (d) The check should have been crossed generally or specially to the bank.

Some important judgements on this issue are as under:

- (i) It is the duty of the bank to open account with references. [*Syndicate Bank vs. Jaishree Industries & others, 1994 Karnataka HC, Indian Bank vs. Catholic Syrian Bank, 1981, Madras HC*]
- (ii) Duty to follow up references where referee is not known. [*Harding vs. London Joint Stock Bank, 1914*]
- (iii) Duty to ensure crossing in favour of the bank. [*Crumpling vs. London Joint Stock Bank Ltd. 1911*]
- (iv) Duty to verify instruments or any apparent defect in instruments [*Underwood Ltd. vs. Bank of Liverpool Martin Ltd. 1924, Savory Co. vs. Lloyds Bank 1932, ANZ Bank vs. Ateliers de Constructions Electriques Cherleroi, 1967 etc.*]

### **Marking of cheques**

One of the essential differences between a Bill of Exchange and a Cheque is that a cheque does not require acceptance as it is intended for immediate payment on presentation. However, by custom there is a practice of marking a cheque good for payment by drawee bank which does not amount to acceptance. Marking is writing on a cheque by drawee banker that it would be honoured when it is duly presented for payment . Cheques may be marked at the instance of the drawer, holder or collecting banker. In India no such practice of getting cheques marked has been established either by judicial decisions or by statutes.

### **M.I.C.R.Cheques/Drafts**

In MICR (Magnetic Ink Character Recognition) cheques:

First six number indicate the cheque number;

Next three numbers indicate city code;

Next three numbers indicate Bank code;

Next three numbers indicate Branch code.

### **Bank draft**

A bank draft is an order drawn by an office of a bank upon another of the same bank instructing the later to pay a specified sum to a specified person or his order. These are also known as Managers Cheques or Cashiers Cheques.

A draft can be drawn either against cash deposited at the time of its purchase or by debiting the buyer's current/ savings account the banker maintains. The buyer of the draft should furnish particulars of the person to whom the amount of the draft should be paid and where (at the time he requests the draft). The banker charges for his services a small commission. The draft like a cheque, can be made payable to drawer on demand without any legal objection thereto.

### **Specific features of a draft**

- (i) It is only issued by a bank on another bank or on one of its branches. It cannot be issued by an individual.
- (ii) It cannot be made payable to bearer.

The legal position with respect to bank drafts was clarified in the case of *Tukaram Bapuji Nikam V. Belgaum Bank Ltd.* AIR 1976 Bom 185, as follows:

- The relationship of the purchaser of draft and the bank from which the draft has been purchased is merely that of the debtor and creditor.
- The purchaser of the bank draft can call upon the bank from which he has purchased it to cancel the draft and pay back the money to him at any time before the draft has been delivered to the payee.
- If the sole object of the issue of the draft was to transit the money to another person, a fiduciary relationship is created between the purchase of the draft and the bank which issued it, and the purchaser of the draft can countermand payment only if the bank has not actually parted with the money held by it as agent thus terminating the relationship of principal and agent.
- Ordinarily, a bank issuing a draft cannot refuse to pay the amount thereof, unless there is some doubt as to the identity of the person presenting it as being or properly representing the person in whose favour it was drawn, or in other words, unless there is reasonable ground for disputing the title of the person presenting the draft; and
- Once the draft has been delivered to the payee or his agent, the purchaser is not entitled to ask the issuing bank to stop payment of the draft to the payee on other grounds such as matters relating to consideration.
- The issuing bank can after the issue of a draft pay back the amount of the draft to the purchaser of the draft only with the consent of the payee.

### **4.1.9 Bill in Sets**

A bill of exchange drawn in parts is known as bill in sets. Each part should contain a reference to other parts. This type of bill is specially drawn when it is to be sent to some foreign country. The object of drawing a bill in set is to avoid undue delay and unnecessary inconvenience which may arise due to miscarriage or misplacement of the bill and to ensure same transmission of at least one set of the bill.



As per section 132 a bill of exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue payable only so long as the others remain unpaid. All the parts together make a set; but the whole set constitutes only one bill, and is distinguished when one of the parts if a separate bill, would be extinguished.

**Exception:** When a person accepts or endorses different parts of the bill in favour of different persons, he and subsequent endorser of each part are liable on such parts as if it were a separate instruments.

As per Section 133, as between holders in due course of different parts of the same set, he who first acquired title to his part is entitled to the others parts and money represented by the bill.

*As between holders in due course of different parts of the same set, he who first acquired title to his part is entitled to the other parts and the money represented by the bill.*

Foreign bills are generally drawn in set of two or three and such a bill is said to have been drawn in set. All these parts form one bill. Each part of the bill is numbered and contains a reference to other parts. This operates as a notice to the holder taking up that all parts constitute one bill and puts him on guard to make inquiries as to the remaining parts of the bill. A person who negotiates a bill drawn in set is bound to deliver up all the parts in his possession.

All parts of the Bill are sent to the destination through different routes so as to ensure safe transmission of at least one part to the drawee and its acceptance by him at the earliest possible opportunity and also to avoid unnecessary inconvenience that may be caused due to loss in transit.

#### **4.1.10 Holder (Sec 8) and holder in Due Course (Sec 9) of a Bill of Exchange**

As per section 8 of the Negotiable Instrument Act", the" holder" of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto. Where the note, bill or cheque is lost or destroyed, its holder is the person so entitled at the time of such loss or destruction.

**Thus a person who has obtained the possession of a bill of exchange by theft or under a forged endorsement is not a holder and is not entitled to recover the amount of the instrument.**

Holder in due course on the other hand means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque if payable to bearer, or the payee or endorsee thereof, if [payable to order,] before the amount mentioned in it became payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title (sec 9)

A person to be regarded as a holder in due course must satisfy the following conditions;

**(a)** Must have taken the instrument for value: This value for which the holder in due course get the instrument is called consideration. In other words the holder in due course must be a holder for valuable consideration as defined in section 2(d) of the Indian Contract Act, 1872. The consideration, however, need not be adequate. It should not be unlawful under section 23 of the Indian Contract Act,1872. All the essentials of a valid consideration must be present at the time of acquiring the instrument.

A donee by way of gift of an instrument is not a holder in due course for want of consideration, although he is holder. However, if the donor is a holder in due course, by virtue of the rule contained in section 53 of the act, the donee *ipso facto* acquires all the rights of the holder in due course. A debt due on a wagering agreement is not valid consideration, and a person who acquires an instrument in consideration of such a debt, is not a holder in due course. The discounter of a bill of exchange may become a holder in due course if the other requirements of the section are satisfied.

In *Daulat ram vs. Nagindas*, 15 Born. L.R.333, it was held that if a debtor hands over a negotiable instrument to his creditor in discharge of a pre-existing debt, the creditor can claim to be holder in due course of the instrument.

If a holder holds a negotiable instrument as a pledge, he is deemed to be holder for value to the extent of his advance or loan.

- (b) Obtained the instrument before maturity: The person must become the holder before the amount becomes payable. A person who takes a bill or note on the day on which it becomes payable is not a holder in due course because he takes it after it becomes payable as instrument can be discharged at any time on that day.

A bill of exchange payable on demand is deemed to be overdue when it appears on the face of it have been in circulation for unreasonable length of time. What is unreasonable length of time for this purpose is question of fact.

A cheque is always payable on demand. However, a cheque is intended for immediate or early payment and not for circulation. It can remain in circulation for a reasonable time which is normally six months, according to custom and practice, from the date of the cheque.

- (c) The instrument is not incomplete or defective or any defect on its face
- (d) Must have taken it in good faith and without any notice of any defect in the title of the person from whom he derived it.

**The difference between holder and holder in due course are:**

**1. Meaning:**

Holder means any person entitled in his own name to the possession of the negotiable instrument and to recover or receive the amount due thereon from the parties thereto. A holder in due course on the other hand, means a holder who takes the instrument in good faith for consideration before it is overdue and without any notice of defect in the title of the person who transferred it to him.

**2. Consideration:**

A person who claims to be a holder in due course must show that he acquired the instrument for consideration. However consideration may not pass from a holder of the instrument.

**3. Title:**

Holder of negotiable instrument does not acquire a better title than that of the person from whom he acquired the instrument. Thus a holder does not acquire a good title if the title of any of the prior parties is defective. But a holder in due course gets a good title even though there was a defect in the title of any prior parties to the instrument.

**4. Liability:**

A holder in due course can sue all prior parties to a negotiable instrument until the instrument is duly satisfied. Whereas a holder of the instrument can enforce it against the person who has signed it and also against the transfer or from whom he obtained it.

**5. Maturity:**

A person will be a holder in due course only if he acquires the instrument before the amount mentioned in it become payable. But a holder may acquire the instrument even after it has become due for payment.

**Privileges of a holder in due course:**

A holder in due course is certain additional privileges under various section of the Negotiable Instrument Act. But in order to entitle him to the privilege or advantages available under the Negotiable Instrument Act it must be beyond doubt that he is a holder in due course.

A holder, to be a holder in due course must not only have acquired the bill, note or cheque for a valid consideration but should have acquired the cheque without having sufficient cause to believe that



any defect existed in the title of the person from whom he derived his title. This condition requires that he should act in good faith and with reasonable caution. However, mere failure to prove bona fide or absence of negligence on his part would not negative his claim. But in a given case it is left to the court to decide whether the negligence on part of the holder is so gross an extraordinary as to presume that he had sufficient cause to believe that such title was defective.

**Holder in due course acquiring the instrument for consideration and in good faith gets the following rights under the act:**

- A) Holder in due course can file a suit in his own name against the parties liable to pay. He is deemed prima facie to be holder in due course (Sec 118).
- B) The holder in due course gets a good title even though the instrument was originally stamped but was an inchoate instrument (Sec 20). The person who has signed and delivered an inchoate instrument cannot plead as against the holder in due course that the instrument has not been filled in accordance with the authority given by him. However, a holder who himself completes the instrument is not a holder in due course.

Thus, if the holder of an inchoate stamped instrument fills more amount than authorized he cannot enforce the instrument for the whole amount and only authorized amount can be recovered. If the instrument is negotiated to a holder in due course he can claim the full amount provided it is covered by the stamp affixed thereon.

**Example:**

X signs and gives to Y a blank instrument and authorizes him to fill the promissory note for ₹ 7500 to secure an advance from Z. Y fills it up for ₹ 12,000 payable to Z who in good faith advances ₹ 12,000 to Y. X is stopped from setting up Y's fraud and Z is entitled to recover ₹ 12000 from X.

- C) Every prior party to the instrument is liable to a holder in due course until the instrument is duly satisfied (Sec 36).
- D) Acceptor cannot plead against a holder in due course that the bill is drawn in a fictitious name (Sec 42). In *Bank of England v Vagliano Bros (1891 – Ac 107)* it was held that the acceptor should consider whether the bill was genuine or false before signing his acceptance in it.
- E) The other parties liable to pay cannot plead that the delivery of the instrument was conditional or for a specific purpose only (Sec 46).

**Example:** A the holder of bill, endorses it "B or order" for the specific purpose that B may get it discounted. B does not do so and negotiates it to C, a holder in due course a good title to the bill and all prior parties are liable to him.

- F) He gets a good title to the instrument even though the title of the transferor or any prior party to the instrument is defective (Sec 53) He can recover the full amount unless he was a party to fraud; or if the instrument is negotiated by means of a forged endorsement.

In other words the pleas on the part of the person liable on negotiable instrument which had been lost or obtained by means of an offence or fraud or for an unlawful consideration, cannot be set up against a holder in due course. It may be noted that a holder in due course can purify a defective title but he cannot create any title unless the instrument is payable to bearer.

**Example 1:**

A bill is payable to "A or order". It is stolen from A and the thief forges A's signature and endorses it to B who takes it as a holder in due course. B cannot recover the money. But if the bill is payable to bearer and is stolen and delivered to B by the thief, a holder in due course B can recover the amount of the bill.

**Example 2:**

A Bill originally obtained by fraud from the drawer gets into the hands of A, a holder in due course. A indorses the bill to B by way of gift. B cannot sue the acceptor for he stands on A's title.

**Example 3:**

A by fraud induces B to make a promissory note in his favor. He endorses the note to C who takes it as a holder in due course. C subsequently indorses the note to A for value. A cannot sue B on the note as he himself is a party to fraud.

In *firm Kalka Prasad Ram Charan v Kanwar Lal AIR 1957 ALL 104*, it was held that the indorsement on a negotiable instrument through which a holder in due course claims must be genuine and therefore, a forged indorsement creates no title in favor of the holder in due course.

- G) Even if the negotiable instrument is made without consideration, if it gets into the hands of the holder in due course, he can recover the amount on it from any of the prior parties thereto.
- H) The person liable cannot plead against the holder in due course that the instrument had been lost or was obtained by means of an offence of fraud or for an unlawful consideration (sec 58).

**Example:**

A cheque is given to an employee of a company to enable him to withdraw money for payment to workers bonus; he instead transferred the cheque to a bank for consideration the bank will be entitled to get the payment on the cheque.

- I) The validity of the instrument as originally made or drawn cannot be denied by the maker or drawer of a negotiable instrument or by acceptor of a bill of exchange for honor of the drawer (Sec 120).
- J) The maker of a note or an acceptor of a bill payable to order cannot deny the payee's capacity to indorse the same at the date of the note or bill (sec 121).
- K) Endorser is not permitted as against the holder in due course to deny the signature or capacity to contract of any prior party to the instrument (Sec 122).
- l) Privilege in case of a fictitious payee: According to section 42 an acceptor of a Bill of exchange drawn in a fictitious name and payable to the drawer's order is not, by reason that such name is fictitious, relieved from liability to any holder in due course claiming under an endorsement by the same hand as the drawer's signature and purporting to be made by the drawer". In case of a fictitious bill both the drawer and payee are fictitious persons. By fictitious payee we mean a person who is not in existence or being in existence is never intended by the drawer to have the payment.

**Example:**

In *Bank of England v Vagliano Brothers (1891) AC 107 153*, Vagliano used to accept bills drawn on him by a foreign agent and payable to a foreign firm P & Co. Vagliano's clerk obtained acceptance on certain false bills all purporting to be drawn by a foreign agent and payable to the foreign firm. He indorsed the bill in the name of a foreign firm and obtained payment from the Bank of England where Vagliano's bills were payable and in accordance with Vagliano's account which was opposed by Vagliano contending that the bills were fictitious. It was held that the Bank of England being the holder in due course, was protected against all such defences.

It will therefore be observed that the title of the holder in due course of a negotiable instrument is free from equities and other defences which could be pleaded against the prior parties.

**Liability of prior parties to holder in due courses:**

Every prior party to negotiable instruments is liable thereon to a holder in due course until instrument is duly satisfied (Sec 36).



The prior parties to an instrument are maker, drawer acceptor and endorser. The instrument is duly satisfied when the parties to the instrument are discharged by payment or when the liabilities of the parties are extinguished. Till then all the prior parties to the instrument continue to remain liable to the holder in due course.

#### **Holder deriving title from holder in due course**

A holder of a negotiable instrument who derives title from a holder in due course has the rights thereon of that holder in due course. The law presumes that every holder is a holder in due course until the contrary is proved [sec 118(g)]

The instrument once reaching the hands of a holder in due course is cleansed of all defects. It becomes pure and passes also to subsequent parties as an instrument immune from any defect. However, where holder in due course himself is a party to fraud or illegality he does not acquire the rights of a holder in due course.

#### **4.1.11 Due Date of a Bill or Note**

Every instrument payable, otherwise, than **on demand** is entitled to three days of grace. Instruments not entitled to 'period of grace' are:

- i) a cheque,
- ii) a bill or note payable on demand,
- iii) a bill or note in which no time is mentioned.

Instruments entitled to 'period of grace' are:

- i) a bill or note payable on a specified day,
- ii) a bill or note payable 'after sight',
- iii) a bill or note payable at a certain period on happening of a certain event.

So in case of time bill or note, it becomes due on the last day of grace period. Where an instrument is payable by installments, each installment is due three days after the date fixed for payment of the installment. If the due date falls on a public holiday, the bill becomes due on immediate preceding business day. If the month in which the period is to terminate has no corresponding day, the period will terminate on the last day of the month.

#### **Examples:**

- (i) A bill dated 6th February, 2012 is made payable 90 days after date. It's due date is 9th May, 2012.
- (ii) A bill dated 1st January, 2012 is made payable one month after date. It falls due on 3rd March, 2012.
- (iii) A bill falls due on 9th May, 2012 which happens to be a Sunday. Then due date becomes 8th May, 2012.

#### **Payment in Due Course:**

Payment in due course means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof. The payment to the person in possession of the instrument must be under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned in the instrument.

Payment in due course results in discharge of the instrument. A payment is said to be 'payment in due course' if it satisfies the following conditions:

- i) It is in accordance with apparent tenor of the instrument. Apparent tenure means what appears to be on the face of the instrument to be the intention of the parties. A payment before the maturity

date is not a payment according to the apparent tenor of the instrument. Accordingly payment must be made at or after the maturity date

- ii) It is made on behalf of drawee or acceptor. It must be made in money term only which includes cheque and currency notes. The holder of a negotiable instrument cannot be forced to accept payment in any other mode except with his consent.
- iii) It is made to the person in possession of the instrument and also entitled to payment.
- iv) It is made in good faith, without negligence and under bonafide circumstances. If a cheque bears forged signature of the drawer, the payment will not be payment in due course if the banker fails to exercise the necessary care. (Allahabad Bank Ltd vs. Kul Bhushan)
- v) There is no ground for believing that possessor is not entitled to receive payment.

#### **To whom payment should be made?**

The payment of the amount due on promissory note, bill of exchange or a cheque must in order to discharge the maker or acceptor be made to the holder of the instrument. As per section 82(c) the maker, acceptor or indorser respectively of a negotiable instrument is discharged from liability thereon to all parties thereto if the instrument is payable to bearer, or has been endorsed in blank and such maker, acceptor or endorser makes payment in due course of the amount due thereon.

In *Sangeshwar V Gita Devi aIR 1975 Pat 81* it was held that the maker of a promissory note can obtain the discharge of his debt by making payment to the holder of the instrument alone and no one else.

#### **4.1.12 Presentation of a Negotiable Instrument.**

Presentation of a bill means showing the same to the drawee, acceptor or maker for acceptance, sight or payment. An instrument can be presented in three ways.

- (a) Presentation for acceptance.
- (b) Presentation of a promissory note for sight.
- (c) Presentation of a negotiable instrument for payment.

## **4.2 ACCEPTANCE AND NEGOTIATION**

### **4.2.1 Acceptance**

Only certain types of bills require acceptance. Essentials of a valid acceptance are—

- (i) Must be written on the face of the bill,
- (ii) The bill must be signed by drawee or his authorized agent.
- (iii) The accepted bill is required to be delivered to the holder of the instrument.

#### **Meaning of acceptance:**

A bill is said to be accepted when the drawee (i.e., the person on whom the bill is drawn), after putting his signature on it, *either delivers it or gives notice of such acceptance to the holder of the bill or to some person on his behalf.*

#### **Acceptor:**

After the drawee has accepted the bill, he is known as the acceptor. It is only the bill of exchange (other than cheque) which requires acceptance. However, acceptance is not necessary to make a valid bill. If a bill is not accepted, it does not become invalid. It only becomes dishonoured by non-acceptance.



**Presentation for acceptance may be excused in the following circumstances:**

- (a) Where the drawee is dead or insolvent.
- (b) Where the drawee is a fictitious person or one incapable of contracting.
- (c) When the drawee cannot be found with reasonable efforts.
- (d) When acceptance has been refused on some other grounds.

**Acceptance in Case of Bills in Sets:**

Where a bill is drawn in sets, the acceptance is required to be put on one part only. Where the drawee signs his acceptance on two or more parts, he may become liable on each of them respectively.

**When presentation for acceptance is necessary:**

- (a) Where the bill is payable at a given time after acceptance or after sight.
- (b) Where the bill expressly stipulates that it shall be presented for acceptance before presented for payment.
- (c) Where the bill is made payable at a place other than the place of residence or business of the drawee.

In no other case is presentation for acceptance necessary in order to render liable any party to the bill.

**Types of Acceptance:**

Acceptance may be either general or qualified.

**General Acceptance:** An acceptance is said to be general when the drawee accepts the bill without qualification to the order of the drawer. If the acceptance is not absolute, the holder may treat the bill as dishonoured by non-acceptance.

**Qualified Acceptance:** An acceptance is said to be qualified when the drawee accepts the bill subject to qualification. It may be noted that an acceptance will not be treated as a qualified acceptance unless the qualification is expressed on the bill in the clearest language. The qualification may relate to an event, amount, place, time, etc.

**Circumstances indicating Qualified Acceptance**

According to Section 86, an acceptance is qualified under the following circumstances:

- (a) Where it undertakes the payment on the happening of an event therein stated;
- (b) Where it undertakes the payment of part only of the sum ordered to be paid;
- (c) Where it undertakes the payment at a specified place of his choice and not otherwise or elsewhere;
- (d) Where it undertakes the payment at a time other than that at which under the order it would be legally due.
- (e) Where it is not signed by all drawees who are not partners.

**Effect of Qualified Acceptance**

- (a) The holder may, treat the bill as dishonoured due to non-acceptance and after giving due notice of dishonour, sue the drawer and prior endorsers.
- (b) If he accepts a qualified acceptance all prior parties whose consent is not obtained are discharged as against the holder and those deriving title from him.

### **Examples of Qualified Acceptance**

- (a) Accepted payable when in funds.
- (b) Accepted payable on giving up bill of lading.
- (c) Accepted payable when a cargo consigned to me is sold.
- (d) A bill drawn for ₹ 1,000 accepted for ₹ 900 only.
- (e) Accepted payable at Delhi only where no place of payment is specified in the order.
- (f) Accepted payable at Delhi only where the place of payment specified in the order was Bombay.
- (g) Accepted payable 4 months after date where the bill drawn as payable 3 months after date.
- (h) Accepted by A, B and C where drawees were A, B, C and D who not partners.
- (i) Accepted payable on receiving income tax refund
- (j) A bill drawn for ₹ 1,000 but accepted to the extent considered reasonable and just by a common friend of both.

### **Time for presentation for sight:**

If promissory note is payable after sight it must be presented for acceptance within the specified time or if no time is specified within a reasonable time. What is a reasonable time is a question of fact that depends upon the means of communication available and usage of a particular trade.

Where to present: As per section 61 the bill should be presented at a place specified for presentation. If the drawee cannot be found at that place after reasonable effort the bill is deemed to be dishonored. If no such place is mentioned it should be presented at the drawee's place of business or residence.

### **Presentation for Payment:**

As per section 64 it is the duty of the holder to present the bill for payment in accordance with the provisions of the Act. If the bill is not presented for payment in accordance with the rules provided the other party is discharged from their liability to the holder.

In case of a promissory note which is payable on demand and is not made payable at a specified place presentation for payment is not required.

### **Time of presentation:**

As per section 67 where an instrument is payable after a fixed period of time it should be presented for payment on its maturity. If the promissory note is payable in installment, it should be presented for payment on the 3<sup>rd</sup> day after the date fixed for each installment. An instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder.

### **Place of Presentation:**

Where a bill or cheque is made, drawn or accepted payable at a specified place and not elsewhere it must be presented at that place otherwise any party would be liable to the holder. Similarly a bill or note made payable at a specified place must be presented at that place, otherwise the drawer or maker will be discharged from liability to the holder.

### **4.2.2 Negotiation and Assignment**

An essential characteristic of a negotiable instrument is that it is freely transferable. The transfer may take place through (i) negotiation (ii) assignment.

## Difference between negotiation and assignment

Sl.No.	Negotiation	Assignment
(1)	Negotiation may be effected by mere delivery if the instrument is bearer one or endorsement and delivery if it is an order instrument.	Assignment should always be on a written document signed by transferor.
(2)	Transferee gets the rights of Holder in due course.	Title of the transferee is always subject to the title of the transferor.
(3)	Consideration is always presumed.	Consideration must be proved.
(4)	No information of transfer needs to be given to the debtor in order to bind him.	Notice of assignment is must in order to bind the debtor.

A negotiable instrument may be transferred either by negotiation or by assignment.

**Meaning of Negotiation [Section 14]** An instrument is said to be negotiated when a negotiable instrument is transferred to any person so as to constitute that person the holder of the instrument.

Thus, the essence of the negotiation is that it must be made with the intention of transferring a title of the instrument to the transferee.

### Example 1

X was the holder of a cheque of ₹ 10,000 payable to bearer. He delivered this cheque to Y to keep it in his (Y) safe custody. In this case there is no negotiation of cheque from X to Y because the transfer of the cheque to Y makes him a bailee only and not the holder of the cheque

### Example 2

X was the holder of a cheque of ₹ 500 payable to bearer. X owes ₹ 5000 to Y. X delivered this cheque to Y with the advice to treat as in settlement of amount due to him. This is a proper negotiation.

### Example 3:

X hold a bearer cheque of ₹ 5,000 which he kept in his pocket, Y a pick-pocket or stole this cheque.

This is not a negotiation of cheque by X to Y as there was no voluntary delivery from X to Y.

## How to Effect Negotiation?

There are two methods of transfer by negotiation as follows:

### (i) Negotiation by delivery [Section 47]:

A bearer instrument is negotiable by voluntary delivery thereof.

Thus, the instrument must be actually delivered and the delivery must also be voluntary.

#### Example

X was the holder of a cheque for ₹ 10,000 payable to bearer. He kept the cheque in his safe. Y, a thief stole the cheque from X'S safe. In this case, there is no negotiation of the cheque from X to Y because the cheque was not voluntarily delivered to Y. It may also be noted that if Y delivers this cheque for some consideration to Z who receives the same in good faith and before maturity. Z will become the holder in due course and will be entitled to receive the amount of the instrument. [Section 58]

### (ii) Negotiation by endorsement and delivery [Section 48]: An order instrument is negotiable by endorsement and delivery thereof. Thus, a mere endorsement (i.e., signing of a negotiable instrument for the purpose of negotiation) does not amount to negotiation unless there is delivery of the same. There must be not only voluntary delivery of instrument but intention to transfer property in the holder to complete negotiation.

Who can Negotiate a negotiable instrument? As per section 51 of the Negotiation Act every maker, drawer, payee or endorsee or all of several joint makers, drawers, payees or endorsees of a negotiable instrument may endorse or negotiate a Negotiable Instrument if such instrument has not been restricted or excluded under section 50 of the Act. However, such maker, drawer can negotiate or endorse the negotiable instrument only when he is in lawfull possession of the instrument. Accordingly, a person who steals or find a lost instrument, cannot endorse and negotiate an instrument, as he is not the holder.

### **Duration of Negotiability [Section 60]**

A negotiable instrument may be negotiated;

- by person other than the maker, drawer or acceptor until payment;
- by the maker, drawee or acceptor until maturity.

### **Transfer by Assignment:**

When a person transfers his right to receive the payment of a debt, assignment of debt takes place. Thus where the holder of an instrument transfers it to another so as to confer a right on the transferee to receive the payment of the instrument, transfer by assignment takes place. Negotiable Instrument Act does not deal with transfer of negotiable instruments by assignment.

### **Endorsement**

Endorsement (Endorsement) means writing of a person's name (other than maker) on the face or back of an instrument or on a slip of paper attached thereto for the purpose of negotiation. The person signing the instrument is known as endorser and the person in whose favour it is endorsed is known as endorsee.

### **Essentials of a valid endorsement (endorsement)**

- (I) It must be on the instrument itself or on a separate slip of paper (called allonge) attached thereto.
- (II) For the purpose of negotiation, it must be signed by the endorser.
- (III) The instrument may contain in addition to the signature of the endorser, the name of the endorsee also. No particular form of words is necessary for endorsement.
- (IV) Endorsement is complete when the instrument is delivered to the endorsee with the intention of passing the property in it to the endorsee. Delivery is to be made by the endorser himself or someone on behalf of him.

### **Who may endorse a bill**

The first endorsement of an instrument can be made by the payee only, however, subsequent endorsement can be made by any person who becomes the holder of the instrument. As per section 15 endorsement can not be made by the maker or holder of an instrument as maker. Thus if a bill is drawn payable to the drawer's order the first signature of the drawer as a drawer is not an endorsement, but if he signs the bills second time for the purpose of negotiating it, the second signature would be an endorsement.

It may noted that as per section 51 every sole maker, drawer, payee or indorsee or all of several joint makers, drawers, payees or indorsees of a negotiable instrument may endorse and negotiate it.

### **Types of endorsement**

The endorsement of a negotiable instrument can be (i) blank (ii) full (iii) restrictive endorsement or (iv) conditional endorsement

As per section 16(1), if the endorser signs his name only, the endorsement is said to be "**in blank**", and



if he adds a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person, the endorsement is said to be “**in full**”, and the person so specified is called the “endorsee” of the instrument. Section 49 of the Act provides the mechanism of conversion of a blank endorsement into a full endorsement. As per section 49 the holder of a negotiable instrument indorsed in blank may, without signing his own name, by writing above the endorser’s signature a direction to pay to any other person as endorsee, convert the endorsement in full; and the holder does not thereby incur the responsibility of an endorser.

**Example:**

X is a holder of a bill which has been endorsed in blank by Y and delivered to him. If X writes over the signature of Y “Pay to Z or order”, X is not liable as a endorser but this operate as full endorsement by Y to Z.

As per section 55 if a negotiable instrument, after having been indorsed in blank, is indorsed in full, the amount of it cannot be claimed from the endorser in full, except by the person to whom it has been indorsed in full, or by one who derives title through such person. As per section 54, subject to the provisions hereinafter (section 55) contained crossed cheques, a negotiable instrument indorsed in blank is payable to the bearer thereof even although originally payable to order.

**Example:**

If A is a payee and holder of a negotiable instrument. He endorses it in blank and delivers it to B who in turn endorse in full” Pay to C or order”. C transfers it to D without any formal endorsement. In the instant D as the bearer of the instrument is entitled to payment or to sue drawer, acceptor or A who endorsed the bill in blank but he cannot hold B or C liable. However, C can sue B as he received the bill in full endorsement from B. But if C makes a proper endorsement in favor of D and then delivers to him, D can claim payment from all the prior parties including A and B in addition to C.

As per section 50 endorsement of a negotiable instrument followed by delivery thereof has the effect of transferring the property in the instrument to the endorsee with a further right to negotiate the instrument. But the endorser may by express words restrict or exclude such rights in which it will be called a **restrictive endorsement**. As per section 50 the of a negotiable instrument followed by delivery transfers to the endorsee the property therein with the right of further negotiation; but the endorsement may be express words, restrict or exclude such right, or may merely constitute the endorsee an agent to indorse the instrument, or to receive its contents for the endorser, or for some other specified person. The effect of restrictive endorsement is that the endorsee gets the right to full payment of the bill when due for payment and has right to sue any party to the bill but he has no right to transfer this right to any other person unless he expressly authorized to do so. The negotiability of the instrument comes to an end and the last endorsee is the person to sue upon. However, when the restrictive endorsement transfer the right of further endorsement or transfer all the subsequent endorsee get the bill with same right and liabilities as the fires endorsee after the first restrictive endorsement.

As per section 40 if the holder of a negotiable instrument without consent of the endorsee, destroys or impairs the endorser’s remedy against a prior party, the endorser is discharged from liability as if the instrument had been paid at maturity.

Quite possible the holder of a negotiable instrument lost the instrument before its date of maturity. In such cases as per section 45 A of the act the holder has right to claim a duplicate copy of the lost bill subject to giving security to the drawer, if required, to indemnify him against all persons whatever in case the bill alleged to have been lost shall be found again. If the drawer on request as aforesaid refuses to give such duplicate bill, he may be compelled to do so as he has no option to give a duplicate copy of the said instrument.

As per section 52 of the Act, the endorser of a negotiable instrument may, by express words in the endorsement, exclude his own liability thereon, or make such liability or the right of the endorsee to receive the amount due thereon depend upon the happening of a specified event, although such event may never happen. This is called **conditional endorsement**.

Where an endorser so excludes his liability and afterwards becomes the holder of the instrument all intermediate endorsers are liable to him.

**Example 1:**

The Endorser of a negotiable instrument signs his name adding the words “without recourse” upon this endorsement he incurs no liability.

**Example 2:**

X is both holder as well payee of a negotiable instrument. Excluding personal liability by an endorsement “without recourse” he transfers the Instrument to B and B further endorses it to C who endorses it to A. A is not only reinstated in his former rights, but has the rights of an endorsee against B and C.

As clear from the above examples we can say that an endorser can exclude or limit his liability in the following ways;

- (a) By excluding his liability by making a Sans recourse endorsement. This can be done by adding the words 'Sans recourse (Without recourse) to the endorsement. For example the endorsement can be in the form "Pay A or order without recourse to me" or "pay A or order sans recourse" or 'Pay A or order at his own risk'. In the instant case if the instrument is dishonored, the subsequent holder or the endorsee cannot look to the endorser for the payment of the same. Where an endorser excludes or limits his liability in this manner and afterwards becomes the holder of the same instrument, all intermediate endorsers continue to be liable to him.
- (b) Sans Frais endorsement: It may be understood that where the endorser does not want that the endorsee or any other holder to incur any expense on his account, it is called a “sans frais endorsement”. In a “Sans Frais” endorsement the endorsee or any other holder does not want to incur any expense on his account This is called without expense endorsement also.
- (c) By making his liability contingent upon an uncertain event which may never happen as when the uncertain future event is not possible his liability is extinguished. But the endorsee can sue the prior parties before happening of the event.

**Example:**

The holder of a bill may endorse it “pay A or order on the arrival of the ship ‘Vikrant’ at Surat or pay A or order on his marriage with B. In all these cases, the liability of the holder as an endorser would arise upon the happening of the event specified.

- (d) By making right of endorse to receive payment on event which may never happen. In this case endorsee can not sue prior parties before the happening of the specified event.
- (e) Partial endorsement: In order to be called a proper and valid endorsement the whole amount of the bill has to be endorsed. A part of the amount of an instrument cannot be endorsed. However, where a part of the amount has been paid or received by the holder, in such endorsement of the remaining unpaid amount can be made.

**Example:**

An instrument is of ₹ 5,000 however, if any party to the instrument endorses it for ₹ 4000/ in favor of any party such endorsement will not be valid.

However, where ₹ 1000 has been received against that instrument and the fact is recorded in the instrument then the endorsement of balance ₹ 4000 is perfectly valid.

- (f) Facultative endorsement:-In case of such an endorsement the endorser abandons some rights or increases his liability as endorser e.g “Pay A or order, notice of dishonor waived”



### 4.3 LIABILITIES OF PARTIES

Sections 30 to 32 and 35 to 42 of the Negotiable Instruments Act, 1881 deal with the question of liability of parties to negotiable instruments. These sections are discussed below:

**a) Liability of drawer:**

The drawer of a bill of exchange or cheque is bound in case of dishonour by the drawee or acceptor thereof, to compensate the holder, provided due notice of dishonour has been given to, or received by, the drawer as hereinafter provided. (Sec 30)

**b) Liability of drawee of cheque:**

The drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment, must compensate the drawer for any loss or damage caused by such default. (Sec 31)

**c) Liability of maker of note and acceptor of bill:**

In the absence of contract to the contrary, the maker of a promissory note and the acceptor before maturity of a bill of exchange are bound to pay the amount thereof at maturity according to the apparent tenor of the note or acceptance respectively, and the acceptor of a bill of exchange at or after maturity is bound to pay the amount thereof to the holder on demand.

In default of such payment as aforesaid, such maker or acceptor is bound to compensate any party to the note or bill for any loss or damage sustained by him and caused by such default. (Sec 32)

**d) Liability of endorser:**

In the absence of a contract to the contrary, whoever indorses and delivers a negotiable instrument before maturity, without in such endorsement, expressly excluding or making conditional his own liability, is bound thereby to every subsequent holder, in case of dishonour by the drawee, acceptor or maker, to compensate such holder for any loss or damage caused to him by such dishonour, provided due notice of dishonour has been given to, or received by, such endorser as hereinafter provided.

Every endorser after dishonour is liable as upon an instrument payable on demand. (Sec 35)

**e) Liability of prior parties to holder in due course:**

Every prior party to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied (Sec 36).

**f) General rules regarding liability- the principle of suretyship:**

**i) Maker, drawer and acceptor principals**

The maker of a promissory note or cheque, the drawer of bill of exchange until acceptance, and the acceptor are, in the absence of a contract to the contrary, respectively liable thereon as principal debtors, and the other parties thereto are liable thereon as sureties for the maker, drawer or acceptor, as the case may be (Sec 37).

**ii) Prior party a principal in respect of each subsequent party**

As between the parties so liable as sureties, each prior party is, in the absence of a contract to the contrary. Also liable thereon as a principal debtor in respect of each subsequent party. (Sec 38)

**Example:**

A draws a bill payable to his own order on B, who accepts, A afterwards endorses the bill to C, C to D to E. As between E and B, B is the principal debtor, and A, C and D are his sureties. As between E and A., A is the principal debtor, and C and D are his sureties. As between E and C, C is the principal debtor and D is his surety.

**iii) Surety ship**

When the holder of an accepted bill of exchange enters into any contract with the acceptor which, under section 134 or 135 of the Indian Contract Act, 1872 ( 9 of 1872), would discharge the other parties, the holder may expressly reserve his right to charge the other parties, and in such case they are not discharged.(Sec 39)

**iv) Discharge of endorser's liability**

Where the holder of a negotiable instrument, without the consent of the endorser, destroys or impairs the endorser's remedy against a prior party, the endorser is discharged from liability to the holder to the same extent as if the instrument had been paid at maturity.

**Illustration**

A is the holder of a bill of exchange made payable to the order of B, which contains the following endorsements in blank-

- First endorsement, "B".
- Second endorsement, "C".
- Third endorsement, "D".
- Fourth endorsement "E".

This bill A puts in suit against E and strikes out, without E's consent, the endorsements by C and D. A is not entitled to recover any thing from E.

**g) Acceptor bound, although endorsement forged**

An acceptor of a bill of exchange already indorsed is not relieved from liability by reason that such endorsement is forged, if he knew or had reason to believe the endorsement to be forged when he accepted the bill (Sec 41).

**h) Acceptance of bill drawn in fictitious name**

An acceptor of a bill of exchange drawn in a fictitious name and payable to the drawer's order is not, by reason that such name is fictitious, relieved from liability to any holder in due course claiming under an endorsement by the same hand as the drawer's signature, and purporting to be made by the drawer.

**Other rules:**

- I) Where instrument is negotiated to holder in due course, other parties to instrument cannot escape liability on the pretext that delivery of the instrument was conditional or for special purpose only. (Sec 46).
- II) A holder of a negotiable instrument who derives title from a holder in due course has the rights thereon of that holder in due course (Sec 53).
- III) When a negotiable instrument has been lost, or has been obtained from any maker, acceptor or holder thereof by means of offence or fraud, or for an unlawful consideration, no possessor or endorsee who claims through the person who found or so obtained the instrument is entitled to receive the amount due thereon from such maker, acceptor or holder, or from any party prior to such holder, unless such possessor or endorsee is, or some person through whom he claims was, a holder thereof in due course (Sec 58).



- IV) No maker of a promissory note, and no drawer of a bill of exchange or cheque, and no acceptor of a bill of exchange for the honor of the drawer cannot deny against holder in due course, presume the fact of dishonor, validity of the instrument as originally made or drawn (Sec 120).
- V) No maker of a promissory note and no acceptor of a bill of exchange or cheque, and no acceptor of a bill of exchange payable to order shall in suit thereon by a holder in due course, be permitted to deny the payee's capacity, at the rate or the note or bill, to endorse the same (Sec 121).

#### 4.4. DISHONOUR OF NEGOTIABLE INSTRUMENT

A bill may be dishonoured by non-acceptance or non-payment. A cheque or note is dishonoured by non-payment only. If an instrument is dishonoured, the holder must give notice of dishonour to all prior parties unless the notice is excused, otherwise he loses his right of action against all prior parties.

**4.4.1 Noting:** Noting means recording the fact of dishonour by Notary Public upon the instrument. Noting must contain the following particulars:

- (i) the fact of dishonour,
- (ii) date of dishonour
- (iii) reasons, if any, assigned for dishonour,
- (iv) if the instrument is not expressly dishonoured, reasons why the holder thinks so.

**4.4.2 Object of Notice:** Notice of dishonour is necessary to inform the prior parties liable on the instrument about liability which accrues as a result of dishonour of the instrument. If he does not give notice of dishonour of the bill or cheque, except when the notice of dishonour is excused, all the parties liable thereon are discharged of their liability.

**Example:**

X writes a bill of exchange for ₹ 1000/ upon Y to be paid within 3 months. Y accepted the same. X endorsed it in favor of Z, Z in turn endorsed to A. On the due date when A presented it to Y for payment on the due date Y regretted to honor the bill on due date. A must give a notice of dishonour to X and Z.

**4.4.3 Form of Notice:** Notice of dishonour may be oral or written. When written, it may be sent by post. It must be given within reasonable time at the place of business or residence (if there is no place of business) to the party for whom it is intended. Whatever be the form of giving notice of dishonour of the bill, it must clearly indicate that the bill has been dishonoured.

Notice must be given within a reasonable time. What is a reasonable time depends on nature of instrument and usual course of dealing with respect to similar instruments. Public holidays are to be excluded in calculating time.

Delay caused by circumstances beyond the control of the party desiring to serve notice is excused provided it is not imputable to his default, misconduct or negligence [(*Beweridge v Burgis* 91812) 3 Camp262]

If the holder and the party entitled to notice of dishonour carry on business or live in different cities, the notice must be dispatched by the next post or on the day next after the day of dishonour. On the other hand if the parties carry on business or live in the same place, the notice must be dispatched in time to reach its destination on the day next after the day of dishonour.

A party receiving notice of dishonour, who seeks to enforce his right against a prior party, transmits the notice within a reasonable time if he transmits it within the same time after its receipt as he would have had to give notice if he had been the holder (Sec. 107).

**4.4.4 Notice of dishonour is not necessary in the following circumstances:**

- i) When it is dispensed with by the party entitled thereto.
- ii) When the party charged could not suffer damage for want of notice.

- iii) In case of a promissory note which is not negotiable.
- iv) To charge the drawer when drawer and acceptor are the same person.
- v) When the party entitled to notice , promises unconditionally to pay the amount due on the instrument.
- vi) When the party entitled to notice could not be found after due search.
- vii) To charge the drawee, when he has countermanded payment.

#### **4.4.5 Duties of the holder upon dishonour**

- i) The holder must give notice of dishonour to all prior parties who are liable to pay.
- ii) Upon dishonour of the instrument, the holder may get the fact of dishonour noted and protested by the Notary Public.
- iii) After the formality of noting and protesting, the last option available to the holder is to file suit for the amount due against the parties liable for payment.

**4.4.6 Instruments acquired after the notice of dishonour/maturity:** Holder acquiring the instrument after notice of dishonour or after maturity, as against the other parties, has the rights of his immediate transferor.

#### **4.4.7 Protest and protest for better Security:**

When a promissory note or bill of exchange has been dishonored by non-acceptance or non-payment, the holder may, within a reasonable time, cause such dishonor to be noted. Such dishonor to be noted and certified by a notary public. Such certificate is called a protest. The contents of protest are provided in section 101 of the Act which will be discussed subsequently. In case of foreign bills of exchange must be protested for dishonor when such protest is required by the law of the place where they are drawn(section 104).

At times before maturity of a bill of exchange the acceptor becomes insolvent or his credit is impeached signaling possible dishonor of the Instrument. According to section 100 when the acceptor of a bill of exchange has become insolvent, or his credit has been publicly impeached, before the maturity of the bill, the holder may, within a reasonable time, cause a notary public to demand better security of the acceptor, and on its being refused, may, with a reasonable time, cause such facts to be noted and certified as aforesaid. Such certificate is called a protest for better security.

A protest under section 100 must contain (section 101) –

- (a) either the instrument itself, or a literal transcript of the instrument and of everything written or printed thereupon;
- (b) the name of the person for whom and against whom the instrument has been protested;
- (c) a statement that payment or acceptance, or better security, as the case may be, has been demanded of such person by the notary public; the terms of his answer, if any, or a statement that he could not be found;
- (d) when the note or bill has been dishonored, the place and time of dishonor, and, when better security has been refused, the place and time of refusal;
- (e) the subscription of the notary public making the protest;
- (f) in the event of an acceptance for honor or of a payment for honor, the name of the person by whom, of the person whom, and the manner in which, such acceptance or payment was offered and effected.

A notary public may make the demand mentioned in clause (c) of this section either person or by his clerk or, were authorized by agreement or usage, by registered letter.



When a promissory note or bill of exchange is required by law to be protested; notice of such protest must be given instead of notice of dishonor, in the same manner and subject to the same conditions; but the notice may be given by the notary public who makes the protest. In such a case notice of dishonor is not required.

When a bill of exchange is drawn payable at some other place than the place mentioned as the residence of the drawee, and is dishonored by non-acceptance, such bill are required to be protested for non payment in the place specified for payment, unless paid before or at maturity. In such case presentation of the bill to the drawee for payment is not necessary (section 103).

#### **When noting equivalent to Protest:(section104 A)**

Where a bill of notes is required to be protested within a specified time or before some further proceeding is taken is it sufficient that the bill has been noted for protest before the expiration of the specified time or the taking of the proceeding; and the formal protest may be extended at any time thereafter as of the date of the noting.

**4.4.8 Protest:** When a promissory note or bill of exchange has been dishonored by non-acceptance or non-payment., the holder may within a reasonable time, cause such dishonor to be noted and certified by a Notary Public. Such certificate is called protest. It is a formal notarial certificate attesting the dishonour of a bill or note. A protest must contain the following particulars:

- i) the instrument or literal transcript of the same;
- ii) the name of the person for whom or against whom the instrument is protested;
- iii) the fact of dishonour;
- iv) place and time of dishonour;
- v) signature of the Notary Public;
- vi) in case of acceptance/payment for honour, name of the person accepting or paying and the name of the person for whom it is paid or accepted.

#### **Rules as to Compensation**

##### **A) Compensation to holder:**

The holder is entitled to receive-

- i) the amount due on the instrument,
- ii) expenses incurred in presenting, noting and protesting the instrument.

##### **B) Re-exchange:**

Where the person charged resides in a country different from that in which the instrument was payable, the holder is entitled to receive the compensation at current rate of exchange between two countries on the date of dishonour.

##### **C) Compensation to endorser:**

The endorser, who being liable has paid the amount due on the instrument is entitled to receive the amount along with interest @18%p.a. from the date of payment till realization of the amount together with the incidental expenses.

##### **D) Re-draft:**

The party entitled to compensation may draw a bill for the amount due along with expenses incurred thereon. Such a bill is called 'redraft'. If redraft is dishonoured, the party dishonouring the same is liable to compensate in the same manner as in case of original bill.

#### **4.4.9 Penalties in Case of Dishonour of Certain Cheques for Insufficiency of Funds (Section 138 To 142)**

Advent of cheques in the market have given a new dimension to the commercial and corporate world, its time when people have preferred to carry and execute a small piece of paper called Cheque than carrying the currency worth the value of cheque. Dealings in cheques are vital and important not only for banking purposes but also for the commerce and industry and the economy of the country. But pursuant to the rise in dealings with cheques also rises the practice of giving cheques without any intention of honoring them. Before 1988 there being no effective legal provision to restrain people from issuing cheques without having sufficient funds in their account or any stringent provision to punish them in the vent of such cheque not being honoured by their bankers and returned unpaid. Of course on dishonour of cheques there is a civil liability accrued. However in reality the processes to seek civil justice becomes notoriously dilatory and recover by way of a civil suit takes an inordinately long time. To ensure promptitude and remedy against defaulters and to ensure credibility of the holders of the negotiable instrument a criminal remedy of penalty was inserted in the Negotiable Instruments Act, 1881 in form of the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988 which were further modified by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002[3].

##### **I. Dishonour of cheque for insufficiency of funds in the account:**

Section 138 creates statutory offence in the matter of dishonour of cheques on the ground of insufficiency of funds in the account maintained by a person with the banker. Section 138 of the Act can be said to be falling either in the acts which are not criminal in real sense, but are acts which in public interest are prohibited under the penalty or those where although the proceeding may be in criminal form, they are really only a summary mode of enforcing a civil right. Normally in criminal law existence of guilty intent is an essential ingredient of a crime. However the Legislature can always create an offence of absolute liability or strict liability where 'mens rea' is not at all necessary.

While elucidating on this aspect the Kerala High Court in *K. S. Auto v. Union of India* held that:

*"Knowledge or reasonable belief, that pre requisite could be statutorily dispensed with in appropriate cases by creating strict liability offences in the interest of the Nation."*

Further the creation of the strict liability is an effective measure by encouraging greater vigilance to prevent usual callous or otherwise attitude of drawers of cheques in discharge of debts or otherwise attitude of drawers of cheques in discharge of debts or otherwise. The words as appearing in clause (b) of Sec 138 cannot be construed even to imply failure without reasonable cause in view of the explicit language in which the provision is couched, the principle of strict liability incorporated in the main enacting clause.

##### **II. Presumption in favour of the holder (sec 139)**

It shall be presumed unless otherwise proved that the holder of a cheque has received the cheque for discharge in whole or in part of any debt or liability.

##### **III. Defence which may not be allowed in any prosecution u/s 138 (sec 140)**

The drawer cannot pray that at the time of issue of cheque, he had no reason to believe that the cheque will be dishonoured.

##### **IV. Offences by Companies (sec 141)**

In case the party committing an offence is a company, every person in charge of the company and responsible in carrying out the business, shall deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly. However the person will not be liable if-

- i) it is proved that the offence was committed without his knowledge;
- ii) where he has exercised all due diligence to prevent occurrence of that offence;
- iii) where a person is Director as a Government nominee.

## V. Cognizance of offences

**Cognizance of Offence** – The payee/holder must make a complaint with the court [Sec 142(1)]. The following conditions should be satisfied :

1. A complaint should be made to the court, and the complaint shall be in writing.
2. It shall be made – (i) by the payee, or (ii) the holder in due course of a cheque.
3. The complaint shall be made within 1 month of the date on which the cause of action arises u/s 138(c). However the court may relax this time period if the complainant satisfies the court that he had sufficient cause for not making the complaint within such period.

The offence under section 138 shall be inquired into and tried only by a court within whose local jurisdiction [Sec 142(2)] –

(a) If the cheque is delivered for collection through an account,

The branch of the bank where the payee or holder in due course, as the case may be, maintains the account, is situated; or

(b) If the cheque is presented for payment by the payee or holder in due course otherwise through an account, the branch of the drawee bank where the drawer maintains the account, is situated.

For the purpose of clause (a), where a cheque is delivered for collection at any branch of the bank of the payee or holder in due course, then, the cheque shall be deemed to have been delivered to the branch of the bank in which the payee or holder in due course, as the case may be, maintains the account.

### Validation for transfer of pending cases [Section 142A]

- (1) Notwithstanding anything contained in the Code of Criminal Procedure, 1973 or any judgment, decree, order or directions of any court, all cases transferred to the court having jurisdiction under sub-section (2) of section 142, as amended by the Negotiable Instruments (Amendment) Ordinance, 2015, shall be deemed to have been transferred under this Ordinance, as if that sub-section had been in force at all material times.
- (2) Notwithstanding anything contained in sub-section (2) of section 142 or sub-section (1), where the payee or the holder in due course, as the case may be, has filed a complaint against the drawer of a cheque in the court having jurisdiction under sub-section (2) of section 142 or the case has been transferred to that court under sub-section (1), and such complaint is pending in that court, all subsequent complaints arising out of section 138 against the same drawer shall be filed before the same court irrespective of whether those cheques were delivered for collection or presented for payment within the territorial jurisdiction of that court.
- (3) If, on the date of the commencement of this Ordinance, more than one prosecution filed by the same payee or holder in due course, as the case may be, against the same drawer of cheques is pending before different courts, upon the said fact having been brought to the notice of the court, such court shall transfer the case to the court having jurisdiction under sub-section (2) of section 142, as amended by the Negotiable Instruments (Amendment) Ordinance, 2015, before which the first case was filed and is pending, as if that sub-section had been in force at all material times."

### Constitutional validity of the provisions

In **B. Mohana Krishna v. Union of India**, the question came up for consideration that whether the presumption raised in section 139 that the holder of the cheque received the cheque of the nature referred to in section 138, unless the contrary is established is violative of Article 20 (3) of the Constitution of India. The Court while answering negative held that:

*“Unless a person is compelled to be a witness against himself Article 20 (3) has no application. The person charged under section 138 is not compelled to be a witness against himself. The presumption of the nature incorporated in section 139 is a common feature in criminal statutes for example section 12 of the Protection of Civil rights Act. The presumption under section 139 in favour of holder of cheque would not, therefore be violative of Article 20 (3).”*

Further such imposition of strict liability was put to judicial scrutiny on grounds of unreasonableness and arbitrariness in **Mayuri Pulse Mills v. Union of India** where the Bombay High Court held that:

*“Normally in Criminal law existence of a guilty intent is an essential ingredient of a crime and the principle is expressed in the maxim ‘actus non facit rum nisi mens sit rea’. This is a general principle. However the legislature can always create an offence of absolute liability or strict liability is justified and cannot be said to be unreasonable.”*

Section 138 was also put to test in **Ramawati Sharma v. Union of India** in light of Article 21 of the Constitution of India where the court held that:

*“Mere taking of loan is not, thus, made punishable under certain circumstances and after following certain conditions. It may not, therefore, be stated that the liberty of a person was being curtailed by an arbitrary procedure or that such a provision is violative of Article 21 of the Constitution”.*

In **K.S. Anto v. Union of India** the question of double jeopardy as enshrined in Article 20 (2) in light of section 138 and section 420 of the Indian Penal Code where the court held that:

*“Offences under section 138 of the Negotiable Instruments Act and section 420 of the Penal Code are different and the ingredients are different and the ingredients are also different. Convictions for different offences separately are not barred under article 20 (2). In spite of prosecutions and convictions under section 138, there will be no constitutional bar in prosecution for an offence punishable under section 420 of the Penal Code and a prosecution will be if such an offence is made out.”*

#### **Question of maintainability of criminal charge with a civil liability:**

There is nothing in law to prevent the criminal courts from taking cognizance of the offence, merely because on the same facts, the person concerned might also be subjected to civil liability or because civil remedy is obtainable. Civil and criminal proceedings are co extensive and not exclusive. If the elements of the offence under section 138 of the Negotiable Instruments Act are made out on the face of the complaint petition itself, enforcement of the liability through a civil court will not disentitle the aggrieved person from prosecuting the offender for the offence punishable under section 138 of the Act.

#### **Summary Trial and Disposal (sec. 143 to 147)**

##### **(a) Power of court to try cases summarily (sec 143)**

- (i) All offences u/s 138 to 147 shall be tried by Metropolitan Magistrate or Judicial Magistrate of first class. The Magistrate can pass a sentence of imprisonment for a term not exceeding one year and an amount of fine exceeding five thousand rupees.
- (ii) Trial should be done in continuous manner on day to day basis. If adjournment is required beyond the following day, the reasons should be recorded in writing.
- (iii) Every effort should be made to conclude trial within 6 months from the date of filing.

##### **(b) Mode of service of summons (sec 144)**

Summons may be serviced to the accused or witness at his usual place of residence or business by speed post or courier approved by a court of session.

##### **(c) Evidence on affidavit (sec 145)**

- (i) The evidence produced by the plaintiff may be given on affidavit and may be read in evidence of any enquiry, trial or other proceeding under the Code of Criminal Procedure.



- (ii) The court may on application of the prosecution or accused, if it thinks fit, summon any person producing evidence on affidavit as to facts contained therein.

**(d) Bank's slip acting as prima facie evidence (sec 146)**

The Court shall in respect of every proceeding under Chapter XVII, presume the fact of dishonour on basis of production of bank's slip or memo having thereon the official mark denoting that the cheque has been dishonoured, unless such fact is proved false.

**(e) Offences to be compoundable (sec 147)**

Notwithstanding anything contained in the Code of Criminal Procedure, 1973, every offence punishable under this Act shall be punishable.

**Conclusion**

Though insertion of the penal provisions have helped to curtail the issue of cheque lightheartedly or in a playful manner or with a dishonest intention and the trading community now feels more secured in receiving the payment through cheques. However there being no provision for recovery of the amount covered under the dishonoured cheque, in a case where accused is convicted under section 138 and the accused has served the sentence but, unable to deposit amount of fine, the only option left with the complainant is to file civil suit. The provisions of the Act do not permit any other alternative method of realization of the amount due to the complainant on the cheque being dishonored for the reasons of "insufficient fund" in the drawer's account. The proper course to be adopted by the complainant in such a situation should be by filing a suit before the competent civil court, for realization/ recovery of the amount due to him for the reason of dishonoured cheque which the complainant is at liberty to avail of if so advised in accordance with law.

**4.5 DISCHARGE OF A NEGOTIABLE INSTRUMENT**

An instrument is said to be discharged when all rights of actions under it are completely extinguished and it ceases to be negotiable. In relation to a Negotiable Instrument, the term is used in two senses:

- (i) discharge of the instrument, and
- (ii) discharge of one or parties from liability thereon.

Discharge of an Instrument and discharge of a party to an instrument are two different concepts and events. A party to a negotiable instrument is said to be discharged from his when liability on the instrument comes to an end. On the other hand an instrument is said to be discharged when the party who is ultimately liable thereon is discharged from liability. So discharge on a party to an instrument does not necessarily means discharge of the instrument also. The provisions regarding discharge from liability are provided in section 80-90 of the act which provides various modes of discharge.

Section 82 provides three modes of discharge of a party to an instrument:

- (a) By cancellation:** to a holder thereof who cancels such acceptor's or endorser's name with intent to discharge him, and to all parties claiming under such holder: Where the holder of an instrument or his agent cancels the name of any party on the instrument with the intent to discharge him, such party and all subsequent parties who have a right of recourse against the party who name is cancelled are discharged from liability. It must be noted that the cancellation must be intentional and not accidental and must be apparent on the instrument.
- (b) Release:** If a holder of an instrument discharge the maker, acceptor or endorser otherwise than by cancellation of the names, by separate agreement of waiver, release or remission, the party so released and all parties subsequent to him who gave a right of action against the party so released are discharged from liability. In a way the effect of release is same as that of cancellation.

- (c) By payment:** This is the most obvious and desirable way of discharge of an instrument. The maker, acceptor or endorsee respectively of a negotiable instrument is discharged from liability thereof to all parties, if the instrument is payable to bearer, or has been endorsed in blank and such maker, acceptor or endorsee makes payment in due course of the amount due therein.

Section 78 of the act says that " subject to the provision of section 82(c) payment of the amount due on a promissory note, bill of exchange or cheque must, in order to discharge the maker or acceptor, be made to the holder of the instrument.

As per section 78 payment must be made to the holder whereas as per section 82(c) if the instrument is bearer or endorsed in blank, payment is a good discharge if it is payment in due course. Payment in due course we have discussed earlier in this study note.

**Discharge by allowing drawee more than forty-eight hours to accept (section 83):**

Section 83 provides another method of discharge by allowing more than 48 hrs for acceptance of a bill. As per section 83 if the holder of a bill of exchange allows the drawee more than forty eight hours, exclusive of public holidays, to consider whether he will accept the same, all previous parties not consenting to such allowance are thereby discharged from liability to such holder.

**Non- presentation of cheque:**

Section 84 provides that if a cheque is not presented for payment within a reasonable time of its issue, and the drawer or person on whose account it is drawn had the right, at the time when presentment ought to have been made, as between himself and the banker, to have the cheque paid and suffers actual damage through the delay, he is discharged to the extent of such damage, that is to say, to the extent to which such drawer or person is a creditor of the banker to a large amount than he would have been if such cheque had been paid. In determining what is a reasonable time, regard shall be had to the nature of the instrument, the usage of trade and of bankers, and the facts of the particular case. The holder of the cheque as to which such drawer or person is so discharged shall be a creditor, in lieu of such drawer or person, of such banker to the extent of such discharge and entitled to recover the amount from him.

**Illustrations**

- (a) A draws a cheque for ₹ 1,000, and, when the cheque ought to be presented, has funds at the bank to meet it. The bank fails before the cheque is presented. The drawer is discharged, but the holder can prove against the bank for the amount of the cheque.
- (b) A draws a cheque at Puna on a bank in Mumbai. The bank fails before the cheque could be presented in ordinary course. A is not discharged, for he has not suffered actual damage through any delay in presenting the cheque.

**Section 85 provides two another ways of discharge of a party to an instrument.**

These are:

- (1) Where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course.
- (2) Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any endorsement whether in full or in blank appearing thereon, and notwithstanding that any such endorsement purports to restrict or exclude further negotiation.]

**Drafts drawn by one branch of a bank on another payable to order (Sec 85A).**

Where any draft, that is an order to pay money, drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand, purports to be endorsed by or behalf of the payee, the bank is discharged by payment in due course.

### **Qualified Acceptance:**

A Qualified acceptance varies the effect of the bill as drawn and the holder is not bound to take a qualified acceptance. As per section 86 if the holder of a bill of exchange takes a qualified acceptance, or one limited to part of the sum mentioned in the bill, or which substituted a different place or time for payment or which, where the drawees are not partners, is not signed by all the drawees, all previous parties whose consent is not obtained to such acceptance are discharged as against the holder and those claiming under him, unless on notice given by the holder they assent to such acceptance. (section 86)

### **An acceptance is said to be qualified in the following ways:--**

- (a) where it is conditional, declaring the payment to be dependent on the happening of an event therein stated;
- (b) where it undertakes the payment of part only of the sum ordered to be paid;
- (c) where, no place of payment being specified on the order, it undertakes the payment at a specified place, and not otherwise or elsewhere, or where a place of payment being specified in the order, it undertakes the payment at some other place and not otherwise or elsewhere;
- (d) where it undertakes the payment at a time other than that at which under the order or would be legally due.

### **Material alteration in the instrument renders the parties discharged (section 87)**

Any material alteration of a negotiable instrument renders the same void as against anyone who is a party thereto at the time of making such alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties:

Alteration by endorsee: And any such alteration, if made by an endorsee, discharges his endorser from all liability to him in respect of the consideration thereof.

It may be noted that to get benefit of this section the alteration must be intentional and not purely accidental. Secondly the alteration must be material. In *Lookaram Sethiya V Ivon E John (1977) SC* defined the term material alteration as follows:

“A material alteration is one which varies the rights, liabilities or legal position of the parties as ascertained by the deeds in its original state or otherwise varies the legal effects of the instruments as originally expressed or which may otherwise prejudice the party bound by the deed as originally executed. Some of the alterations which have been held to be material in various cases are as under;

- (i) Alteration of an order cheque to a bearer cheque except by or with the consent of the drawer.
- (ii) Alteration by tearing material part of the instrument.
- (iii) Alteration by erasing account paying crossing (*J Ladies Beauty V State Bank of India, AIR 1984 Guj 33*)
- (iv) Alteration by affixing stamps without the promisor's knowledge to a note. (*Thommer v Union Khan 1967 Ker LJ 80 N Gowda v B Gowda 1968 1 Mysr LJ 591*)
- (v) Alteration of the date of payment [(*A Subha Reddy v Neelapa Reddy Rammanna Reddy AIR 1966 AP 267*)]
- (vi) Alteration of the time of payment. (*Long v Moore, 1790 3 Esp 155*)
- (vii) Alteration of the place of payment (*Tidamarsh v Grover 1813 23 LJ QB 261*)
- (viii) Alteration of the sum payable (*Scholfield v Earl of Londesborough 1896 AC 514*)
- (ix) Alteration by adding new party to the instrument (*Garner v Walsh 1855 5 ESB 83*)
- (x) Alteration by tearing a material part of the instrument.

(xi) Alteration of the rate of interest (*Seeth Tulsidas Lalchand v Rajagopal 1967 2 MLJ 66*)

From the above cases of alteration which have been treated material alteration we can say that any alteration which changes the legal character of the instrument or alters the liabilities of the parties, whether change is prejudicial or beneficial is a material alteration.

Though we have discussed that material alteration discharges the parties to an instrument. But still there are some alterations which do not vitiate the instrument. These are as under;--

- (i) Alteration before the completion of the instrument.
- (ii) Crossing of an open cheque or conversion of general crossing into a special crossing.
- (iii) Making qualified acceptance.
- (iv) Completion of inchoate instrument.
- (v) Making a blank endorsement into full endorsement.
- (vi) Conversion of a bearer cheque into an order cheque.
- (vii) Alteration with the consent of the party liable on the instrument.
- (viii) Alteration made for the purpose of correcting mistake.
- (ix) Making a blank instrument into a full endorsement.

#### **Payment of instrument on which alteration is not apparent**

So far we have discussed that material alteration on a instrument discharge the parties to it. Still there may be some alteration in an instrument which may not be apparent at the time of payment. As per section 89:

- (1) Where a promissory note, bill of exchange or cheque has been materially altered but does not appear to have been so altered, or where a cheque is presented for payment which does not at the time of presentation appear to be crossed or to have had a crossing which has been obliterated, payment thereof by a person or banker liable to pay an paying the same according to the apparent tenor thereof at the time of payment and otherwise in due course, shall discharge such person or banker liable to pay and paying the same according to the apparent tenor thereof at the time of payment and otherwise in due course, shall discharge such a person or banker from all liability thereon, and such payment shall not be questioned by reasons of the instrument having been altered, or the cheque crossed.
- (2) 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.
- (3) 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.

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.(Section 90)

#### **4. 6 HUNDIS**

There are many other types of negotiable instruments recognised by the customs, Hundi is one of those instruments. Hundis are indigenous negotiable instruments written in vernacular language. The term *hundī* is derived from the Sanskrit word '*hund*' which means 'to collect'. Hundis' are indigenous



negotiable instrument which in local language is called hundi and have been in circulation even before the Negotiable Instrument Act 1881 came into existence and recognised by customary law as valid and effective negotiable instrument. Though Negotiable Instrument Act is not applicable to Hundis but they are governed by local usages and customs of the trade where they are intended to be used.

There are two main kinds of hundis:

- 1) Darshani hundi, i.e. hundi payable at sight: It is similar to demand bill of exchange, that is which is payable; on demand. Darshani Hundi sometimes sell at discount and sometimes they sell at a premium. A Darshani Hundi should be presented for payment within a reasonable time by the holder
- 2) Muddati hundi, i.e. Hundi payable after a specified period The term Muddat or Miadi Hundi is payable after a specified period of time. It is similar to time bill of exchange

**Some common types of hundis which belongs to above two types are as follows:**

- (a) Shah Jog Hundi: Payable only to respectable person like Shah but is freely transferable
- (b) Nam Job Hundi: This is payable to the person specified therein. This is payable to the payee or his order and therefore can be negotiated by endorsement and delivery.
- (c) Dhani jog Hundi: Dhani means owner. A dhani jogi hundi is payable to a dhani owner. The words dhani-jog is inserted in the hundi.
- (d) Firman-jog Hundi and Dekhanhar Hundi: Hundis payable to order are called firman jog hundis and those payable to bearer are called Dekhanhar hundi
- (e) Jawabee hundi: A jawabi hundi is a means of remittance of money from one person to another person via a banker.
- (f) Jakhami hundi: It is in the nature of an Insurance policy, with the difference that money is paid before hand to be recovered if the ship is not lost.

A notice of dishonor of a hundi is not given if there is a local custom or usage. The parties may however, exclude any prevalent customs or usage. In such a case and also when there is no customary rule on certain points, the provisions of the Negotiable Instrument Act will apply.

## 4.7 BANKER AND CUSTOMER

The law regulating the relations between banker and customer are governed by –

- i) The Indian Contract Act, 1872
- (ii) The Negotiable Instruments Act, 1881.

However, these Acts are not exhaustive. The Courts refer to English Common Law whenever any point not covered by the Indian Acts arises.

### 4.7.1 Banker

The Banking Regulation Act, 1949 defines 'banking company' as 'a company which transacts business of banking in India,' and the term banking as 'accepting for the purpose of lending or investment, of deposits of money from public repayable on demand or otherwise, and withdrawable by cheque, draft, and order or otherwise. There is no statutory definition of the term Banker. However, the Negotiable Instrument Act, defines a banker as including any person acting as a banker.'

### 4.7.2 Customer

A person becomes a customer of a bank when the bank agrees to open an account of him. The term has not been defined by statutes. A person becomes customer of a banker when he opens his account with that bank. The duration of relationship or holding account with the bank is immaterial.

#### 4.7.3 Legal relationship between banker and the customer-special features:

- (i) A banker, having sufficient funds in the account of the customer, has legal obligation to honour the cheques of the customer. Wrongful refusal on the part of banker makes him liable to customer to claim damages.
- (ii) The banker is also under obligation to maintain proper record of transactions of customer.
- (iii) The banker has to follow the express instructions of the customer provided these are within the scope of banker-customer relationship.
- (iv) The banker may in absence of a contract to the contrary, retain as security for general balance of account, any goods and securities bailed to him by customer.
- (v) The banker has right to claim incidental charges for service provided and interest for money lent to customer as per rules and regulations.
- (vi) The banker has legal obligation to maintain secrecy about state of affairs of customer's accounts.
- (vii) The banker has right to set-off debit balance of one account with credit balance of another account of the same customer.
- (viii) The banker has right of appropriation against the customer.

#### 4.7.4 A banker must dishonour a customer's cheque under following circumstances:

- i) The customer becomes insolvent.
- ii) The customer becomes insane.
- iii) The customer countermands payment.
- iv) On receiving the notice of death of a customer.
- v) The customer gives notice of closure of account.
- vii) The customer gives notice of assignment of credit balance of his account.
- viii) When the banker has reason to believe that the title of the person presenting the cheque is defective.
- ix) When the banker receives notice of loss of cheque by customer. Apart from above circumstances a banker may dishonor a customer's cheque in the following circumstances:
  - (a) When the customer is not having sufficient fund in his account.

##### **Example:**

X issued a cheque of ₹ 5,000 in favor of Y. Y presented the cheque before the bank. However, X's A/c in the bank had only ₹ 4,000. Bank may dishonor the cheque for insufficient funds

- (b) Where the customer's signature does not match with his specimen signature with the bank

##### **Example:**

X holds an a/c in ABC bank in the name of Mr. XK Singh and signs accordingly. However, he issued a cheque to B for ₹ 1000/ and signs it differently than his specimen signature. Bank can dishonor the cheque.

- (c) Where the funds to the credits of the customer are not applicable to the payment of the cheque e.g. when the money is held in trust.
- (d) When the cheque is mutilated.
- (e) Where the cheque is ambiguous or of doubtful legality.



- (f) When the cheque become stale.
- (g) When presented to different branch.

**Example:**

X holds a account in CP branch of SBI. He issued a cheque of ₹ 500 to Y who presented it for payment to INA Branch of SBI. Bank may reject payment.

- (h) In case of joint holders signature of one or another joint holder are missing
- (i) Where the cheque is post dated.

**Protection of banker in respect of uncrossed chouse**

*As per section 85 of the Act when a banker makes payment on an uncrossed cheque in due course he is authorized to debit the account of his customer with the amount so paid irrespective of the genuineness of the Endorsement thereon.*

For example, a cheque is drawn payable to N or order and it is stolen. Thereafter, the thief or someone else forges N's endorsement and presents the cheque to the bank for encashment. On paying the cheque, the banker would be able to debit the drawer's account with the amount of the cheque.

The original character of the cheque issued as bearer, is not altered by subsequent endorsements , so far as the paying bank is concerned, provided that the payment is made in due course. Hence the proposition that "*once a bearer instrument always a bearer instrument*".

**Protection in respect of crossed cheques**

When a banker pays a cheque drawn by his customer in accordance with section 126 of the Act he can debit the drawer's account with the amount paid, even though the amount of the cheque does not reach the true owner.

**Prerequisites for claiming protection:**

The protection in both the cases referred above can be availed of only if the payment has been made in due course i.e.

- (a) According to the apparent tenor of the instrument;
- (b) In good faith and without negligence;
- (c) To any person in possession thereof;
- (d) In circumstances that do not incite any suspicion that he is not entitled to receive payment of the cheque.

**4.7.5 Liability of Drawee of Cheque**

Section 31 of the Act states that:

The drawee bank is under a duty to pay the cheque, provided he has in his hands sufficient funds of the drawer and the funds are properly applicable to such payment. If the banker refuses payment without sufficient cause being shown, he must compensate the drawer, not the holder, for any loss caused by such improper refusal (Section 31).

The banker must pay the cheque only when he is duly required to do so e.g. if there is an agreement between the drawer and the banker that the former shall not draw more than one cheque every week, the banker is not bound to pay the second cheque.

The amount of compensation that the drawee would have to pay to the drawer is to be measured by the loss or damage say loss of credit, suffered by the drawer. The principle is: "*The lesser the value of the cheque dishonoured, the greater the damage to the credit of the drawer*".

#### 4.7.6 Liability of Payee's Banker

Section 131 gives protection to a banker who collects a crossed cheque on behalf of customer. The Act provides that –

*“A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself, shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment.”*

According to section 131A the same protection is available to a bank while collecting bank overdraft as in case of a cheque. This protection is available even when the cheque is crossed “not negotiable”

Section 131 of the Act confers a special protection on the collecting banker which is available to him subject to fulfillment of certain conditions. If the following conditions do not co-exist, this protection would be denied to the collecting banker:

##### (i) **The Collecting Banker Should have Acted in Good Faith and Without Negligence:**

An act is in good faith if it is done honestly. To claim protection under this section the onus is on the bank to prove that there was no negligence and it collected the cheque in good faith. In *Lloyds Savouy Co. (1933) A.C. 201*, the court held that if the banker receives payment of a cheque to which the customer has no title, the onus is on him to disprove negligence. What amounts to negligence is, however a question of fact in each case. “Negligence” means want of “reasonable care” with reference to the interest of the true owner. The test of “negligence” is whether the transaction of paying in any given cheque coupled with the circumstances antecedent and present was so flagrantly out of the ordinary course that it ought to have aroused suspicion in the mind of the banker and caused him to make enquiry (*Bopulal Prem Chand v. The Nath Bank Ltd. 48 Bom. L.R.393*).

In *Syndicate bank v Jayshree Industries AIR 1994 Karnatak 315* a draft in the name of Mrs Rama was collected and credited to the account of Mr Ram. It was held that bank was negligent and thus not entitled to prosecution It is no defence that the bank acted in good faith.

*The following are the cases where a collecting bank may be held liable for negligence;*

- (a) When a cheque payable to order without verifying the endorsement therein is collected. (*Central Bank of India v Gopinath 1972 KLT 518*)
- (b) When it collects a cheque payable to an official for his private account.
- (c) When it collects a cheque for a large sum for an account whose balance is generally is low. (*Brahma Shum Sher Jung Bahadur v Chartered bank, All 1956 cal 399*)
- (d) When it collects a cheque on behalf of partner which is payable to the partnership firm
- (e) When it collects a cheque payable to a company for a private account of the Director or official of the company (*United Commercial Bank Ltd v Reliable Hire Purchase co(P),Ltd 1976 Comp cas 403*)

**(ii) That the collecting banker acts only to receive payment of the crossed cheque for a customer:** To make a person a customer of a bank it is essential that there must be some sort of account, either a deposit or a current account or some similar relationship. Protection under section 131 is available only when the banker is acting as an agent for collection but not to a case where the banker is himself the holder.

**(iii) That crossing had been made before the cheque fell into the hands of the collecting banker:** Section 131 does not provide an absolute immunity to the collecting banker and unless the banker brings himself within the conditions stipulated under this section, he is left to his common law for conversion. The onus of proving that he had taken all reasonable steps to ensure compliance with the requirements of this section lies on the banker.



It shall be the duty of the banker who receives payment based on an electronic image of a truncated cheque held with him, to verify the *prima facie* genuineness of the cheque to be truncated and any fraud, forgery or tampering apparent on the face of the instrument that can be verified with due diligence and ordinary care.

For a customer, the payment must be received on behalf of and for the customer. Customer means a person who has some sort of account either a deposit or a current account or a saving a/c or some similar relation. The account must be operative when the cheque was received for collection.

#### **4.7.7 Dishonour of cheque**

##### **4.7.7.1 Definition of Dishonour**

Section 92 of the Act reads as under –

*"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."*

If on presentation the banker does not pay then dishonour takes place and the holder acquired at once the right of recourse against the drawer and the other parties on the cheque.

##### **4.7.7.2 Effects of dishonour**

The important point to be noted in connection with the dishonour of a cheque is that its negotiability is lost.

##### **4.7.7.3 Types of dishonour**

Dishonour of cheque can be divided into two categories i.e.

- (a) Rightful dishonour:** Dishonour of cheque by the drawee banker for any of the reasons specified above or for any other rightful reason. In this case there is no remedy available against the banker but the holder in due course has remedy both civil and criminal against the drawer.
- (b) Wrongful dishonour:** Dishonour of cheque by the banker due to negligence or carelessness by its employees. The drawer may bring an action against the bank for losses suffered by him. The payee has no action against the banker in this case.

##### **4.7.7.4 Dishonour of cheque is an offence**

Section 138 of the Negotiable Instruments Act states that the return of a cheque by a banker because the money standing to the credit of the account holder is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from the account by an agreement made with the bank, is a criminal offence. The drawer shall be deemed to have committed an offence and such offence will be punishable with imprisonment for a term up to two years imprisonment or with a fine twice the amount of the cheque or both.

Provisions of section 138 of the Act are applicable only if –

- (a) The cheque in question has been issued in discharge of a liability only. Unless contrary is proved, as per the provisions of section 139, a cheque is presumed to have been received by the holder in discharge of a debt or liability. A cheque given as gift will not fall in this category.
- (b) The cheque is presented to the bank for payment within six months or its specific validity period, whichever is earlier.
- (c) The payee or holder in due course has given notice demanding payment within thirty days of the receiving information of dishonour which should be for a reason other than insufficiency of funds.
- (d) The drawer does not make payment within 15 days of the receipt of the notice, the complaint can be made only by the payee/holder in due course, within one month.

#### 4.7.7.5 Conditions for fastening criminal liability -

It may be noted that dishonour of a cheque is criminal offence, however before fastening any criminal liability upon the drawer the following conditions must be satisfied before a drawer can be fastened with criminal liability;

- (a) Cheque issued** is in discharge of a debt or liability enforceable by law and not a mere gift or donation or in discharge of a moral obligation or unlawful act or illegal considerations; Under section 139 of the Act there is a legal presumption that there is a legal presumption that the holder of a cheque which falls within section 138 received it for the discharge of a debt or liability. However, the drawer may refute the presumption by proving to the contrary; stating that the cheque was not in discharge of any debt and it was a voluntary payment in the form of gift or donation.

In *Shivaji v Lognathan (1996) 85 Comp. Cas(Mad)* it was held that the payment of capitation fee and refund thereof were not for an unlawful purpose within the meaning of section 23 of the Indian Contract Act, 1872. The refund of fee was held to be in discharge of legally enforceable debt or liability.

In *Sudhir Kumar Bhall v Jagdish (2008) 7 SCC 137* it was held that the offence under section 138 was made out only if cheque were in discharge of a debt or other liability but not when they were issued as a security.

In *Uplanche V RK Vimala, 1998 ISJ(Banking) 175(AP)* it was held that if the payment by way of cheque is made as a gift or charity, it is not a payment for a legally enforceable debt or liability.

- (b) Presentation of the cheque to the drawee bank:** The cheque must be presented to the drawee bank, either personally or through a collecting banker within the validity period from the date on which it was drawn or within the period of its validity whichever is earlier. However, unless the drawer established the actual date of drawing, the cheque would be presumed to be drawn on the date it bears.

In *Goaplast(P) Ltd v Chico Ursula D Souza(2003) 3 SCC 232* it was held that section 138 of the Negotiable Instrument Act is attracted if a post dated cheque issued by a person to settle his debt or other liability is stopped for payment by the drawer even before the date of the cheque.

- (c) Reasons for dishonor:** Cheque must have returned by the banker either because of insufficiency of funds or because the cheque exceeds the amount arranged to be paid from the account by an agreement made with the bank. However, this section is not applicable when the cheque is returned on technical grounds like irregularity of an endorsement or a discrepancy between the amount in words or figure.

In *Mode Cements Ltd v Kuchil Kumnar Nandi Air 1998 SC 1057(1988) 3 SCC 249*, the Supreme Court while elaborating the elements of insufficiency of funds on the date of issue of cheque observed that " if a person draws a cheque with no sufficient funds available to his credit on the date of issue, but makes the arrangement or deposits the amount thereafter before the cheque is put in the bank by the drawer and the cheque is honored, in such a situation drawing a presumption of dishonesty on the part of the drawer under section 138 would not be justified. Section 138 of the Act gets attracted only when the cheque is dishonored.

- (d) Dishonour/demand notice to drawer:** The payee or the holder in due course must make a demand for payment by giving a notice in writing within 30 days of receipt of information by him from the bank as unpaid. The Act is silent about the manner of serving the notice. However, sending by registered post is desirable as it will be easier to prove the service of notice.

In *SIL Import, M/s USA v M/s Exim Aides Silk Exporter's AIR 1999* Supreme court ruled that a notice envisaged in clause (b) of provision to section 139 was transmitted by fax, it would be a compliance



with the legal requirement. Therefore notice demanding payment can be sent by a fax is also equitably acceptable,

It must be remembered that the notice issued must demand payment of cheque amount in categorical terms and demand should not be vague. Notice can not be an omnibus demand. The Supreme Court in the case of *Suman Sethi v Ajay K Churiwala & Anr* AIR 2000 SC 828 ruled that the said amount of money occurring in clause (b) and (c) of section 138 refers to the words "payment of any amount of money" stated in the main section 138. It implies that the demand has to be made for the amount of the cheque dishonored.

In *Tonny Jacob kattikkaran v Thomas Manjaly*, AIR 1998 SC 366 the Supreme court held that it was established that the payee or holder in due course as the case may be did not serve the notice of dishonor on the drawer within the period prescribed the acquittal of the drawer was justified.

- (e) **Drawer's Failure to pay:** The drawer must have failed to pay within 15 days of the date of receipt of notice. If the drawer does not pay till the expiry of the 15 day's time, the cause of action would arise on the 16<sup>th</sup> day.
- (f) **Filing of written complaint:** Section 142 provides that a written complaint should have been made to the court or a metropolitan or first class Judicial Magistrate or a superior court within one month from the date of cause of action. However, the court have jurisdiction to waive the requirement of one month in case sufficient grounds are adduced.

In *Shankar Finance and Investment v State of AP (2008) 8 SCC 536* it was held that it was permissible to lodge a complaint in the name of payee proprietary concern itself.

In *Veera Exports v T Kalavathy*, it was held that it is always open to a drawer to voluntarily revalidate a negotiable instrument, including a cheque. The validity period of a cheque is now only 3 months with effect from 1<sup>st</sup> April 2012

#### 4.7.8 Jurisdiction:

At time cause of action arises at various places like drawer and payee living at different places, cheque drawn at different place and returning banker also of different place. In such a cases confusion may arise as to where to file the complaint. Section 178 of the Criminal Procedure Code provides that every offence shall ordinarily be inquired into and tried by a court within whose local jurisdiction it was committed. Section 178 provides that offence may be tried at a court having jurisdiction over any of the local areas where the offence is committed.

In *K Bhaskaran v Sankaran Vaidyaa Balan and others* 1999 7 SCC 510, the SC opined that offence can be completed only with concatenation of a number of acts, namely, drawing of a cheque, presentation of a cheque, returning of the cheque by the bankers, notice by the payee and failure of the drawer to pay within 15 days of receipt of notice of demand. Any of the courts under whose jurisdiction the above acts have taken place can try the offence. In other words complainant can file complaint in any one of the above courts where the cause of action arise or acts have been committed.

In *Harman Electronics(P)Ltd and others v National Panasonic India(2009) comp LJ 29 SC* the Hon'ble SC had the occasion to examine the issue of jurisdiction again. In this case the appellant is a resident of Chandigarh issued a cheque which was dishonored. The cheque was issued at Chandigarh where the complainant had a branch and was presented at Chandigarh. Notice demanding payment was issued from a complaint from its HQ at Delhi to the accused's office Chandigarh. On failure to respond to the notice, a complaint was filed in Delhi. Both the lower Court and Higher Court placed reliance on *K Bhaskaran V Sankaran Vaidyaa Balan and others* case and held that Delhi Court also has jurisdiction. The Appellant/Respondent in appeal contended that Chandigarh court had jurisdiction to try the offence but his appeal was dismissed. But in appeal, the SC held that the court derives jurisdiction when the cause of action arises. Jurisdiction can not be conferred for any act or omission or commission on the part of the accused. Issuance of notice would not give rise to cause of action but communication

of the notice would and therefore Delhi HC would not have jurisdiction and it was directed for transfer of the case pending in Delhi to Chandigarh Court.

#### **4.7.9 Offences by companies**

If the person committing an offence under section 138 is a company, every person who was in charge of the affairs of the company and was responsible for the business of the company at the time offence was committed shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly (Section 139). However, a person shall not be punishable under section 139 if it is proved that the offence has been committed without his knowledge or consent and that he had taken all due care to prevent commission of the offence.

Where a person is nominated as a Director of a company by virtue of his holding any office or employment in the Central Government or State Government or a financial corporation owned or controlled by the Central Government or the State Government, as the case may be, he shall not be liable for prosecution under section 138-147 of the Negotiable Instrument Act.

Company means any body corporate and includes a firm or other association of individuals and in Director in case of a firm means a partner in the firm.

Section 141 does not make all partners of a firm liable. Liability is fastened only on those who, at the time of commission of the offence, were in charge of and were responsible to the firm for the conduct of the business. There is no presumption that every partner knows about the transaction (*Monaben Ketanbhai Shah v State of Gujarat*, (2004) 7 SCC 15), so the complainant must make necessary averment in the complaint and establish the fact that when the offence was committed the accused was in charge of and responsible to the firm for the conduct of its business.

Under the Act, if the person committing an offence under section 138 is a company, by application of section 141 it is deemed that every person who is in charge of and responsible to the company for the conduct of business of the company as well as the company are guilty of the offence. A person who proves that the offence was committed without his knowledge or that he had exercised all due diligence is exempted from becoming liable by operation of the proviso to section 141(1) (*SV Mazumdar v Gujrat State Fertilizer Co Ltd* (2005) 4 SCC 173).

In *Aneeta Hada v Travels and Tours (P) Ltd* (2008) 13 SCC 703 it was held that there was a complaint against a Director (authorized signature) who signed the cheque. Company was not joined as an accused. It was held that the complainant could proceed against Director alone.

It may be noted that the holder of a cheque shall be presumed to have received the cheque for discharge, in whole or in part, of any debt or other liability (sec.139). The drawer of the dishonoured cheque cannot defend himself on the ground that he had no reason to believe when he issued the cheque, that the cheque may be dishonoured on presentation on account of insufficiency of funds (sec140).

However, no court shall take cognizance of any offence punishable under Sec138 except upon a complaint, in writing, made, by the payee, or, as the case may be, the holder in due course of the cheque. Further, no court inferior to that of a Metropolitan Magistrate or Judicial Magistrate of the First Class shall try any offence punishable under Sec 138 (Sec142).

Further vide Negotiable Instrument (Amendment) Act, 2002 section 143 to 147 were added. The relevant provisions have already been discussed in earlier in this study note.



## 4.8 INTERNATIONAL LAW RELATING TO FOREIGN NEGOTIABLE INSTRUMENTS

- (i) **Liability** – As per section 134 of the Act, the liability of a drawer /maker of a foreign bill, note or cheque is governed by the law of land where the instrument is made. The liability of the acceptor/endorser is determined by law of the place where the instrument is payable. This rule is however subject to contract between parties.

**Example:**

A bill of exchange was drawn by A in California where the rate of interest is 25% and accepted by B payable at Washington, where the rate of interest is 6%.The bill is endorsed in India an is dishonored. An action on the bill is brought against B in India. He is liable to pay interest at the rate of 6% but B is charged as drawer. A is liable to pay interest at the rate of 25%

- (ii) **Dishonour** – As per section 135,Where a promissory note bill of exchange or cheque is made payable in a different place from that in which it is made or indorsed the law of the place where it is made payable determines what constitute dishonour and what notice of dishonour is sufficient .

**Example:**

A bill of exchange drawn and endorsed in India but accepted payable in France, is dishonoured. The endorsee causes it to be protested for such dishonour and gives notice thereof in accordance with the law of France, though not in accordance with the rules herein contained in respect of bills which are not in force. The notice is sufficient.

- (iii) Foreign Instruments made in accordance with Indian law. As per section 136 If an instrument is made/drawn/accepted in a place out of India as per Indian Law, its subsequent acceptance / endorsement in India will not invalidate it even if it is invalid in a foreign country.
- (iv) Presumption as to foreign law as per section 137 the law regarding the Negotiable Instrument is presumed to be same as that of India unless the contrary is proved.

**Let us Recapitulate:**

- The word negotiable means transferable by delivery and the instrument means a written document by which a right is created in favor of some person. Sec. 13 defines a negotiable instrument as 'a promissory note, bill of exchange or cheque payable either to order or to bearer.'
- **Characteristics of a negotiable instrument:** Freely transferable; Holder's title is free from all defects; The holder in due course can sue on the instrument in his own name and for this purpose notice of transfer need not be given; A negotiable instrument is subject to certain presumptions (**Sec 118and 119**)
- A 'promissory note' is an instrument in writing (not being a bank note or currency note) containing an *unconditional* undertaking signed by maker , to pay a certain sum of money only to or to order of a certain person or to bearer of the instrument. (**Sec.4**)
- A Bill of Exchange is defined in section 5 of the Act "as an instrument in writing containing an unconditional order signed by 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"
- **As per section 6 a** cheque is a bill of exchange drawn on a specified banker payable on demand. Further the expression includes the electronic image of a truncated cheque or a cheque in electronic form.

- A bill is said to be accepted when the drawee (i.e., the person on whom the bill is drawn), after putting his signature on it, *either delivers it or gives notice of such acceptance to the holder of the bill or to some person on his behalf.*
- A negotiable instrument may be transferred either by negotiation or by assignment.
- A bill may be dishonoured by non-acceptance or non-payment. A cheque or note is dishonoured by non-payment only. If an instrument is dishonoured, the holder must give notice of dishonour to all prior parties unless the notice is excused, otherwise he loses his right of action against all prior parties.
- An instrument is said to be discharged when all rights of actions under it are completely extinguished and it ceases to be negotiable.
- Hundis are indigenous negotiable instruments written in vernacular language. The term *hundi* is derived from the Sanskrit word '*hund*' which means 'to collect'.
- The law regulating the relations between banker and customer are governed by –
  - The Indian Contract Act, 1872.
  - The Negotiable Instruments Act, 1881.

However, these Acts are not exhaustive. The Courts refer to English Common Law whenever any point not covered by the Indian Acts arises.

# Study Note - 5

## LAWS RELATED TO PARTNERSHIP



### This Study Note includes

#### 5.1 Concepts and Definitions

#### 5.2 The Limited Liability Partnership Act, 2008

### 5. INDIAN PARTNERSHIP ACT, 1932 - INTRODUCTION

The law relating to partnership in India, prior to 1932 were contained in Chapter XI of the Indian Contract Act, 1872. On various occasions it was held that chapter XI of the Indian Contract Act, 1872 was not exhaustive and on certain points it was not clear and definite. Thus, certain amendments were desired and certain points relating to partnership needed proper clarification. Accordingly Chapter XI of the Indian Contract Act was repealed and new and comprehensive legislation in the shape of the Indian Partnership Act 1932 was passed.

This Act is based on the English Partnership Act, 1890 and does not differ in substantial way from the English Law. The main principle of both the laws are same accordingly wherever the Indian Partnership Act is silent the provisions or decisions based on English Law are applied in India.

The Act is applicable to whole of India except the state of Jammu and Kashmir and came into effect from 1<sup>st</sup> October 1932 except section 69 which came into operation after one year of enactment of the Act i.e., from 1<sup>st</sup> October 1933. The act is divided into 8 chapters having 74 sections in all.

### 5.1 CONCEPTS & DEFINITIONS

#### 5.1.1 Definition of Partnership:

Section 4 of the Act, defines Partnership as "partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all-----"

Section 239 of the repealed chapter XI of the Indian Contract Act 1872 defined partnership as" Partnership is the relation which subsists between persons who have agreed to combine their property, labour or skill in some business and to share the profits thereof between them."

Partnership has not been found easy to define. Eminent Jurists and authors have defined the term in various ways. Some of the definitions of eminent jurists and authors are as under;

Partnership, often called co-partnership, is usually defined to be a voluntary contract between two or more competent persons to place their money, effect, labor and skill or some or all of them, in lawful commerce or business, with the understanding that there shall be communion of the profits thereof between them.

Kent-" Partnership is a contract between two or more competent persons to place their money, effects, labor, and skill or some or all of them in lawful commerce or business and to divide the profits and bear the loss in certain proportions."

Pollock "Partnership is the relation which subsists between person who have agreed to share the profits of a business carried on by all or any of them on behalf of all of them."

From the above definitions of the word Partnership by various authors it is noted that the definition of partnership adopted in section 4 of the Partnership is the same as suggested by Pollock with a small

variation. It underlines the fundamental principle of mutual agency e.g. the partners when carrying on the business of the firm are both the agent as well principals. Partnership is not merely an agreement or an association of two or more persons it is much more than that It is a relationship arising out of such an agreement.

**Section 2 of the act defines,**

- (a) An “act of a firm” means any act or omission by all the partners, or by any partner or agent of the firm which gives rise to a right enforceable by or against the firm;
- (b) “Business” includes every trade, occupation and profession;
- (c) “Prescribed” means prescribed by rules made under this Act;
- (c-1) “Registrar” means the Registrar of Firms appointed under sub-section (1) of section 57 and includes the Deputy Registrar of Firms and Assistant Registrar of Firms appointed under sub-section (2) of that section;
- (d) “third party” used in relation to a firm or to a partner therein means any person who is not a partner in the firm; and
- (e) expressions used but not defined in this Act and defined in the Indian Contract Act, 1872, shall have the meanings assigned to them in that Act.

**5.1.2 Essential Characteristics of a Partnership:**

An analysis of the definition of partnership underlines the following essentials of a partnership:

- (a) **Association of or more persons:** At least two persons who are competent to contract are required to form a partnership. There is no restriction on the maximum number of persons to form a partnership firm in the Partnership Act. But section 11 of the Companies Act, 1956 treats a partnership firm carrying on banking business having more than 10 and other business having more than 20 partners as illegal association unless registered as a Company. Accordingly indirectly a non banking partnership firm and a banking partnership firm cannot have more than 10/20 partners respectively as the case may be. It may, further be noted that the statutory limit on the maximum number of partners does not apply to a Hindu Undivided family. However, if two or more HUF amalgamate the statutory limit mentioned above will apply. In *CIT V Jadavji Narsidas & co AIR 1963 SC 1947* it was held that a firm cannot enter into partnership with another person, such person can be admitted into firm or members of firm can enter into a partnership with that other person in their individual capacity. In *Mahabir Cold storage v CIT AIR 1991 SC 1357* it was held that under the Indian Partnership Act the partnership firm registered there under is neither a person nor a legal entity. It is merely a collective name for the individual members of the partnership. A firm as such cannot be a partner in another firm though its partners may be a partner in another firm in their individual capacity. Thus there must be at least two persons natural or artificial competent to contract acting as principal for the existence of a partnership.

A question may arise what happens when a partnership firm is declared illegal due to number of partners exceeding the number so provided in section 11 of the Companies Act, 1956 and is so declared illegal association and carry on its business. The consequences of an Illegal Association are as under:

- (a) Every member of such an illegal association are personally liable for all liabilities incurred by the business.
- (b) Members of illegal associations are liable for fine which may extend to rupees one thousand.
- (c) Members of such association cannot maintain an action in respect of any contract made by it.
- (d) There can be no suit between members of illegal association for dissolution or for rendition of accounts.



- (b) It is the result of an agreement:** Section 5 declares that a partnership is created by contract and not by status. It is created by agreement between two or more persons. It is so essential element of a partnership which distinguishes it from other business relations like Joint Hindu family which have discussed in earlier section. There must be an agreement to form a partnership, This agreement may be express (whether written or oral) or implied. By express agreement it is meant an agreement which is made by means of words, written or spoken and by the words implied agreement means an agreement which is inferred from the conduct of the parties .When the partnership is created by means of an express agreement the terms of the agreement are set out in a document called partnership deed the contents of which will be discussed in subsequently at appropriate place. It may further be noted that an oral agreement to form a partnership as valid as a written agreement. Thus existence of an agreement is an essential element of a valid partnership. This essential element is further clarified under Section 5. Section 5 provides that the relation of partnership arises from contract and not *from* status. That is why, a Hindu undivided family carrying on a family business is not considered a partnership, The reason is that the coparceners of a Hindu undivided family acquire interest in the business because of their status {i.e., birth} in the family and not because of any agreement between them. Thus, partnership is voluntary and contractual in nature.

In the case of *Pratibha Rani v Suraj Kumar AIR 1985 SC 628* it was held that the entrustment by a wife of his *stridhan* to her husband does not amount to an agreement of partnership even if the husband was making a business.

- (c) It is organized to carry on a business:** We have discussed that partner is the result of an agreement, but agreement for which purpose? Agreement should be to carry on some business. There must exist a business. The term business is defined in section 2(b) of the Act as 'Business' includes every trade, occupation and profession. For example, when two or more persons agrees to share the income of a joint property (e.g., rent from a building), it does not amount to a partnership because there does not exist any business. Similarly, an association created for charitable, religious or social purpose cannot be regarded as partnership because there does not exist any business. It may also be noted that an agreement to carry on business at a future time does not result in partnership unless that time arrives and the business is started. [*R R Same, v. Heuberr*]

In [*RR Sarna v Reuben AIR 1946 Qudh 68*], the plaintiff deposited a sum of money in the name of Civil Engineering co with the Kanpur Municipal Board for obtaining a licence to produce electricity. The licence was refused and money refunded. The other partner contended that it would be paid after meeting partnership liabilities. However, it was held that there is no partnership as yet.

**Example:**

Ten major persons form an association to which each member contributes ₹ 1,50,000. The purpose is to produce medicines for free distribution to poor patients. Is there a valid partnership? Since there is no intention to carry on the business share the profit accruing therefrom, there is no partnership.

Another point which is worth noting is whether business should be temporary or permanent. So long there is a valid agreement to carry on legal business there exists a partnership. It may further be noted that unless the person joins for the purpose of carrying on a business, it will not amount to partnership. Thus partnership does not exists between the members of a charitable society or a religious association or a sports club.

**Example:**

Two persons agreed to produce a film and share the profits of hiring it out; it was held to be sufficient to constitute a partnership (*Minck v Roshal Lal Shorey, AIR 1931 lah390*).

An agreement to carry on business at future time does not result in partnership unless that time arrives and business is commenced, as an agreement to agree in future is not an agreement.

A single snap act even if done by certain person together unless it involves some continuity cannot be regarded business.

A society for religious or charitable purpose or social obligations is not a partnership.

- (d) Agree to share profit:** The joint carrying on a business alone is not enough, there must be an agreement to share profits arising from the business. There must be sharing of profits. Sharing of profits does not necessarily imply sharing of losses as well. That is why there are minor partner and partner in profits only. It may also be noted that sharing of profits is prima facie evidence and not a conclusive evidence of partnership. That is why; everyone who shares the profits of business need not necessarily be a partner. For example, a manager who receives a particular share in the profits of a business as part of his remuneration, is simply an employee and not a partner

The section does not insist upon loss sharing. Thus a provision for loss sharing is not essential (*Walker West Development v FJ Emmett (1978)252EG1171*).

The Act does not prescribe any particular manner of distribution of profits, monthly, yearly or otherwise. Partners are free to share the profit in the manner they like. They may also agree that one of them will receive a fixed monthly or annual sum in lieu of a particular proportion of the profits actually earned. Similarly the Act does not prescribe the degree or kind of participation of profits, for, rent paid to a propertied member may be taken as his share of profit. (*Girdharbhai v Saiyed Md Kadri, AIR 1987 SC 1782*)

There may be some relationships akin to partnership relationship, it is not always necessary to infer either partnership or agency from the mere fact that one shares the profit of another. Section 6 of the Act, makes it amply clear 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 real relation between the parties, as shown by all relevant facts taken together. Section 6 of the act explains some cases where the relationship does not constitute partnership.

The following cases make it clear.

- (i) Joint owners of property sharing profits or gross returns arising from the property do not become partner (Ex 1 to section 6)

**Example:**

A and B jointly purchased a tea shop, each contributing half of the expenses for purchase of pottery and utensils. They then leased out the shop and shared the rent equally. Held they were co-owners and not partners [*Govind Nair v Moga AIR (1933) Rang120*]. The decision could have been different had they started the business and shared the profit.

- (ii) Where a person has lent money to persons engaged or about to engage in business and receive a rate of interest varying with profits.

**Example:**

A advanced money to two merchants engaged in business subject to control of A in several respects. A was to receive 20% commission on all profits. This was held not to be a partnership, because there is no sharing of profit. [*Mollow March & co v The court of wards, 1872LR2CP419*]

- (iii) Where a servant or agent is engaged in a business and receives his remuneration as a share of profits.

**Example:**

A contractor for loading and unloading railway wagons appointed B his servant to manage it. B was to receive 75% of profits and share all the losses if any. Held not to be a partnership as B servant was agent of A and not a partner. No valid partnership is created by simply that servant/agent share the profits [*Munshi Abdul Latif v Gopeshwar AIR (1933) Cal 204*].



- (iv) A widow or child of a deceased partner receives a portion of profits.
- (v) Where a person has sold his business along with goodwill and receives a portion of profits in consideration of sale (Explanation 2 to section 6) It may further be noted that sharing of profits is not a conclusive test of partnership. In *Grace v Smith (1775) 2 Win Blaks 998* it was laid down that every man who has a share of the profits of a trade ought also to bear the loss. This was approved in *Waugh v Carver (1793) 2H Blacks 235*.

**(e) The business is carried on by all or any of them acting for all of them.** Partnership is based upon the idea of mutual agency. There must exist a mutual agency relationship among the partners. 'Mutual Agency' relationship means that each partner is both an agent and a principal. Each partner is an agent in the sense that he has the capacity to bind other partners by his acts done. Each partner is a principal as well an agent in the sense that he is bound by the acts of his own but also of other partners, Similarly he bounds not only himself but also other partner partners. The foundation of the law of partnership is agency and it is therefore said that "the law of partnership is a branch of law of principal and agent. Each partner is an agent binding the other partners who are his principals and each other partner is again a principal who in is bound by the acts of the other partners .The mutual relationship of agency is emphasized in Section 18 of the Indian Partnership Act, which reads as under:

*"Subject to the provision of this Act, a partner is the agent of the firm for the business of the firm."* Moreover, the use of the words 'carried as by all or by any of them acting for all, in Section 4 of the Act clearly emphasizes agency relationship.

Because of the existence of mutual agency relationship amongst the partners, the law of partnership is also regarded as a extension of the general law of agency. It may be noted that the mutual agency relationship distinguishes a partnership from co-ownership and simple agreement for sharing profits.

**(f) Utmost good faith:**

The relations between partners are based upon mutual trust and confidence. Every partner is expected to act in the best interests of other partners and of the firm as a whole.

He must observe utmost good faith in all the dealings with his co-partners. He must render true accounts and make no secret profits from the business.

**(g) Unlimited liability:**

Every partner is jointly and severally liable to an unlimited extent for the debts of the partnership firm. In case the assets of the firm are insufficient to pay the debts in full, the personal property of each partner can be attached to pay the creditors of the firm.

**(h) Restriction on transfer of interest:**

No partner can transfer his share in the partnership without the prior consent of all other partners.

**5.1.3 Test of Partnership:**

As per Section 6, '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.' Sec 6 is based on case of *Cox v. Hickman, (1860) H.L.C. 268* Thus test of partnership can be analyzed as under:

- i) The partnership is determined by real relation among partners and relation must show existence of mutual agency.
- ii) The sharing of profit is prima facie evidence but not conclusive evidence of Partnership.

### Cases where no partnership relation exists:

Sec 6 enumerates in its two Explanations where partnership relation does not exist. These cases are:

- (a) Joint owners of property sharing profits or gross returns arising from the property do not become partner (Ex 1 to section 6)

**Example:**

A and B jointly purchased a tea shop, each contributing half of the expenses for purchase of pottery and utensils. They then leased out the shop and shared the rent equally. Held they were co-owners and not partners [*Govind Nair v Moga AIR (1933) Rang120*]. The decision could have been different had they started the business and shared the profit.

- (b) Where a person has lent money to persons engaged or about to engage in business and receive a rate of interest varying with profits.

**Example:**

A advanced money to two merchants engaged in business subject to control of A in several respects. A was to receive 20% commission on all profits. This was held not to be a partnership, because there is no sharing of profit. [*Mollow March & co v The court of wards, 1872LR2CP419*]

- (c) Where a servant or agent is engaged in a business and receives his remuneration as a share of profits.

**Example:**

A contractor for loading and unloading railway wagons appointed B his servant to manage it. B was to receive 75% of profits and share all the losses if any. Held not to be a partnership as B servant was agent of A and not a partner. No valid partnership is created by simply that servant/agent share the profits. [*Munshi Abdul Latif v Gopeshwar AIR (1933) Cal 204*].

- (d) A widow or child of a deceased partner receives a portion of profits.
- (e) Where a person has sold his business along with goodwill and receive a portion of profits in consideration of sale(Explanation 2 to section 6)

In all the five cases (a) to (e) provided in explanation to section 6 one thing which is absolutely missing is the essential element of partnership called Agency relationship as none of these i.e. a creditor, employee or even widow or children of a deceased partner cannot bind the firm for any act done on behalf of the firm. Undoubtedly only those persons who enjoy some authority either as per the Partnership Act or as per the agreement can bind the firm for their action done on behalf of the firm and the a person who can bind the firm is partner. Accordingly the important test of partnership is not profit sharing but agency and authority to bind the firm. The real test of partnership was laid down by the House of Lords in the case of *Cox v Hickman 1860 8 HLC 268* wherein a debtor transferred his business to trustee with instructions to carry on the business and use the profits for paying his creditors. It was held that the creditors were not partners of the business. The essence of this decision has been recognised in section 6 of the Partnership Act.

However, this is not as simple as appears to be, the courts must take into account all the relevant circumstances e.g the terms of the agreement, if any, the conduct of the parties, the mode of doing the business, who owns the property of the firm, the manner of keeping books of accounts and the manner of distribution of profits etc while deciding whether in real sense partnership exists between the persons who have agreed to carry on some business.

As regards sharing of losses, it may be noted that sharing of losses is a consequence of partnership rather than a test of partnership. Losses are not mentioned any where in section 4 of the Partnership Act. In the case of *Raghunandan v Hormasji 1949 51 Bomb 342* it was held that partners may agree that one or more of them shall not be liable for loses. But such agreements will be binding only among themselves. All the partners will be liable to third parties for the debts of the firm.



## Who are not partners? (Sec 5, Para 2)

In addition to cases already discussed, the following entities are not partners:

- i) The members of a Hindu undivided family carrying on a family business as such,
- ii) A Burmese Buddhist husband and wife carrying on business as such are not partners in such business.

## Who can be a partner?

After understanding the nature of partnership and essentials of a valid partnership, the next question arises, is who is competent to be a partner of a firm. Partnership Act is silent on this. Since partnership is result of agreement between two or more persons who have entered into a contract to form a partnership, we have to refer to the Indian Contract Act. A contract of partnership may be entered into by every person who is competent to enter into a contract under section 11 of the Indian Contract Act.

Let us refer to section 11 of the Indian Contract Act: It says every person is competent to contract who is of the age of majority according to the law which he is subject, and who is of sound mind and is not disqualified from contracting by any law to which he is subject to.

The term person does not include a partnership firm or a Limited Company For example a firm under the name say XYZ Associates cannot form a partnership with another firm say for ABC Associates. But nothing prevents all the partners of ABC Associates and XYZ Associates to form a single partnership subject to limitation on the maximum number of partners of a firm. The following persons for want of capacity cannot enter into contract and accordingly cannot be a partner in a firm.

**(a) Minor:** A minor cannot become a partner in a firm. According to section 30 of the Indian Partnership Act, a person who is a minor, according to the law to which he is subject may not be a partner in a firm, but with the consent of all the partners, a minor can be admitted to the benefits of partnership. The rights and liabilities of a minor partner are defined in section 30 as follows;

- (i) He has a right to such share of property and of the profits of the firm as may be agreed between the partners
- (ii) He may have access to and inspect and copy any of the accounts of the firm.
- (iii) Minors' share in the property and the profits of the firm is liable for the acts of the firm, but not personally liable for any such acts.
- (iv) During continuance of a partner he has no right to file a suit against other partners for accounts or for payment of his share in the profits or the property of the firm, However, he can file suit only when he want to sever his connection with the firm
- (v) At any time within six months of his attaining majority or of his obtaining the knowledge that he had been admitted to the benefits of the partnership, whichever date is later, he may give a public notice that he has elected to become or not elected to become partner of the firm

It may be noted that if he elects to become partner or decides to not to be partner but does not give a notice thereof, he would be liable for the debts of the firm contracted since the time he was admitted to the benefits of the partnership.

It may further be noted that on attaining age of majority if a minor elect to continue a partner, his rights and duties are similar to those of a full fledged partner. He will be personally liable for all the acts of the firm done since he was first admitted to the benefits of the firm. His share in the property and profits remains the same as was before unless altered by agreements. However, if he elects not to be a partner, his rights and liabilities shall continue to be those of a minor up to the date of public notice, his share shall not be liable for any acts of the firm done after the date of his notice and he shall be entitled to sue the partners for his share of property and profits.

- (b) Alien Enemy:** An Alien enemy cannot enter into a partnership with an Indian subject. However, a native of Alien fried country can enter into a partnership with Indian citizen.
- (c) Person of unsound mind-**A person of unsound mind is not competent to enter into a contract of partnership.
- (d) Corporation:** A Registered company can enter into a contract of partnership as a single individual but not as a group of Individuals comprising it (Shri Murugan Oil Industries (Pvt) Ltd V AU Suryanarayana Chettiar(1963)33 Comp.Cas 833(Mad). It may be noted that a company can be a partner in a firm only if so authorized by its Memorandum of Associations. You may like to know how a company be a partner in a firm. Answer is very simple a company is a legal entity, separate from its members; it can enter into any contract subject to the provisions of its Memorandum of Association.

**Can two partnership firms enter into a partnership with each other ?**.NO, A firm is not a legal person except for income tax, sales tax purpose. A firm is not a person. At best it is only a collective name of those individuals who constitute the firm.(Dulichand Laxminarayan v CIT(1956)29ITR-535AIR1956SC354).

**Similarly a partnership firm cannot become a partner in another firm.**

#### 5.1.4 Partnership and Other Associations:

##### **(A) Partnership and Hindu Undivided Family(HUF):**

According to Hindu law, 'Hindu undivided family is a family which consists of all persons lineally descended from a common ancestor and includes their wives and unmarried daughters'.

Distinction between Partnership and HUF:

##### **(i) Regulating law:**

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.

##### **(ii) Mode of creation:**

A partnership arises out of a contract, whereas a joint Hindu family business arises by the operation of law and is not the result of a contract.

##### **(iii) Admission of new members:**

In a partnership no new partner is admitted without the consent of all the partners, while in the case of a joint Hindu family firm a new member is admitted just by birth.

##### **(iv) The position of females:**

In a partnership women can be full-fledged partners, while in a joint Hindu family business membership is restricted to male members only. After the passage of the Hindu Succession Act, 1956, females get only co-sharer's interest at the death of a coparcener and they do not become coparceners themselves.

##### **(v) Number of members:**

In partnership the maximum limit of partners is 50 but there is no such maximum limit of members in the case of joint Hindu family business.

##### **(vi) Authority of members:**

In partnership each partner has an implied authority to bind his co-partners by act done in the ordinary course of the business, there being mutual agency between various partners.



In a joint family business all the powers are vested in the 'Karta' and he is the only representative of the family who can contract debts or bind his coparceners by acts done in the ordinary course of business, there being no mutual agency between various coparceners.

But a coparcener other than the 'Karta' of the family may be authorised expressly or by implication to contract debts on behalf of the firm (*Lai Chand vs. Ghanayalal*).

**(vii) Liability of members:**

In partnership, the liability of the partners is joint and several as well as unlimited. In other words, each partner is personally and jointly liable to an unlimited extent and if partnership liabilities cannot be fully discharged out of the partnership property each partner's separate personal property is liable for the debts of the firm.

In a joint Hindu family business only the 'Karta' is personally liable to an unlimited extent, i.e., his self-acquired or other separate property besides his share in the joint family property is liable, for debts contracted on behalf of the family business.

Other coparceners' liability is limited to the extent of their interest in the joint family property and they do not incur any personal liability.

But an adult coparcener can be made personally liable if he is also, expressly or impliedly, a party to the contract or if he has subsequently ratified and accepted the transaction out of which the obligation of the creditor arose (*Lai Chand vs. Ghanayalal*).

**(viii) Right of members to share in profits:**

In a partnership each partner is entitled to claim his separate share of profits but a member of a joint Hindu family business has no such right. His only remedy lies in a suit for partition.

**(ix) Effect of death of a member:**

A partnership, subject to contract between the partners, is dissolved on the death of a partner, but a joint Hindu family firm is not dissolved on the death of a coparcener (*Baij Nath vs. Ram Gopal*).

**(B) Partnership and Company:**

**Distinction between Company and Partnership:**

Sl.No.	Company	Partnership
(i)	Company is an artificial legal person	Partnership is not a legal person.
(ii)	Company has perpetual succession.	Partnership firm does not have perpetual succession.
(iii)	Company is created by registration under Companies Act.	For a partnership firm registration is not compulsory. It is guided by the Indian Contract Act and the Indian Partnership Act.
(iv)	Private Limited Company shall have at least 2 members and maximum 50 members. Public Ltd Company shall have minimum 7 members and there is no maximum limit.	Partnership firm shall have at least 2 members and maximum 50 members.
(v)	A member is not an agent of company or of other members.	Partner is an agent of firm and other partners.
(vi)	Member cannot bind company by his act.	Partner can bind firm by his act.
(vii)	Ordinary members cannot take part in management of a company. Only director members can take part in management	Partners can take part in management of a firm.

Sl.No.	Company	Partnership
(viii)	Private limited company shall have a minimum paid up capital of ₹ 1,00,000 (Rupees One Lakh Only) and public limited company of ₹ 5,00,000 (Rupees Five Lakh Only).	There is no minimum paid up capital for a partnership firm.
(ix)	Shares of a private limited company can be transferred with ease.	Partners can transfer his share but the assignee does not become a partner. He is only entitled to share of Profits.
(x)	A company is an entity distinct from its members. It may own property, make contracts, sue and be sued in its own name.	The property of a firm is owned by the partners. It can also sue and be sued in the firm's name and partners can also be sued individually.
(xi)	A single member cannot wind up a company.	A partnership may be dissolved by any partner at any time.
(xii)	Liability of a member is limited by shares or guaranty.	Liability of partners is unlimited.

**(C) Partnership and Club:****Distinction between Partnership and Club:**

Sl.No.	Partnership	Club
(i)	Business oriented objects aimed at profit sharing.	Not aimed at profit sharing.
(ii)	Number of Members 50.	No limit to number of members.
(iii)	Change in membership affects its existence.	Change in membership does not affects its existence.
(iv)	Based on agency relationship.	No agency relationship among members.

**5.1.5 What is Partnership, who is Partner, what is Firm and Firm Name?**

The answer to these four questions is provided at one place in section 4 of the Act itself, which reads as under: -'Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.' The Person who has entered into partnership with one another is called individually partners and collectively a firm and the name under which their business is carried on is called the firm name". Let us make it clearer.

**Example 1:**

A,B&C, entered into a partnership for trading in Fashion Garments in the name of M/s Elite Garments. Here A,B,C individually are called partner of M/S Elite Garments, they are collectively called firm and name in which business is carried out i.e. M/s Elite Garments is the name of the firm.

Partnership firm is not a legal entity, like a company, it is a group of individual partners, *Comptroller & Auditor General of India V Kamlesh Vadilal Mehta(2003)2SCC349*.

**Example 2:**

Firm name is only a compendious name given to the partnership and partners are the real owners of assets and partnership firm is not legal entity [*khandelwal Sahib V N Gudu Saheb(2003)3SCC229*].

Quite often the terms "Partnership" and "firms' are used interchangeably but that is not correct. Partnership is simply a relationship between the individuals called partners, it is an abstract. On the other hand firm is a physical visible entity.



### 5.1.6 Duration of Partnership:

The duration of partnership may or may not be fixed. It may be constituted for a particular purpose.

#### (A) Particular partnership:

In accordance with section 8 of the Act a particular partnership is one which is formed for a particular adventure or particular undertaking. Such a partnership is dissolved on the completion of the adventure or undertaking. For example two legal firms may be engaged in a particular legal case. This is a case of particular partnership. On settlement of the case the partnership ceases, as the partnership has been created for a particular purpose.

#### (B) Partnership at will:

In accordance with section 7 of the Act a partnership is called partnership at will where (a) it is not constituted for a fixed period of time and (ii) there is no provision made as to the determination of the partnership in any other way. Therefore such a partnership has no fixed or definite date of termination. Accordingly death or retirement of a partner does not affect the continuance of such a partnership. Section 43 provides that such a firm may be dissolved by any partner by giving notice in writing to all the partners of his intention to dissolve the firm.

##### Example:

S, T and U formed a partnership firm for export and import of Electronic items. Since there is nothing in the agreement about the duration or termination of the partnership, the Partnership will be called Partnership at will. Any partner can give a notice for dissolution of the firm .

In *Uduman v Aslum (1991)J SCC 412* the partnership deed provided that the partnership was to continue till there were two partners. The Supreme Court held that this was a provision as to dissolution and therefore, the firm was not at will. Therefore a suit for dissolution on the basis of notice was not maintainable.

In *Moss v Elphick (1910)KB 846* it was held that if two partners agree that they will continue indefinitely in partnership until by mutual consent they decide to dissolve the partnership, that is not a partnership at will.

In *Gobardhan Chakraborty v Abani Mohan AIR 1991 cal 195* a firm formed for obtaining a license for running a cinema hall has been held to be a partnership at will.

#### (C) Partnership for a fixed period:

When the partnership is constituted for a fixed period or duration it is called fixed partnership. The partnership comes to an end at the expiry of the fixed period. Section 17(b) provides that if the partners continue to carry on the business after the expiry of the fixed period, the rights and liabilities of the partners remain the same as they were before the expiry of the period and the partnership becomes a partnership at will.

##### Example:

ABC entered into a partnership to carry on the business of real estate consultancy for five year. Here in the partnership deed or agreement the duration of the partnership is fixed as five year. So this type of partnership is called Partnership for a fixed duration. On the other hand if the partnership deed or agreement is silent, it will be treated partnership at will. If the partnership is for a particular venture like Construction of Stadium for Olympic games, this partnership will be called Particular Partnership.

#### (D) Limited Liability Partnership:

Limited liability partnership is a form of business organisation which embraces the characteristic of both a corporate and a Partnership form of business organisation. As the name suggests limited

liability is the real feature of this form of this form of business organisation. It can be formed by any individual and or a body corporate provided the individual is of sound mind and is neither insolvent nor is an un-discharged insolvent person. The characteristic of LLP and relevant provisions thereof will be discussed in another chapter titled "The Limited Liability Partnership Act 2008."

### 5.1.7 Types of Partners

There are different types of partners. A person who deals with the firm may have to ascertain, at some point or time or other as to not only who the partners are but also as to what extent each is liable. The liability of different partners is different.

#### (a) Actual or Ostensible Partner:

A person who is actively engaged in the conduct of the business of the partnership firm is called an actual or ostensible partner. He binds himself and other partners for all the acts which he does in the ordinary course of the business and in the name of the firm. Actual or ostensible partner must give a public notice of his retirement from the firm in order to absolve himself from the liability for the acts of the other partners done after his retirement.

#### (b) Sleeping or Dormant Partner:

Though all the partners have equal right to take part in the business of the firm, but it is not necessary that all partners take active part in the day to day business of the firm. A sleeping partner is one who does not take part in the conduct of the business of the firm. A question may be asked since a partner is not taking active part in the business of the firm, can he escape from any liability on this pretext. No, he is equally liable along with other partners for all the debts of the firm.

His position is that of an undisclosed partner. But a sleeping partner, unlike other active partner or known partners is not required to give public notice of his retirement from the firm. He is not liable for any acts of the firm after he ceases to be a partner even if he does not give a public notice thereof. Also his insanity or any such other disability does not dissolve the firm.

#### (c) Nominal Partner:

Sometimes persons lend their names and credit to the firm but neither contribute any capital nor take any active part in the management of the business of the firm. A nominal partner is one who lends his name to the firm without having any real interest in the firm. He neither contributes share capital nor share profits. He even does not take part in the management of the business of the firm. He is also equally liable to the outsiders for all the debts of the firm. He is not entitled to any share of profit in the firm but he is liable for all the acts of the firm as if he is a real partner of the firm.

#### (d) Partner in Profits Only:

A partner who shares only profit but does not bear any loss is called a partner in profits only. He is also liable for all the debts of the firm. He is not allowed to take part in the management of the firm.

#### (e) Sub Partner:

A sub partner comes into existence when a partner agrees to share his profit with a third person, that third person is known as sub-partner. Sub-partner has no rights against the firm nor is he liable for the acts of the firm. A sub partner is not a partner in the eyes of law and thus therefore has no right against the firm.

#### Example:

A, B, C are three partners. C agreed to share 1/3<sup>rd</sup> of this share of profit with D, B does not take part in the management of the firm. Here A, C are called Active partners, whereas B is Sleeping or Dormant partner, D is a sub partner.

**(f) Working Partner:**

A partner because of his special qualifications may be assigned the management and control of business. Such a partner is known as working partner. A working partner normally receives a fixed amount of salary besides his share in the profits of the firm. Other partners are liable to third party for all acts of the partners including working partners.

**(g) Partner by Holding Out or Estoppels:**

Sometimes a person who is not a partner in a firm may under certain circumstances be liable for its debts as he were a partner such a person may either be a partner by estoppels or a partner by holding out. If he behaves in such a way that others consider him to be a partner he will be held liable to those persons who have been misled and lent finance to the firm on the assumption that he is a partner. Such a person is known as a partner by estoppels. He is not a true partner of the firm and is not entitled to any share in the profit of the firm.

If any person declared that so and so is a partner in a firm, that concerned person immediately after coming to know of that should deny it. If he fails to do so, he will be liable to that person who extends credit to the firm on the basis of his being a partner. Such a person is known as partner by holding out. Such a person is liable as a partner in that firm to anyone who has, on the faith of any such representation has given credit to the firm, However, such a partner does not acquire any claim thereby on the firm.

**Example 1:**

A retired businessman of some repute assumed honorary presidentship of business of a person who requested him. B gave goods on credit to the firm having a bonafide belief that A is a partner of the firm which A never denied by his action. A is liable for the debts. *[[lake v duke of Argyll 1844 6QB 477].*

**Example 2:**

X is a partner in XYZ firm, he retires from the firm but does not give public notice of his retirement from the firm. He will be held to be a partner by holding out.

**Example 3:**

X induces Y to believe that he (X) is a partner in XYZ Associates. Believing on the representation of X that he is a partner of the firm Y gave credit to the firm. X will be treated as a partner by holding out and Y can claim refund of the credit given to the firm on his representation.

**(h) Minor Partner:**

Minor person has no capacity to enter into any contract. At time with the consent of all partners a minor is admitted to the benefits of partnership. The position of minor, his rights and liabilities have already discussed in the earlier section.

**5.1.8 Partnership Property**

It is upto the partners to decide by agreement amongst them as to what shall be the property of the firm and what shall be individual property of one or more partners. If there is no express agreement, the source from which it was acquired, the purpose and the mode in which it had been dealt with are important points in determining whether or not the property belongs to the firm.

Section 14 of the Act states, subject to contract between the partners, the property of the firm includes all property and rights and interest in property originally brought into the stock of the firm, or acquired, by purchase or otherwise, by or for the firm for the purposes and in the course of the business of the firm, and includes also the goodwill of the business.

It further states that unless the contrary intention appears, property and rights and interest in property acquired with money belonging to the firm are deemed to have been acquired for the firm.

**Example 1:**

P, Q, R are partners of a business. They buy a property in a fictitious name with money and account of the firm. The property will belong to the firm.

**Example 2:**

Q, a partner of a firm buys shares in his own name, without the consent of other partners. The shares are partnership property.

**Example 3:**

R's private car in his own name is used by other partners as well. The car is not partnership property.

It should be understood that private property of a partner does not become partnership property merely because it is being used for the purpose of business of the firm. It becomes property of the firm only if the partners show an **intention** to make it so.

Once the question as to what is partnership property is understood, the next question arises as to how the property is to be used. Section 15 says that subject to the contract between the partners, the property of the firm shall be held and used by the partners exclusively for the purposes of the business. However the partners by agreement may change the nature of property.

The issue of what is joint property of firm and what is individual property is an important issue specially at the time of dissolution of the firm.

Section 49 which deals with payment of firm's debts and of separate debts points out that where there are joint debts due from the firm, and also separate debts due from any partner, the property of the firm shall be applied in the first instance in payment of the debts of the firm, and, if there is any surplus, then the share of each partner shall be applied in payment of his separate debts or paid to him. The separate property of any partner shall be applied first in the payment of his separate debts, and the surplus (if any) in payment of the debts of the firm.

**5.1.9 Registration of a Firm**

Prior to the passing of the Indian Partnership Act, 1932 there was no provision for registration of a firm in India. Registration of firm means the recording of full details of firm in the Register of firms kept in the office of Registrar of Firms.

Though the Indian Partnership Act, 1932 has not made registration of a firm compulsory nor does it impose any penalty on non-registered firm. It is option of the firm to register or not to register the firm. The non-registration of firm does not affect the partnership agreement nor the transaction between the firm and third party. However, section 69 of the Act, imposes certain limitations/disabilities upon a non-registration firm. Thus to get out of the mischief of section 69 it is otherwise necessary for firms in India to register itself with the Registrar of firms. Registration of a firm provides only a reliable evidence and conclusive proof of the existence of a partnership.

**Mode of Registration: (Secs 58 and 59)**

The mode of registration of a firm is provided in section 58. Registration may be carried out any time by sending by post or by delivering to the Registrar of the area in which any place of business of the firm is situated or proposed to be situated, a statement in the prescribed form accompanied by fee stating therein:

- (a) the name of the firm;
- (b) the place or principle place of business of the firm;
- (c) the name of any other place where the firm carries on business;
- (d) the date when each partner joined the firm;
- (e) the names in full and permanent address of the partners;
- (f) the duration of the firm.



The statement is required to be signed by all the partners or by their agents specially authorized in this behalf. It is also required to be verified in the prescribed manner.

Further section 59 lays down that when the Registrar is satisfied that the provisions of section 58 have been complied with he shall record the entry of the statement in a register called the Register of firms and shall file the statement. After satisfying himself, the Registrar of firm will issue a certificate of Registration.

As regards name of the firm with the firm is required to be registered, care should be taken to ensure that a firm shall not have any of the names or emblems specified in the Schedule to the Emblems and Names (Prevention of Improper Use) Act, 1950, or any colourable imitation thereof, unless permitted so to do under that Act, or any name which is likely to be associated by the public with the name of any other firm on account of similarity, or any name which, in the opinion of the Registrar, for reasons to be recorded in writing, is undesirable; following words, namely: " Crown", " Emperor", " Empress", " Empire", " Imperial", " King", " Queen", " Royal", or words expressing or implying the sanction, approval or patronage of Government cannot be used as a part of firms name except when the State Government signifies its consent to the use of such words as part of the firm name by order in writing.

The statement under sub-section (1) of section 59 is required to be sent or delivered to the Registrar within a period of one year from the date of constitution of the firm . If the statement is not sent or delivered to the Registrar of firms within the stipulated time then the firm may be registered on payment of a late penalty of one hundred rupee per year of delay or a part thereto (59A-1) . The statement so sent or delivered to the Registrar of firms is required to be signed and verified by each person in the prescribed manner. Any person who signs any statement, amending statement, notice or intimation containing any particulars which he knows to be false or does not believe to be true, or containing particulars which he knows to be incomplete or does not believe to be complete, shall, on conviction, be punished with imprisonment for a term which may extend to one year, or with fine, or with both: However, in the absence of special and adequate reasons to the contrary to be mentioned in the judgment of the Court, the fine shall not be less than one thousand rupees.

As per sub section (4) of section 59A any person aggrieved by an order of the Registrar under sub-section (3), may, within 30 days from the date of communication of such order, appeal to the officer not below the rank of Deputy Secretary to Government authorised by the State Government in this behalf, in such manner, and on payment of such fee, as may be prescribed. On receipt of any such appeal, the authorised officer shall, after giving an opportunity of being heard to the appellant, decide the appeal, and his decision shall be final.

**Recording of alterations in firm-name, nature of business and principal place of business.-** As per section 60 when an alteration is made in the firm name or in the nature of business of a firm or in the location of the principal place of business of a registered firm, a statement shall be sent to the Registrar, within a period of 90 days from the date of making such alteration, accompanied by the prescribed fee, specifying the alteration and signed and verified in the manner required under section 58. The Registrar of firm on being satisfied the compliance of required provisions shall amend the entry relating to the firm in the Register of Firms in accordance with the statement, and shall file it along with the statement relating to the firm filed under section 59.

Similarly when a registered firm discontinues business at any place or begins to carry on business at any place, such place not being its principal place of business, any partner or agent of the firm shall send intimation thereof to the Registrar, within a period of 90 days from the date of such discontinuance or, as the case may be, from the date on which the firm begins to carry on business at such place. The Registrar shall then make a note of such intimation in the entry relating to the firm in the Register of Firms, and shall file the intimation along with the statement relating to the firm filed under section 59 (section 61)

**Noting of changes in names and addresses of partners.-** As and when any party of a register firm alters his name or permanent address, he, any partner of the firm or an agent if the firm is required to give an

intimation of the alteration, within a period of 90 days from the date of making such alteration, to the Registrar, who shall deal with it in the manner provided in section 61 (section 62).

**Recording of changes in and dissolution of a firm (sec 63).-**

- (1) When a change occurs in the constitution of a registered firm, every incoming, continuing or outgoing partner, and when a registered firm is dissolved, every person who was a partner immediately before the dissolution, or the agent of every such partner or person specially authorised in this behalf shall, within a period of 90 days from the date of such change or dissolution, given notice to the Registrar of such change or dissolution, specifying the date thereof; and the Registrar shall a record of the notice in the entry relating to the firm in the Registrar of Firms and shall file the notice along with statement relating to the firm filed under section 59.
- (1A) Where a change occurs in the constitution of a registered firm, all persons, who after such change are partners of the firm, shall jointly send an intimation of such change duly signed by them, to the Registrar, within a period of 90 days from the date of occurrence of such change and the Registrar shall deal with it in the manner provided by section 61.
- (2) RECORDING OF WITHDRAWAL OF A MINOR. When a minor who has been admitted to the benefits of partnership in a firm attains majority and elects to become or not to become a partner, and the firm is then a registered firm, he, or his agent specially authorized in this behalf, shall within a period of 90 days from the date of his election, give notice to the Registrar that he has or has not become a partner, and the Registrar shall deal with the notice in the manner provided in sub-section (1). (section 63)

**Rectification of mistakes (sec 64).**- If any discrepancies is noticed in any entry in the Register of firms the Registrar have power at all time to rectify any mistake in order to bring the entry in the Register of Firms relating to any firm into conformity with into documents relating to that firm filed by the firm.

**Effect of non-registration (Sec 69).**

The consequences of non –registration of a firm are as under:

- (a) **Suit between the partners and firm or between the partners themselves** for any dispute arising on any account including dispute arising from partnership deed or upon the rights conferred by the partnership Act, a partner of an unregistered firm cannot file a suit.
- (b) **No suit against a third party:** No suit can be filed on behalf of an unregistered firm against any third party for the purpose of enforcing the rights arising from a contract. However, third party can sue against the firm

**Example 1:**

X Y a unregistered firm supplied goods worth ₹ 50,000 to A. A refuses to pay the amount due to the firm. The firm has no legal remedy against A as it is an unregistered firm.

**Example 2:**

A supplied goods worth ₹ 50,000 to BC an unregistered firm. The firm refuses to make the payment. A can file a suit against the firm.

- (c) **Claim of set-off:** Any unregistered firm cannot claim a set off in a suit.

**Example:**

A buys goods worth ₹ 30,000 from XY an unregistered firm. The firm is already indebted to A for ₹ 35,000. The firm cannot set off the claim against the amount due by A and ask him to accept ₹ 5000 in settlement of the amount due to him. The right of set –off being not available to an unregistered firm.



### Exception to non-registration of firm

It may be noted that non registration of firm does not affect the following rights.

- (a) The right of third party to sue the firm or any partner.
- (b) To enforce a right arising otherwise than out of contract.

#### Example:

A infringes the trade mark of XY Associates an unregistered firm. XY firm even though is an unregistered firm can file a suit against A even though it is an unregistered firm.

- (c) The rights of firms or partners having no place of business in India.
- (d) The power of an official Assignee or Receiver to realize the property of an insolvent partner.
- (e) A partner can bring a suit for damages for misconduct against another partner.
- (f) Enforcement of any right to sue for the dissolution of the firm.
- (g) Suit for account of dissolved firm.
- (h) suit for realization of the property of a dissolved firm.
- (i) The right of a partner of a firm to refer the dispute to an arbitration.
- (j) Right to file a suit or claim a set off for a sum not exceeding ₹ 100 in value where the suit is of such a nature that it has to be filed in the Small Causes Court. Proceedings incidental to such suits eg execution of decrees are also allowed.
- (k) Non-registration of firm does not affect its legality. A non-registered firm is perfectly legal form of business organization but suffer only certain limitations.

### 5.1.10 Relations of Partners to One Another

The relation of the partners of a firm to one another arises through an agreement between them. Such an agreement can be express or may be implied from the course of dealing between them. It may be varied with the consent of all the partners. Such consent may be expressed or may be implied from the course of dealing. If there is no specific agreement or the agreement is silent on a certain point, or where no agreement exists, the relations of the partners to one another as regard their rights and duties are governed by section 9 to 17 of the Act.

Since partners are mutual agent, they must act in good faith. They are free to determine their mutual rights, duties and liabilities subject to the provisions of the Act. If the partnership deed/agreements does not lay down the mutual rights, duties and liabilities of the partners. Provisions of the Partnership Act apply. Such contract between the partners may be varied by consent of all partners. Some of the rights and duties cannot be varied even by consent of all the partners. Some duties and rights can be varied by agreement between the partners. Such contract may provide that a partner shall not carry on any other business than that of the firm while he is a partner.

The Partnership Deed contains the mutual rights, duties and obligations of the partners, in certain cases, the Partnership Act also makes a mandatory provision as regards to the rights and obligations of partners. When there is no Deed or the Deed is silent on any point, the rights and obligations are governed by Sections 9 to 17 of Partnership Act .

#### A) Rights of a Partner:

- i. A partner has right to take part in the day-to-day management of the firm.[Sec 12(a)]

This right is subject to contract between the partners which cannot be taken away except by a contract between the partners. The fact that any partner has not contributed to the capital of the firm or has made unequal contribution does not vitiate this right.

- ii. A partner has right to be consulted and heard while taking any decision regarding the business.[Sec 12(c)] This right is subject to contract between the partners which cannot be taken away except by a contract between the partners. Any difference of opinion on ordinary matters must be resolved by majority decision but matters having fundamental implications can be resolved only by consensus and not by majority decision. This power of being consulted though not in itself of a judicial kind, is subject to the rule of natural justice. Every partner must have an opportunity of being heard and the decision must be made in good faith with a view to collective interest of the firm.
- iii. A partner has right of access to books of accounts and call for the copy of the same.[Sec 12(d)] This right is subject to contract between the partners which can not be taken away except by a contract between the partners. The term books used is more comprehensive than the term books of accounts used in section 30(2) of the Act. As such no exemption can be made to any books of the firm, even though a particular book may contain business secrets. This right can be exercise by the partner himself or by an agent who is not objectionable to the firm.
- iv. A partner has right to share the profits equally or as agreed upon by the partners.[Sec 13(b)
- v. A partner has right to get interest on capital contributed by the partners to the firm.[Sec 13(c)] This right is subject to contract between the partners which cannot be taken away except by a contract between the partners. Since this provision is subject to the contract between the partners, partners are open to decide their profit sharing ratio mutually . The contract may provide that a particular partner will bear all losses of the business or on the contrary that one of the partners may have a fixed salary for taking interest in the day to day administration of the business of the firm.
- vi. A partner has right to avail interest on advances paid by the partners for business purpose. [Sec 13(d)]. A partner has right to interest on the money advanced to the firm whether there is any profit or not. But a partner is not entitle to interest after the date of dissolution of the firm.
- vii. A partner has right to be indemnified in respect of payment made or liabilities incurred or for protecting the firm from losses.[Sec 13(e)]Subject to the contract between the partners, the firm shall indemnify a partner in respect of payment made and liabilities incurred by him in the ordinary and proper conduct of business and in doing such act, in an emergency, for protecting the firm from loss as would be done by a person of ordinary prudence in his own case under similar circumstances.
- viii. A partner has right to the use of partnership property exclusively for partnership business only not himself [Sec 15]. This right is also subject to the contract between the partners.
- ix. A partner has right as agent of the firm and implied authority to bind the firm for any act done in carrying the business [Sec 18].
- x. A partner has right to prevent admission of new partners/expulsion of existing partners [Sec 31(1)].
- xi. A partner has right to continue unless and otherwise he himself cease to become partner [Sec 33(1)].
- xii. A partner has right to retire with the consent of other partners and according to the terms and conditions of deed [Sec 32(1)].
- xiii. A partner has right of outgoing partner/legal heirs of deceased partner.[Sec 37]The right of an outgoing partner includes right to carry on competing business and right in certain cases to share subsequent profits.



## B) Duties of a Partner:

The duties of a partner are as follows:

- i. To carry on the business to the greatest common advantage. Every partner is bound to carry on the business of the firm to the greatest common advantage. In other words, the partner must use his knowledge and skill in the conduct of business to secure maximum benefits for the firm. The duty to carry on business to the greatest common advantages and the duty to be just and faithful to each other are two sides of the same coins, which is the duty of good faith. All the endeavours of a partner must be to secure the maximum profits to the firm. He should not try to make a personal profit for himself at the cost of his co-partners.
- ii. To be just and faithful to each other. Partnership is a fiduciary relation. Every partner must be just and faithful to other partners of the firm. Every partner must observe utmost good faith and fairness towards other partners in business activity.
- iii. To render true accounts. Every partner must render true and proper accounts to his co-partners. Each and every entry in the books must be supported by vouchers and give explanations if demanded by other partners.

The duty to render true accounts is not limited to submitting statement of accounts, but it includes the duty to handover to the firm the balance money of the firm which have come in the hands of a partner. He must also be ready to explain to his other partners the true account and produce vouchers relating to everything coming into his hands.

- iv. To provide full information. Every partner must provide full information of the activities affecting the firm to the other co-partners. No information should be concealed, kept secret.

If a partner is in possession of more information about the things affecting the firm he should disclose it to his co-partners

It may be noted that the duties discussed above (i) to (iv) are absolute duties imposed by the law which cannot be varied by agreement between the partners.

Duties being discussed in (v) to (xiv) are subject to contract to the contrary between the partners. Accordingly these duties can be varied by agreement between the partners.

- v. To attend diligently to his duties. Every partner is bound to attend diligently to duties in the conduct of the business of the firm. [Sec 12(b)] Diligent functioning means functioning with careful efforts and absence of carelessness is negligence.
- vi. To work without remuneration. A partner is not entitled to receive any kind remuneration for taking part in the conduct of the business. But in practice, the working partners are generally paid remuneration as per agreement, so also commission in some case [Sec 13(a)].
- vii. To indemnify for loss caused by fraud or willful neglect. If any loss is caused to the firm because of a partner's willful neglect in the conduct of the business or fraud committed by him against a third party then such partner must indemnify the firm for the loss [Sec 10].
- viii. To hold and use partnership property exclusively for the firm. The partners must hold and use the partnership property exclusively for the purpose of business of the firm not for their personal benefit.
- ix. To account for personal profits. If a partner derives any personal profit from partnership transactions or from the use of the property of the firm or business connection the firm or the firm's name, he must account for such profit and pay it to the firm.

This section lays down the following two of the most important duties of a partner.

- (a) Duty to not to make secret profit
- (b) duty to not to compete with the firm.

According to section 16(a) a partner is liable to account for profits derived for himself arising out of the following ways.

- (a) from any transaction of the firm;
- (b) from the use of firms property;
- (c) from use of firms name;
- (d) from use of firms business connection.

If any partner has derived any profit from either of these ways he is liable to account for to the firm.

- x. Not to carry on any competing business. A partner must not carry on competing business to that of the firm. If he carries on and earns any profit then he must account for the profit made and pay it to the firm.

Section 11(2) provides that notwithstanding anything contained in section 27 of the Indian Contract Act, the partners may agree that they or some or any of them, shall not carry on any business other than that of the firm while he is a partner in the firm. Section 16(b) of the Indian Partnership Act provides that if a partner carries on any business of the same nature as to compete with that of the firm, he shall account for all profits made by him in that business.

- xi. To share losses.[Sec 13(b)] .It is the duty of the partners to bear the losses of the firm. 'Partners share the losses equally when there is no agreement or as per their profit share ratio.
- xii. To act within authority.[Sec 19(1)]. Every partner is bound to act within the scope of authority. If he exceeds his authority and the firm suffers from any loss, he shall have to compensate the firm for such loss.
- xiii. Duty to be liable jointly and severally [Sec 25]. Every partner is jointly and individually liable to the third parties for all acts of the firm done while he is a partner.
- xiv. Duty not to assign his interest [Sec 29]. A partner cannot assign or transfer his partner interest to an outsider so as to make him the partner of the firm without the consent of other partners. However, he can assign his share of the profit and his share in the assets the firm where the assignee shall not be entitled to interfere in the conduct of the business.

### **3. Liabilities of a Partner to Third Parties:**

The following are the liabilities of a partner to third parties:

#### **i. Liability of a partner for acts of the firm (Section 25):**

Every partner is jointly and severally liable for all acts of the firm done while he is a partner. Because of this liability, the creditor of the firm can sue all the partners jointly or individually.

In order that a partner may be held liable for any acts of the firm, the same must have been done while he was a partner irrespective of the fact that at the time of the action he had ceased to be a partner of the firm or the firm has been dissolved.

#### **ii. Liability of the firm for wrongful act of a partner:**

If any loss or injury is caused to any third party or any penalty is imposed because of wrongful act or omission of a partner, the firm is liable to the same extent as the partner. However, the partner must act in the ordinary course of business of the firm or with authority of his partners.

The liability of the firm under section 26 arises only (i) if the act is done in the ordinary course of the firm or done with the authority of the other partners or on behalf of the firm in its name and the firm subsequently ratifies them with full knowledge of what those acts were and (ii) the results of the wrongful act or omission is the injury to any third party, or any penalty is incurred



In *Hurruck chanc v Govind Land* 1906 10 CWN 1053 one of the partners received the stolen goods and credited the sale proceeds to the credit of the firm. It was held that both firm and partner are liable for this wrongful conversin.

In *Hamlayan v John Housten & co*, 1903 1 KB & 81 one of the two parters without the knowledge of his sleeping co-parter by bribery induced a clerk of the plaintiff, a competitor in trade, in breach of duty to his employer to give confidential information in regard to the plaintiff business. It was in the ordinary course of business of the firm to obtain such information by legitimate methods, and the partners acted in the interest of the firm. Both partners were held liable to the plaintiff.

### iii. **Liability of the firm for misutilisation by partners (Section 27)**

Where (a) a partner acting within his apparent authority receives money or property from a third party and misutilises it (b) or a firm receives money or property from a third party in the course of its business and any of the partners misutilises such money or property, then the firm is liable to make good the loss.

Under clause (a) of section 27 to hold the firm liable a partner must have received money or property while acting within his apparent authority and it must have been misapplied by that partner.

Under clause (b) of section 27 to hold the partner liable the money or property must have been received by the firm in the course of the business of the firm and the money must have been misapplied by any partner while it is in the custody of the firm.

### iv. **Liability of an incoming partner:**

An incoming partner is liable for the debts and acts of the firm from the date of his admission into the firm. However, the incoming partner may agree to be liable for debts prior to his admission. Such agreeing will not empower the prior creditor to sue the incoming partner. He will be liable only to the other co-partners.

### v. **Liability of a retiring partner:**

A retiring partner is liable for the acts of the firm done before his retirement. But a retiring partner may not be liable for the debts incurred before his retirement if an agreement is reached between the third parties and the remaining partners of the firm discharging the retiring partner from all liabilities. After retirement the retiring partner shall be liable unless a public notice of his retirement is given. No such notice is required in case of retirement of a sleeping or dormant partner.

### vi. **Liability for holding out:**

As per section 28 of the Act if anyone by words spoken or written or by conduct represent himself, or knowingly permits himself to be represented, to be a partner in a firm, is liable as a partner in that firm to anyone who has on the faith of any such representation given credit to the firm, whether the person representing himself or represented to be a partner does or does not know that the representation has reached the person so giving credit. Similarly where after partner's death the business continued in the old firm-name, the continued use of that name or of the deceased partner's name as a part thereof shall not of itself make his legal representative or his estate liable for any act of the firm done after his death.

## 5.1.11 Implied Authority of a Partner

### Doctrine of Implied Authority

A firm acts through its partner so the acts of the partners are the acts of the firm. Accordingly the liability that a partner incurs is for the act of the firm and the firm is accordingly liable for the act of the partner. So another question arise what act of the partners are treated as act of the firm to bind the firm for the acts of the partners.

A partner's authority may be express or implied. An authority is said to be express when it is given by words, spoken or written. It is implied when there is no express agreement between the partners, in which case, the law impliedly gives certain powers to a partner and also certain negative powers as regards partners. When we talk about certain negative powers we mean the powers which a partner is not conferred by the Act. The word "implied" suggests that authority of a partner which is apparent from his position in a partnership firm in relation to the business of the firm.

**Section 18 and 19 deals with the acts and implied authority of the partners.**

According to section 18; subject to the provisions of this Act, a partner is the agent of the firm for the purpose of the business of the firm. Every partner embraces the character both of a principal and agent. But a partner is an agent for the business of the firm. An act of a partner done by him as an agent in the usual course of business is an act of the firm, which is an implied authority of a partner. The extent and scope of Implied Authority of a partner is determined in section 19 of the Act which reads as under;

**Section 19 Implied authority of the partner as an agent of the firm**

- (1) Subject to the provisions of section 22, the act of a partner which is done to carry on, in the usual way, business of the kind carried on by the firm, binds the firm. The authority of a partner to bind the firm conferred by section 19 is called implied authority.
- (2) In the absence of any usage or customs of trade to the contrary, the implied authority of a partner does not empower him to—
  - (a) submit a dispute relating to the business of the firm in arbitration;
  - (b) open a bank account on behalf of the firm in his own name;
  - (c) compromise or relinquish any claim or portion of a claim by the firm;
  - (d) withdraw a suit or proceeding filed on behalf of the firm;
  - (e) admit any liability in a suit or proceeding against the firm;
  - (f) acquire immovable property on behalf of the firm;
  - (g) transfer immovable belonging to the firm;
  - (h) enter into partnership on behalf of the firm.

It may further be noted that the scope of implied authority depends upon the nature of the business and the manner of carrying out it. In the words of Pollock "The acts of partner done in the name of firm will not bind the firm merely because they are convenient, or prudent or even necessary for the particular occasion. The question is what is necessary for the usual conduct of the partnership business that is the limit of each partner's general authority, he is the general agent of the firm but he is no more.

To know whether a particular act of a partner falls within the ambit of implied authority one cannot just blindly follow section 19. Since the requirements of one business may be wholly different from those of another, the nature of business and the practices, customs and usage of business engaged in that kind of business, must be known before it can be said by what acts of a partner can bind the firm. This can be explained with the help of the following two examples:

**Example 1:**

SYZ Associates is a trading firm engaged in import and export of readymade garments. S a senior partner of the firm acquired an office space for the firm. Question arises whether S has an implied authority to purchase an immovable property for the firm. Going by the provisions of section 19 of the Act, S has exceeded his authority. The above act of S was outside of the implied authority of a partner. Accordingly S cannot bind the firm for his act in the instant case.



### **Example2:**

SYZ Associates is a partnership firm engaged in Real estate trading and development. S finalized a deal for purchase of office space. A question may be asked whether this particular act of S is within the implied authority of a partner.

Just going by the literal interpretation of section 19 one may come to a wrong conclusion that acquisition of immovable property on behalf of the firm is outside the ambit of implied authority of a partner, but having regard to the nature of business of the firm which is engaged in purchase, sale and development of a real estate, purchase and sale of immovable property is the usual business of the firm. According to the provision of section 19(f) the above act of S is within the implied authority of a partner and this act is binding upon the firm.

### **Restriction on implied authority of a partner:**

When a partner is prohibited from doing an act which would otherwise be within the scope of his implied authority, it is said that the implied authority of the partner has been restricted. Such restrictions are of two types statutory restriction as contained in section 19(2) and others which are imposed by partnership deed/agreement.

Statutory restrictions are contained in sub section 2 to section 19, these restrictions are in the absence of any usage or customs of trade to the contrary and are effective against all the world whether a particular person contracting with the firm has knowledge thereof or not.

Another kind of restriction is one which the partners may themselves impose as per the agreement between the partners contained in the partnership deed.

**Section 20** provides that "the partners in a firm, by contract between the partners, extend or restrict the implied authority of any partner, but such restrictions still binds the firm unless the person with whom the partner is dealing knows of such restriction or does not know or believe that partner to be a partner of the firm.

In other words, if an act in question is within the scope of implied authority of a partner but restricted by an agreement between the partners, the firm is bound unless it can be shown –

(a) that the person contracting with the partner had knowledge of the restriction or (b) that he did not know or believe the partner to be a partner.

### **Illustrations:**

P and G were partners in a business of letting lock up garages and requiring cars. G was a sleeping partner. A clause in the partnership deed prohibited partners from buying and selling cars on behalf of the firm. P the acting partner, sold a car to which the firm had no title and obtained \$700. When the buyer found that the seller had no title to sell, he claimed \$700 from G the sleeping partner.

G was held liable. Garage owners usually sell second-hand cars. The act was therefore within the scope of the implied authority. The Plaintiff did not know of any restrictions in the deed and he did not know that he was dealing with a partner within the scope of his usual authority. [*Mercantile Credit Co Ltd v Garrod*(1962)3 All ER 1103]

In *Modi Lal v Unnao Commercial bank*(1930)32 BomLR1571 a trading firm was held liable when one of its partners borrowed money by accepting a bill of exchange despite restrictions on borrowing contained in the partnership deed, the others knowing nothing of the restriction.

In *SN Soni V Taufiq Farooki AIR 1976 Dec 63*, a partner assigned a promissory note for a lesser value without the consent of the other partners. This was held to be not binding on the firm as it amounted to a partial surrender of a claim of the firm, which a partner cannot do. However, it became binding on the firm when the other partner subsequently ratified it.

In *Sanganer Del & Flour Mills V FCI AIR 1992 SC 481* a contract was entered into by one of the partners of the firm with the FCI for the supply of *dal*. It was held that the contract would be binding on the other partners of the firm when the validity of the contract was not denied by the other partners.

**Acts within the implied authority of a partner:**

In a trading firm the implied authority of a partner has been held to include:

- (a) Purchasing goods on behalf of the firm in which the firm deals or which are employed in the firm's business;
- (b) selling the goods of the firm;
- (c) receiving payments of the debts due to the firm and giving receipts for them;
- (d) settling accounts with the person dealing with the firm;
- (e) engaging servants for the partnership business;
- (f) borrowing money on the credit of the firm;
- (g) drawing, accepting, indorsing of bills and other negotiable instruments in the name of the firm;
- (h) pledging any goods of the firm for the purpose of borrowing money; and
- (i) employing a solicitor to defend an action against the firm for the goods supplied.

All the partners of a firm can ratify an act of a person, which has been done by him in excess of his implied authority or without any authority, provided the act is such as could be legally done with the authority of all the partners previously given and that the partners ratify the act with full knowledge of the facts [*SN Soni v Taufic Farooki AIR(1976) Delhi*]. Such ratification can be proved by the conduct of the partners [*Juda Ram Ved Prakash v M/s Maharani of India, AIR(1989)Delhi 169*].

In *M/s National Small Industries corporation Ltd v Punjab printing & Metal Industries AIR 1979 Del 58*; It was held that a partner of a firm cannot an agreement to submit disputes to arbitration on behalf without any authority from other partners. In section 19(2) the word submit includes to refer.

**Authority in Emergency:**

An implied authority of a partner empowers him to do only such acts as are usually done in carrying on the kind of business in which the firm is engaged."A power to do what is usually does not include the power to do what is unusual however urgent it may be [*Lindley in Hawtayne v Bourne(1841) 10LJex244 56 RR806*].

Under section 21, a partner has authority in an emergency to do all such acts for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence, in his own case, acting under similar circumstances and such acts bind the firm.

**Example:**

A partner received goods at Delhi to for being sent to China. The goods are perishable in nature but due to transporter strike are not likely to reach within China before getting spoiled. In the circumstances of the case, A may sell the goods in Delhi. This is an act done in emergency and can bind the firm.

However, to bind the firm for the acts done in emergency the following conditions must be satisfied.

- (a) There should be an emergency;
- (b) The partner should have tried to protect the firm from loss threatened by the emergency;
- (c) The act must be reasonable in the circumstances.

The test of reasonableness is that the partners must have taken all necessary steps to mitigate the loss and acted as the person of ordinary prudence would do in his own case in like circumstances. If this test is not satisfied recourse to authority in emergency under section 21 cannot be made.



### **Mode of exercising authority:**

Section 22 lays down the manner in which a partner is to act on behalf of the firm. In order to bind, an act or instrument done or executed by a partner or other person on behalf of the firm shall be done or executed in the firm name or in any other manner expressing or implying an intention to bind the firm.

The partner acting for the firm must expressly or impliedly let the other party to know that he is acting for and on behalf of firm. But when he fails to do so he will incur personal liability on the contract and the firm may not be liable for his act to the third party.

### **Example:**

A partner of ABC Associates a partnership firm signed a bill of exchange as;--Sd "A "Managing Partner. The firm will not liable as the mode of signing the bill of exchange did not express or imply an intention to bind the firm. The words following the signature only disclose his position or status in the firm which in no way express or indicate his intention to bind the firm.

Where a person signed a pronote describing himself as proprietor of the firm, liability of the firm does not arise. [*Ghisulal v Haji Mohd AIR 1981 Raj 58 M Rajagopal v KS Imam Ali AIR 1981 ker 36*].

### **Example:**

A partner of ABC Associates a partnership firm signed a bill of exchange as;--Sd "A "Managing Partner for ABC Associates.

The firm will be liable as the mode of signing the bill of exchange did expressed or implied his intention to bind the firm as the instrument has been signed for and on behalf of the firm.

### **Admission by partner:**

An admission or representation made by a partner concerning the affairs of the firm is evidence against the firm, if it is made in the ordinary course of business. This is based on the general principle that the partners are agents of each other for the purpose of carrying on the business of the firm but if the admission or representation is made by a partner beyond the scope of his authority, the firm will not be bound by it.

### **5.1.12 Reconstitution of a Firm**

Reconstitution of a firm means readjustment or re-determination of relationship between the partners. As we have already stated partnership is nothing but an association of two or more persons, it has no independent existence of its own. So if there is change in the constitution of partners, it necessitates re-determination of mutual rights and duties of the partners. This is called re-constitution. A firm may be reconstituted in any of the following ways:

#### **(A) Introduction of a partner(Sec 31)**

A new partner can be admitted only with the consent of all the existing partners. This is so because mutual confidence and trust among the partners is an essential requirement of a partnership agreement, so it is essential that all the existing partners must agree to admit a new partner.

#### **(B) Retirement of a partner(Sec 32)**

Another event which calls for reconstitution of a firm is retirement of a partner. According to section 32(1) a partner may retire:

- (a) with the consent of all the other partners ;
- (b) in accordance with the express agreement by the partner ;or
- (c) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

On retirement a retiring partner ceases to be partner of the firm and the firm is reconstituted without any dissolution.

**Liabilities of a Retiring partners:**

- (a) A retiring partner continues to be liable for all the acts of the firm done before his retirement unless discharged by the partners.
- (b) Unless public notice of retirement is given, he and other partners continue to be liable for any done by any of the partners after his retirement.  
So, to get himself discharged from any liability for the acts done after his retirement he must give public notice thereof.

**Rights of a Retiring partner:**

- (i) A retiring partner may carry on any competing business unless to the contrary is agreed. However, he may not (a) use firm's name (b) solicit the customs of persons who were dealing with the firm before his retirement (c) represent himself to carry on the business of the firm.
- (ii) If his dues are not settled he is entitled either 6% interest on his share of property or to share profits earned by the firm after retirement as may be attributable to the use of his share of property of the firm.

**(C) Expulsion of a partner(Sec 33)**

Expulsion of a partner is another event necessitating reconstitution of a firm. A partner may be expelled from a firm if the following conditions are satisfied:

- (a) expulsion should be as per the express provisions in the agreement;
- (b) power of expulsion should be exercised by majority of partners;
- (c) expulsion should be in good faith.

Only when all the above three conditions are satisfied a partner can be expelled from a firm.

As stated above expulsion should be in good faith. The test of good faith may be:

- (i) expulsion is in the interest of the firm
- (ii) expelled partner has been given notice
- (iii) an opportunity of being heard has been afforded to the partner.

If expulsion of a partner is not in accordance with above the expulsion is treated irregular expulsion and the expelled partner has any of these two rights (a) to claim reinstatement or (b) to sue for his share of profit and share of capital in the firm.

**(D) Insolvency of a partner(Sec 34)**

As per section 34 when a partner is declared insolvent he ceases to be a partner of the firm whether the firm is dissolved or not. The effects of insolvency of a partner in the firm are:

- (a) he ceases to be partner the day order of adjudicating him insolvent is passed;
- (b) firm may or may not be dissolved depending agreement upon other partners;
- (c) the estate of the insolvent partner is not liable for the acts done after the date of the order of adjudication;
- (d) the firm is also not liable for any acts of the insolvent partner after the date of such order.

**(E) Death of a partner[Sec 35and 42(c)]**

As per section 42, subject to the contract between the partners, a firm is dissolved by the death of a partner. However, the firm may continue if the partnership deed so provides. Section 35 lays down that the estate of the deceased partner will not be liable for any act of the firm done after his death. However, no public notice of death is required to be given to relieve the deceased partner's estate from future liability.



### (F) Transfer of interest by a partner (Sec 29)

A partner can transfer his interest to a stranger who may be absolute or partial. The transferee in such a case has very limited rights over the firm:

- (a) the transferee does not become a partner of the firm. He cannot interfere in the conduct of the business or require accounts or inspect the books of accounts of the firm;
- (b) the transferee is entitled to receive the share of profits of the transferring partner. The transferee has to accept the accounts of profit agreed by the partners.

### 5.1.13 Dissolution of Firm [Sections 39 To 47]

#### Meaning of Dissolution:

The term 'dissolution' stands for discontinuation of judicial relationship between the partners of the firm. Under the Indian Partnership Act, 1932, the dissolution may be dissolution of partnership, or dissolution of firm.

#### Meaning of Dissolution of Partnership:

Dissolution of partnership refers to the change in the existing relations of the partners. The firm continues its business after being reconstituted. This may happen on admission, retirement or death of a partner or change in profit sharing ratio in the firm.

The relevant provisions regarding Admission, Retirement, expulsion and death of a partner etc have already been discussed earlier in this chapter.

#### Example:

X, Y and Z are three partners in a firm. X retires. The partnership between X Y Z comes to an end and new partnership between Y and Z comes into existence. This new partnership between Y and Z shall be known as 'reconstituted firm'. Thus, on retirement of partner, the old partnership stands dissolved but the firm continues its business with remaining partners Y Z. This is a case of dissolution of partnership.

#### Example:

X, Y are two partners in a firm. Z is admitted in the firm with 1/3<sup>rd</sup> share of profit.. The partnership between X Y comes to an end and new partnership between X, Y and Z comes into existence. This new partnership between X, Y and Z shall be known as 'reconstituted firm'. Thus, on admission of new partner, the old partnership stands dissolved but the firm continues its business with new partners XYZ. This is also a case of dissolution of partnership.

#### Meaning of Dissolution of Firm

Dissolution of a firm means the dissolution of partnership relationship between all the partners of a firm. In such a situation, the business of the firm is discontinued, its assets are realized, the liabilities are paid off and the surplus (if any) is distributed among the partners according to their rights.

#### Difference between dissolution of partnership and dissolution of firm:

Dissolution of partnership and Dissolution of firm are two different terms. *Dissolution of partnership* means termination of existing partnership agreement and the formation of a new agreement which can be due to any reason like admission of a new partner or death or retirement of an old partner. In the case of dissolution of partnership the remaining partners may agree to carry on the business under a new agreement.

Whereas *Dissolution of Partnership* firm means that the firm is closing down its business. In the case of dissolution of firm, the Assets of the business are sold, Liabilities are paid off and the Accounts of the partners are settled out of the remaining amount.

The distinction between dissolution of partnership and dissolution of firm was clarified by the Supreme Court in the case of *CIT V Pigot Champam & Co.*

In *CIT v Pigot Champan & Co*, AIR 1982 SC 1085 the Supreme court held 'Dissolution' and 'Reconstitution' are two distinct legal concepts for, a dissolution brings the partnership to an end while a reconstitution means a continuation of the partnership under altered circumstances but in law there would be no difficulty in dissolution of a firm being followed by the reconstitution of a new firm by some of the erstwhile partners who may take over the assets and liabilities of the dissolved firm. It is not possible to accept the contention of the appellant that upon a dissolution of a firm succession to old business by another person would only arise if a solitary partner takes over assets and liabilities and carries on the business as a sole proprietor thereof or if some of the erstwhile partners along with some stranger takes over the assets and liabilities of the old firm and carry on the business. It is quite conceivable that in cases of dissolution of firm brought about by notice under section 43 or by an order of the court under section 44, some of the erstwhile partner may takeover the assets and liabilities and carry on the same business by constituting a new firm.----"

In the case of *A.W Figgis and Co* 1953 24 ITR 405 SC confirmed the view that "reconstitution without dissolution does not bring into existence a new firm"

### Dissolution of partnership

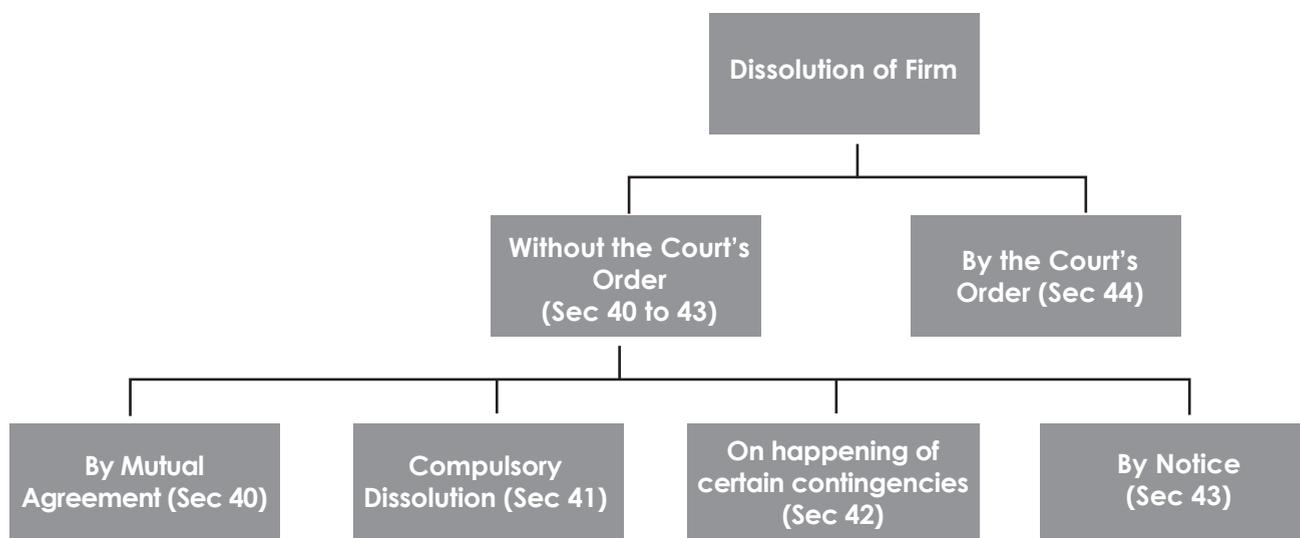
Partnership may be dissolved in the following circumstances:

- (a) At the time of admission of a new partner;
- (b) On the retirement/death of an old partner;
- (c) At the time of change in profit sharing ratio among existing partners;
- (d) If any partner is declared insolvent;
- (e) On the expulsion of any partner;
- (f) On the expiry of the period of partnership.

Thus this is clear from the above discussion that in the case of *dissolution of the partnership* the firm may continue under a new agreement whereas in the case of *dissolution of partnership firm* the business of the firm comes to an end.

### Modes of Dissolution of Firm:

A partnership firm can be dissolved in any of the two ways: A) By the order of the court; B) Without the intervention of the court.





The mode of dissolution of partnership firm are provided in section 40-44 of the Act which will be discussed subsequently but it may be noted that a partnership firm can be dissolved in any of the mode prescribed in sections 40-44 and not any other way. This was confirmed in the case of *Rama Narayan v Kashinath AIR 1954 Pat 53* wherein it was held that partnership could be dissolved only in the modes prescribed by section 40-44 and not by forcible expulsion of a partner from a business in violation of the contract of partnership.

**(A) Dissolution without the order of Court:**

It may take place in one of the following ways stated below:

**i) Dissolution by agreement (Sec 40)**

A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners. The contract may be express or implied.

A firm whether for a fixed period or otherwise, may be dissolved at any time with the consent of all partners. A firm may be dissolved in accordance with a previous contract between the partners. However, the mere closure of business of a partnership is not by itself evidence of an agreement to dissolve the firm because it has been dissolved in one way or the other known to law.

In *Chunni Lal v Sheo Charal Lal (1953) 33 All LJ 1251* it was held that a dissolution is also not to be inferred from the mere refusal of some partners to co-operate with others.

When a partnership consists of two partners only and one partner retire by mutual consent, it amounts to dissolution of the firm. (*Erach FD Mehta v Minoo FD Mehta AIR 1971 SC 1953.*)

In *Mir Abdul Khalid V Abdul Gaffar Sheriff AIR 1985 SC 608* it was held that the retirement of a partner with the consent of the other partners is a sufficient evidence of dissolution, for the purpose of section 40,43 and 48.

Similarly in *KPA Vellayappa Nadar v Bhagirathi Ammal* it was held that cessation of the trading account does not automatically result in dissolution of a partnership firm leaving behind no rights and liabilities unless it was dissolved and accounts settled.

**ii) Compulsory dissolution ( Sec 41)**

A firm is dissolved:

- (a) by the adjudication of all the partners or of all the partners but one as insolvent, or
- (b) by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership:

Provided that, where more than one separate adventure or undertaking is carried on by the firm, the illegality of one or more shall not of itself cause the dissolution of the firm in respect of its lawful adventures and undertakings.

As it is clear from the provisions of section 41 a firm is compulsorily dissolved by adjudication of all or all but one of the partner as insolvent. Similarly a partner ceases to be a partner of the firm on being adjudicated as insolvent or when the business of the firm become unlawful. But if a firm is carrying on more than one business, the illegality of one or more business does not cause dissolution of the firm in respect of its lawful business. This is also confirmed from the following case.

In *R v Kupfer 1915 112 LT 1138* a partnership between persons three of whom were in Germany and one of them in England was held have become illegal on the outbreak of war between Germany and England.

**iii) Dissolution on the happening of certain contingencies (Sec 42)**

Subject to contract between the partners a firm is dissolved:

- (a) if constituted for a fixed term, by the expiry of that term;
- (b) if constituted to carry out one or more adventures or undertakings, by the completion thereof;
- (c) by the death of a partner; and
- (d) by the adjudication of a partner as an insolvent.

Section 42 operates if there is no agreement to contrary. In other words the partners may by agreement between them in the partnership deed exclude dissolution of firm on all or any of the grounds provided in section 42 of the Act. Some of the grounds on which a partnership firm can be dissolved under section 42 are discussed as under:

- (a) Expiry of term [Section 42(a)]: A partnership firm constituted for fixed term is dissolved by the expiry of that term, unless there is contract to the contrary. Such an agreement may be express or implied. If a fresh term is not stipulated in the agreement then it will become a partnership at will.

In *Saligram Ruplal Khanna v Kanwar Rajnath AIR 1974 SC 1094*, the SC held that in the absence of an agreement to the contrary, there was no question of the survival of a firm after the expiry of the term. It was held that the partners decision, subsequent to the expiry of the term, to refer their disputes to arbitration does not amount to the expiry of the term, to refer their disputes to arbitration did not amount to an agreement to the contrary.

- (b) Completion of business (section 42(b)). As per sub section (b) if a firm is constituted to carry out one or more adventures or undertaking the firm stood dissolved after completion of the undertaking or adventure except when there is a contract to the contrary. Again the contract to the contrary may be expressed or implied.

In *Gherulal Parekh v Mahadeodas AIR, 1959 SC 781*, a partnership was constituted to carry out, wagering contracts with specified persons during a particular season. It was held to be a particular partnership as it was held to be a particular partnership as it was constituted to carryout one or more adventures or undertakings. The firm stood dissolved after completion of the said contract. The suit by one partner against the other partners for recovery of losses resulting from wagering transaction was held to be maintainable as the firm stood dissolved although the firm was not registered.

In another case of *Ram Kumar v Kishan Lal Chottey Lal 1971 All LJ 108* a partnership was formed for purchase and sale of 400 bags of sugar. The Allahabad High Court held that when the bags were sold in the year 1949 the partnership stood dissolved.

- (c) Death of a partner [section 42(c)]. This clause is again subject to contract to the contrary between the partners. This contract may be express or implied. A firm is dissolved on death of a partner unless the partners so decide by agreement that the firm will continue. The court may infer an implied agreement from the conduct of the business kept up as before the death and the representatives of the deceased partner stepping into his shoes.

In *Sayad Abdul Hawk v Vaikuntam AIR 1927 Mad 491* it was held that where a firm is constituted for a particular venture or period and a partner dies earlier, it would be dissolved as from the date of death irrespective of the fact neither the term expired nor the venture completed. A mere existence of a term or adventure is not an agreement to contrary. This view was reiterated by the Mad High Court in the case of *Abdul Azeez v Kader Mohideen AIR 1963 Mad 428*.



- (d) Dissolution by insolvency of a partner [Section 42(d)]: Insolvency of a partner operates as a dissolution of the firm unless there is a contract to the contrary. The date of dissolution would be the date on when the order of adjudication is made. In *Ramanathan Chettiar ARK V Lakshminarayan* 1996 2 LW 204 it was held that when a partner is adjudicated as insolvent the date of adjudication should be deemed to be the date of dissolution of firm.

**(iv) Dissolution by notice of partnership at will (Sec 43)**

- (1) Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.
- (2) The firm is dissolved as from the date mentioned in the notice as the date of dissolution or, if no date is so mentioned, as from the date of the communication of the notice.

“As per section 7 where no provision is made by contract between the partners for the duration of their partnership or the determination of their partnership, the partnership is” partnership at will”. Further where a firm is constituted for a fixed term continue to carry on business after the expiry of that term, and there is nothing to show that the parties had agreed to continue in partnership for a particular additional period the partnership is deemed to have become a partnership at will.

In *Ram Singh v Ram Chand* AIR 1924 PC 2, the privy council held that where the partnership was at will, any partner was entitled to a dissolution of the firm by giving notice to that effect and that was his legal right and not an equitable right, under the contract. In *Sat Pal v RK Ahuja* AIR 1973 P&H-HC held that section 44 would be inapplicable in the case of partnership at will.

In *Uduman v Aslum* AIR 1991 SC 1020, the duration of partnership was expressly provided in the deed, namely, that the partnership will continue, till there are two partners' and therefore it was not a partnership at will. A partner's suit for dissolution of partnership was not maintainable. Duration of partnership may be express or may be implied.

**(v) Dissolution by retirement of all but one:**

When all the partners except one retires the firm's dissolution is inevitable through a contingency of this kind is not provided for in section 41-43. This gap can be filled up by the partners by entering into an agreement. In *Abhashabhai v RG Shah* AIR 1988 Bomb 187, the partnership provided that in the case of retirement of all the partners except one, the remaining partner can continue the firm and for this purpose he might take other partners with him. This clause was held valid.

**B) Dissolution by order of Court:**

A partner may apply to the court for getting the firm dissolved. On getting such application by any of the partner the court may proceed to order the dissolution of the firm in the following circumstances:(Sec 44)

- i) If any of the partner becomes of unsound mind [Sec 44(a)]: Lunacy of a partner in itself is not a dissolution of firm. Dissolution requires an order of the court.

The court is not bound to make an order to dissolve the firm if a partner becomes of unsound mind. The power of the court to dissolve the firm is discretionary. The court will issue order in the best interest of all the partners and after considering the interest of the instance and other partners.

Similarly the court may not make an order for dissolution of a firm if a dormant partner becomes unsound mind as it may not affect the business of the firm. The court may make an order for dissolution of the firm on the ground of insanity in very special circumstances. If the court make an order for dissolution of the firm on the ground of insanity, the date of dissolution will be the date of order or any other date fixed by the court.

- ii) If a partner, other than the partner filing the suit has become disabled to perform his duties as a partner [Sec 44(b)]: Permanent incapacity or illness of a partners may be a ground for the court to order dissolution of the partnership firm. However, the court may not order dissolution of the firm on the ground of permanent incapacity of a dormant partner except under a very special circumstances. In *Whitewell v Arthur*, 1865 147 RR 73 a partner suffered from an attack of paralysis but the attack was of a temporary nature and the patient's condition was improving. It was held that the dissolution could not be granted as the medical evidence showed that the attack was only temporary.
- iii) If a partner, other than the partner filing the suit is guilty of misconduct [Sec 44(c)]: If a partner is charged of misconduct the court may order dissolution of firm. It is not necessary that the conduct of which complaint is made should be connected with the partnership business but it is necessary that it should be of such a nature that as having regard to the particular business of the firm, is likely to affect prejudicially the business of the firm.

In *Carmichael v Evans* 1904 90 LT 573 the court ordered the dissolution when one of the partners in a solicitor's firm was convicted for traveling without ticket. Similarly in *Abhot v Crump* 1870 5 Beng LR 109 a partner committed adultery with the wife of another partner. The court ordered dissolution of the firm

In *Essel v Hayward* 1860 30 Beav 130, one of the partners of a solicitors firm fraudulently sold funds and applied for proceeds to his own use. The breach of trust was held to be sufficient to order the dissolution of firm.

**Example:**

X and Y are partners of Firm Z. X has adulterous relations with Y's wife. This is a sufficient ground for dissolution of firm.[*Abbot v. Crump*, (1870") B.L.R 109]

The following cases have been held to be sufficient grounds for dissolution of a firm:

- (a) Gambling by a partner
  - (b) Fraudulent breach of trust by a partner.
  - (c) Persistent refusal or neglect to attend business.
  - (d) Taking away partnership books by a partner.
- iv) If a partner, other than the partner filing the suit is guilty of intentionally and persistently committing a breach of the partnership agreement [Sec 44(d)]. Thus if a partner keeps erroneous accounts and omits to enter receipts there is such a state of animosity that mutual confidence is destroyed, court may order for dissolution of firm. The court may dissolve a partnership firm on the ground of a partner willfully or persistently commits breach of agreement relating to the management of the affairs of the business. In such a case the partner other than one guilty of breach of agreement can approach the court for dissolution of the partnership. There can be various ways of breach of agreement under this clause. In *Cheeseman v Price* 1865 35 Beav 142 it was held that keeping erroneous accounts and not entering receipts is a good ground for dissolution of firm. Refusal to meet the matter of business, impossibility to carry on the business on the stipulated terms (*Waters v Taylor* 1813 2 Ves & B, continued quarrelling and such a state of animosity as precludes all reasonable hope of reconciliation and friendly cooperation have been held to justify a dissolution. The court will not interfere in partnership squabbles not materially affecting the business of the firm. But where the conduct of a partner has resulted in the destruction of mutual confidence and good faith which is the very basis of every contract of partnership the dissolution will be decreed.
  - v) If a partner, other than the partner filing the suit has transferred whole of his interest in the firm to a third party without the consent of the other partners [Sec 44(e)]. Where a partner has



transferred whole of his interest in the firm to a third party a suit for dissolution by any other partner can be brought. A partner may transfer his share to his co partner or transfer a part of his share to a third party unless there is a contract to the contrary. The transfer of share must be by a partner other than the partners suing. When two out of three partners assigned their shares it was held that the case fell under this clause [*Domaty v Ramen chetty 27 cal 93 PC*].

- vi) If the court is satisfied that the business of the firm cannot be carried on except a loss [Sec 44(e)]. Persistent loss is one the solid ground for the court to order dissolution of a partnership firm. A partnership firm is always established in order to attain a given objective and when it becomes no longer possible to attain that objective with which the partnership was started a case of dissolution of partnership firm merit consideration.

In *Handysid v Campbell 1990 17 ILR 623*, it was observed that before dissolution would be ordered on this ground and where there are special circumstances to which the loss could be attributed and where the loss could not be traced to any inherent defect in the business itself, the court would not infer impossibility of profit. The loss in that case could not be attributed to any inherent defect in the business but was due only to mismanagement. The court refused to grant dissolution.

In *Handyside v Compbell 1901 17 TLR 623* losses were partly due to mismanagement by a partner and partly due to the other partner's prolonged illness resulting in failure to attend business . The court refused to grant dissolution. In *Jennigs v Baddely 1856 3 K&J 78*, the whole of the capital contributed by the partners had already been lost and there was no possibility of revival of business unless they contributed further capital which they refused to do. The court allowed dissolution.

- vii) If the court considers it just and equitable to dissolve the firm due to some other reasons.[Sec 44(f)]

### **Rights and Liabilities of Partners on Dissolution of firm:**

#### **A) Rights of a Partner on dissolution:**

##### **i) Right to have business wound up: (Sec 46)**

On the dissolution of a firm every partner or his representative is entitled, as against all the other partners or their representatives, to have the property of the firm applied in payment of the debts and liabilities of the firm, and to have the surplus distributed among the partners or their representatives according to their rights. This authority is called 'partners lien.'

- ii) **Rights to have debts of firm settled out of property of firm:(Sec 49)** Where there are joint debts due from the firm, and also separate debts due from any partner, the property of the firm shall be applied in the first instance in payment of the debts of the firm, and, if there is any surplus, then the share of each partner shall be applied in payment of his separate debts or paid to him. The separate property of any partner shall he applied first in the payment of his separate debts, and the surplus (if any) in payment of the debts of the firm.

##### **iii) Rights to personal profits earned after dissolution(Sec 50):**

Where any partner or his representative has bought the goodwill of the firm, nothing in this section shall affect his right to use the firm name.

##### **iv) Right to return on premium on premature dissolution: (Sec 51)**

Where a partner has paid a premium on entering into partnership of a fixed term, and the firm is dissolved before the expiration of that term otherwise than by the death of a partner, he shall be entitled to repayment of the premium or of such part thereof as may be reasonable, regard being had to the terms upon which he became a partner and to the length of time during which he was a partner, unless-

- (a) the dissolution is mainly due to his own misconduct, or
- (b) the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

**v) Rights where partnership contract is rescinded for fraud or misrepresentation (Sec 52)**

Where a contract creating partnership is rescinded on the ground of the fraud or misrepresentation of any of the parties thereto the party entitled to rescind is, without prejudice to any other right, entitled-

- (a) to a lien on, or a right of retention of, the surplus or the assets of the firm remaining after the debts of the firm have been paid, for any sum paid by him for the purchase of a share in the firm and for any capital contributed to him;
- (b) to rank as a creditor of the firm in respect of any payment made by him towards the debts of the firm; and
- (c) to be indemnified by the partner or partners guilty of the fraud or misrepresentation against all the debts of the firm.

**vi) Right to restrain from use of firm name or firm property (Sec 53)**

After a firm is dissolved, every partner or his representative may, in the absence of a contract between the partners to the contrary, restrain any other partner or his representative from carrying on a similar business in the firm name or from using any of the property of the firm for his own benefit, until the affairs of the firm have been completely wound up:

**B) Liabilities of a partner on dissolution:**

**i) Liability for acts of partners done after dissolution (Sec 45)**

- (1) Notwithstanding the dissolution of a firm, the partners continue to be liable as such to third parties for any act done by any of them which would have been an act of the firm if done before the dissolution, until public notice is given of the dissolution:

Provided that the estate of a partner who dies, or who is adjudicated an insolvent, or of a partner who, not having been known to the person dealing with the firm to be a partner, retires from the firm, is not liable under this section for acts done after the date on which he ceases to be a partner.

- (2) Notices under sub-section (1) may be given by any partner.

**ii) Continuing authority of partners for purposes of winding up (Sec 47)** After the dissolution of a firm the authority of each partner to bind the firm, and the other mutual rights and obligations of the partners continue notwithstanding the dissolution, so far as may be necessary to wind up the affair of the firm and to complete transactions begun but unfinished at the time of the dissolution, but not otherwise:

Provided that the firm is in no case bound by the acts of a partner who has been adjudicated insolvent; but this proviso does not affect the liability of any person who has after the adjudication represented himself or knowingly permitted himself to be represented as a partner of the insolvent.

**Settlement of Accounts on Dissolution:**

The mode of settlement is determined by partnership agreement. In absence of any provisions, provisions of Se 48, 49 and 55 will be applicable.

**Section 48 of the act provide the mode of settlement of accounts between the partners, The rules regarding settlement of accounts are as under;**

- (a) Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and,



lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits;

- (b) the assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:
- (i) in paying the debts of the firm to third parties;
  - (ii) in paying to each partner ratably what is due to him from the firm for advances as distinguished from capital;
  - (iii) in paying to each partner ratably what is due to him on account of capital; and
  - (iv) the residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

Where there are joint debts due from the firm, and also separate debts due from any partner, section 49 of the act provides that the property of the firm shall be applied in the first instance in payment of the debts of the firm, and, if there is any surplus, then the share of each partner shall be applied in payment of his separate debts or paid to him. The separate property of any partner shall be applied first in the payment of his separate debts, and the surplus (if any) in payment of the debts of the firm. (section 49)

**When the firm is dissolved the treatment of goodwill is provided in section 55 of the Act.**

- (1) In settling the accounts of a firm after dissolution, the goodwill shall, subject to contract between the partners, be included in the assets, and it may be sold either separately or along with other property of the firm.
- (2) RIGHTS OF BUYER AND SELLER OF GOODWILL: Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business, but, subject to agreement between him and the buyer, he may not:
  - (a) use the firm-name,
  - (b) represent himself as carrying on the business of the firm, or
  - (c) solicit the custom of persons who were dealing with the firm before its dissolution.
- (3) AGREEMENTS IN RESTRAINT OF TRADE: Any partner may upon the sale of the goodwill of a firm, make an agreement with the buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits, and, notwithstanding anything contained in section 27 of the Indian Contract Act, 1872 such agreement shall be valid if the restrictions are reasonable.

**Recording of changes in and dissolution of a firm(section 65).-**

- (1) When a change occurs in the constitution of a registered firm, every incoming, continuing or outgoing partner, and when a registered firm is dissolved, every person who was a partner immediately before the dissolution, or the agent of every such partner or person specially authorised in this behalf shall, within a period of 90 days from the date of such change or dissolution, given notice to the Registrar of such change or dissolution, specifying the date thereof; and the Registrar shall a record of the notice in the entry relating to the firm in the Registrar of Firms and shall file the notice along with statement relating to the firm filed under section 59.
- (1A) Where a change occurs in the constitution of a registered firm, all persons, who after such change are partners of the firm, shall jointly send an intimation of such change duly signed by them, to the Registrar, within a period of 90 days from the date of occurrence of such change and the Registrar shall deal with it in the manner provided by section 61.

- (2) RECORDING OF WITHDRAWAL OF A MINOR. When a minor who has been admitted to the benefits of partnership in a firm attains majority and elects to become or not to become a partner, and the firm is then a registered firm, he, or his agent specially authorised in this behalf, shall within a period of 90 days from the date of his election, give notice to the Registrar that he has or has not become a partner, and the Registrar shall deal with the notice in the manner provided in sub-section (1).

#### **5.1.15 Public Notice (Sec 72)**

A public notice has to be given on:

- i) retirement or expulsion of a partner from a registered firm;
- ii) the dissolution of a registered firm;
- iii) the election to become or not to become a partner in a registered firm by a minor on attaining majority.

#### **Mode of giving Notice:**

As per section 72 of the Act a public notice under this Act is given-

- (a) where it relates to the retirement or expulsion of a partner from a registered firm, or to the dissolution of a registered firm, or to the election to become or not to become a partner in a registered firm by a person attaining majority who was admitted as a minor to the benefits of partnership, by notice to the Registrar of Firms under section 63, and by publication in the Official Gazette and in at least one vernacular newspaper circulating- in the district where the firm to which it relates has its place or principal place of business, and
- (b) in any other case, by publication in the Official Gazette and in at least one vernacular newspaper circulating in the district where the firm to which it relates has its place or principal.

#### **Consequences if public notice is not given:**

- i) A retired partner can be held liable for acts of the firm after his retirement.[Sec 32]
- ii) In case of expulsion of a partner, if public notice is not given, the expelled and other partners continue to be held liable to third parties as in case of retirement.(Sec 33)
- iii) If public notice of dissolution is not given, the partners continue to be liable to third parties.(Sec 45)
- iv) If a minor partner does not want to continue partnership on attaining major, he needs to give public notice; otherwise he continues to be held liable to third parties as a partner(Sec 30)

#### **Rule making Power of the State Government-**

Section 71 of the Act empowers the State Government to make by notification in the Official Gazette, rules prescribing the fees which shall accompany documents sent to the Registrar or which shall be paid in respect of any intimation, notice or application given to the Registrar or which shall be payable for the inspection of documents in the custody of the Registrar or for copies from the Register of Firms or which is to be paid for supply of any prescribed forms. The rules made under this section are subject to previous publication.

(2) The State Government may also make rules-

- (a) prescribing the form of statement submitted under sub-section (1) of section 58 and of the verification thereof; (aa) prescribing the manner of filing an appeal under sub-section (4) of section 58;
- (b) requiring statements, intimations and notices under sections 60, 61, 62 and 63 to be in prescribed form, and prescribed the form thereof;
- (c) prescribing the form of the Register of Firms, and the mode in which entries relating to firms are to be made therein, and the mode in which such entries are to be amended or notes made therein;



- (d) regulating the procedure of the Registrar when dispute arises;
- (e) regulating the filing of documents received by the Registrar;
- (f) prescribing conditions for the inspection of original documents;
- (g) regulating the grant of copies;
- (h) regulating the elimination of registers and documents;
- (i) providing for the maintenance and form of an Index to the Register of Firms
- (j) generally, to carry out the purposes of this Chapter.

As per sub clause (4) of section 71 it is mandatory to lay every rule made by the State Government before each House of the State Legislature, while it is in session, for a total period of thirty days, which may be comprised in one session or in two successive sessions, and if, before the expiry of the session in which it is so laid or the session immediately following, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, and notify such decision in the Official Gazette, the rule shall, from the date of publication of such decision, have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done or omitted to be done in pursuance of that rule.

#### **Let us Recapitulate:**

- Section 4 of the Indian Partnership Act, 1932 Act, defines Partnership as " partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all-----"
- Essential Characteristics of a Partnership: Association of or more persons; It is the result of an agreement; It is organized to carry on a business; Agree to share profit; The business is carried on by all or any of them acting for all of them.
- Minor, Alien Enemy, Person of unsound mind, Corporation cannot enter into partnership.
- Types of partners: Actual or ostensible partner, Sleeping or dormant partner, Nominal partner, Partner in profits only, Sub partner, Working partner, Partner by holding out or estoppels, Minor Partner.
- The relation of the partners of a firm to one another arise through an agreement between them.
- Section 18 and 19 deals with the acts and implied authority of the partners.
- Reconstitution of a firm means readjustment or redetermination of relationship between the partners.
- Dissolution of partnership refers to the change in the existing relations of the partners. The firm continues its business after being reconstituted. This may happen on admission, retirement or death of a partner or change in profit sharing ratio in the firm.
- A partnership firm can be dissolved in any of the two ways: A) By the order of the court; B) Without the intervention of the court.

## 5.2 LIMITED LIABILITY PARTNERSHIP ACT

### Introduction:

With the growth of Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. The professionals, hitherto, were operating in traditional environment of Partnerships under the Indian Partnership Act of 1932 which inhibited the growth of the form of business governed by the Indian Partnership Act 1932 due to unlimited liability concept and other provisions of the Act. The service sector which contributes a major part in our GDP is predominated by professionals firms governed under the Indian Partnership Act. The world over Limited Liability Partnership [LLP] was viewed as an alternative corporate business vehicle that provides the benefits of the limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement. Accordingly India being an emerging super power cannot lag behind and ignore the importance of a form of business organization which has the benefit of both a corporate and a non corporate body. The need to provide corporate form to the professionals was felt and the demand for making available the alternative of limited liability partnership echoed all around. Considering the potential for growth of the service sector and the dominant role played by the professionals in India's economy and wide spread of LLP form of business in other countries a need was felt for a new corporate form that would provide an alternative to the traditional partnership which exposes its partners to unlimited personal liability.

With a view to provide an alternative form of business the Government of India introduced the Limited Liability Partnership Bill way back in 2006. The Bill was, however, referred to the Parliament Standing Committee, which submitted its report to the Lok Saba on 27th November, 2007. The Government chose to withdraw the Bill of 2006 and reintroduced it in 2008 after taking into consideration the recommendations of the Committee. The Limited Liability Partnership Bill, 2008 was passed by the Parliament and received the assent of the President on 7th January, 2009 and it became the Limited Liability Partnership Act, 2008. The Act has been notified to be effective from 31st March, 2009. The LLP rules have also been notified effective from 1st April, 2009. The LLP Act, 2008 contains 14 chapters and 4 schedules. The entire law is spread over 81 sections. Various sections and schedules of the Act were notified from time to time. Section 67 of the Act empowers the Central Government to extend the provisions of provisions of Companies Act 1956 to Limited Liabilities Partnership. Accordingly recently various sections of the Companies Act 1956 were extended to Limited Liability Partnership also, subject to some modifications.

India was not the first country to introduce LLP. In US LLP was adopted in 1996 whereas UK adopted the model in the year 2000. Other countries like Japan and Singapore brought out legislations for LLP in 2005. In all these countries the LLP form of businesses are operating smoothly. Indian LLP is basically on the pattern of UK/ Singapore model of LLP and is based on the recommendation of Abid Hussan Committee (1997), Naresh Chandra Committee on Corporate Governance 2003 and Irani Committee on New Companies Bill 2005.

### Salient features of LLP

The LLP is a hybrid of corporate and partnership. It assimilates the features of the company and partnership form of business entity. As the name suggest the limited liability of partners is the key feature of this Act. LLP being clothed with a separate legal entity and enjoying perpetual succession also makes it distinct with partnership firms under the Indian Partnership Act, 1932. The duration or life of the LLP does not depend upon the Partnership Deed. The LLP continues till it is wound up in accordance with the process established by law. The separate legal entity of LLP is a concept hitherto known to corporate and the LLP enjoys right to enter agreements in its own name and is entitled to sue and be sued in its own name. The LLP has retained flexible management structure and flexible profit distribution of the partnership. The flexibility of management means that there are no mandatory board meetings or general meeting and there are few legal and procedural requirements to be followed by LLP. The



provisions of the Indian Partnership Act, 1932 do not apply to LLP's. The LLP Act, 2008 has not superseded the Indian Partnership Act, 1932 and partnership firms can continue to be formed and governed under the said Act.

The LLP can be formed by any individual and/or a body corporate provided the individual is of sound mind and is neither an undischarged insolvent nor has applied to be adjudicated as an insolvent. The body corporate can also be a partner of LLP.

Upon incorporation every LLP is allocated a unique identity number called as Limited Liability Partnership Identity Number (LLPIN), similar to Corporate Identity Number allotted upon registration/incorporation of a company. However, each partner in LLP need not obtain any identification number. Only designated partners are liable to obtain unique identification number called as Designated Partner Identification Number (DPIN).

Another feature of LLP is that the designated partner has a major role to play in LLP. The designated partner is responsible for doing all acts, matters and things as are required to be done by LLP as per the Act or as specified in LLP Agreement. The designated partner is liable for all penalties imposed on LLP for any contravention of the provisions of the Act or LLP Agreement.

The Act also provides the provision to convert the existing firm (registered under the Indian Partnership Act, 1932); a private limited company or an unlisted public limited company into a LLP. The provisions are contained in 3 schedules, namely, Second Schedule, Third Schedule and Fourth Schedule attached to LLP Act. The continuation of the activities of such a firm, private limited company and unlisted public company is not affected.

The Act also provides the facility of merger, amalgamation and arrangement of LLPs. The power to order merger lies with the National Company Law Tribunal as defined under the Companies Act, 1956. The provisions are similar to as those contained in the Companies Act, 1956.

As regard winding up the LLP may be wound up voluntarily or compulsorily by the Tribunal. The compulsory winding up may be ordered by the Tribunal, inter alia, on the ground of inability to pay debts or on just and equitable ground. The Registrar has retained the power to strike off defunct LLPs.

The Central Government of India, vide notification dated 23<sup>rd</sup> May 2011 has specified that a Limited Liability Partnership, incorporated under clause (1) of section 3 of the Limited Liability Partnership Act, 2008 will be corporate body for the purpose of clause (a) of sub section(3) of section 226 of the Companies Act, 1956.

Before discussing various important provisions of the LLP Act 2008 let us have comparative analysis of a corporate body, partnership firm and a Limited Liability Partnership

### Comparison between Company, Partnership firm and LLP

Features	Company	Partnership firm	LLP
Registration	Compulsory registration required with the ROC. Certificate of Incorporation is conclusive evidence.	Not compulsory. Unregistered Partnership firms have some disadvantages	Compulsory registration required with the ROC
Name	Name of a public company to end with the word "limited" and a private company with the words "private limited"	No guidelines, but restrictions on use of some words as a part of name of the firm.	Name to end with "LLP" Limited Liability Partnership" but restrictions on use of some words as a part of name of the firm
Capital contribution	Private company should have a minimum paid up capital of ₹ 1 lakh and ₹ 5 lakhs for a public company	Not specified	Not specified

Features	Company	Partnership firm	LLP
Legal entity status	Is a separate legal entity	Not a separate legal entity	Is a separate legal entity
Liability	Limited to the extent of unpaid capital.	Unlimited, can extend to the personal assets of the partners	Limited to the extent of the contribution to the LLP.
No. of shareholders / Partners	Minimum of 2. In a private company, maximum of 50 shareholders	2- 20 partners	Minimum of 2. No maximum limit
Foreign Nationals as shareholder / Partner	Foreign nationals can be shareholders.	Foreign nationals cannot form partnership firm.	Foreign nationals can be partners.
Meetings	Quarterly Board of Directors meeting, annual shareholding meeting is mandatory	Not required.	Not required.
Annual Return	Annual Accounts and Annual Return to be filed with ROC	No returns to be filed with the Registrar of Firms	Annual statement of accounts and solvency & Annual Return has to be filed with ROC.
Audit	Compulsory, irrespective of share capital and turnover.	Compulsory.	Required, if the contribution is above ₹ 25 lakhs or if annual turnover is above ₹ 40 lakhs.
Source of funding	Own fund in case of private ltd company but a public limited company can raise funds from public through IPO/deposits	Public fund cannot be raised.	Public fund cannot be raised.
Dissolution	Very procedural. Voluntary or by Order of National Company Law Tribunal.	By agreement of the partners, insolvency or by Court Order.	Less procedural compared to company. Voluntary or by Order of National Company Law Tribunal
Whistle blowing	No such provision	No such provision.	Protection provided to employees and partners who provide useful information during the investigation process.

From above it is clear that a LLP form of business organisation is indeed advantageous because of comparatively lower cost of formation, lesser compliance requirements, easy to manage and run and also easy to wind-up and dissolve, no requirement of minimum capital contributions, partners are not liable for the acts of the other partners and importantly no minimum alternate tax .Since like a private limited company a LLP cannot raise funds from public through IPO in which case it face same disadvantages as faced by partnership firm despite it now assuming a corporate character. However, it has other advantages over a company formed under the companies Act 1956.So it may not be out of place to mention that a LLP is a hybrid form of business organization having both advantages and disadvantages of a Company under the Companies Act 1956 and a Partnership firm.

Now we discuss the important concepts and provisions of the Act.

### 5.2.1 Concepts and Definitions:

#### The definitions are provided in Sec 2 of the Act

(1) In this Act, unless the context otherwise requires,—

- (a) “address”, in relation to a partner of a limited liability partnership, means
  - (i) if an individual, his usual residential address; and
  - (ii) if a body corporate, the address of its registered office;
- (b) “advocate” means an advocate as defined in clause (a) of sub-section (1) of section 2 of the Advocates Act, 1961;
- (c) “Appellate Tribunal” means the National Company Law Appellate Tribunal constituted under sub-section (1) of section 10 of the Companies Act, 1956;
- (d) “body corporate” means a company as defined in section 3 of the Companies Act, 1956 and includes
  - (i) a limited liability partnership registered under this Act;
  - (ii) a limited liability partnership incorporated outside India; and
  - (iii) a company incorporated outside India,but does not include
  - (i) a corporation sole;
  - (ii) a co-operative society registered under any law for the time being in force; and
  - (iii) any other body Corporate (not being a company as defined in section 3 of the Companies Act, 1956 or a limited liability partnership as defined in this Act), which the Central Government may, by notification in the Official Gazette, specify in this behalf;
- (e) “business” includes every trade, profession, service and occupation;
- (f) “chartered accountant” means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (g) “company secretary” means a company secretary as defined in clause (c) of sub-section (1) of section 2 of the Company Secretaries Act, 1980 and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (h) “cost accountant” means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (i) “Court”, with respect to any offence under this Act, means the Court having jurisdiction as per the provisions of section 77;
- (j) “designated partner” means any partner designated as such pursuant to section 7;
- (k) “entity” means anybody corporate and includes, for the purposes of sections 18,46,47,48,49,50,52 and 53, a firm set-up under the Indian Partnership Act, 1932;
- (l) “financial year”, in relation to a limited liability partnerships, means the period from the 1st day of April of a year to the 31st day of March of the following year:

Provided that in the case of a limited liability partnership incorporated after the 30th day of September of a year, the financial year may end on the 31st day of March of the year next following that year;

- (m) “foreign limited liability partnership” means a limited liability partnership formed, incorporated or registered outside India which establishes a place of business within India;
  - (n) “limited liability partnership” means a partnership formed and registered under this Act;
  - (o) “limited liability partnership agreement” means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership;
  - (p) “name”, in relation to a partner of a limited liability partnership, means—
    - (i) if an individual, his forename, middle name and surname; and
    - (ii) if a body corporate, its registered name;
  - (q) “partner”, in relation to a limited liability partnership, means any person who becomes a partner in the limited liability partnership in accordance with the limited liability partnership agreement;
  - (r) “prescribed” means prescribed by rules made under this Act;
  - (s) “Registrar” means a Registrar, or an Additional, a Joint, a Deputy or an Assistant Registrar, having the duty of registering companies under the Companies Act, 1956;
  - (t) “Schedule” means a Schedule to this Act;
  - (u) “Tribunal” means the National Company Law Tribunal constituted under sub-section (1) of section 10FB of the Companies Act, 1956.
- (2) Words and expressions used and not defined in this Act but defined in the Companies Act, 1956 shall have the meanings respectively assigned to them in that Act.

### **What is a Limited Liability partnership (LLP)?**

A corporate business vehicle that enables professional expertise and entrepreneurial initiative to combine and operate in flexible, innovative and efficient manner, providing benefits of limited liability while allowing its members the flexibility for organizing their internal structure as a partnership’ In a way it is a hybrid form of business organization having the characteristics of both a Company form of organization and a Partnership firm under the Partnership Act, 1932.

### **5.2.2 Nature of Limited Liability Partnership**

#### **Limited liability partnership to be body corporate**

- 3. (1) A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.
- (2) A limited liability partnership shall have perpetual succession.
- (3) Any change in the partners of a limited liability partnership shall not affect the existence, rights or liabilities of the limited liability partnership.

#### **Non-applicability of the Indian Partnership Act, 1932.**

- 4. Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

### **5.2.3 Partners**

- 5. Any individual or **body corporate** may be a partner in a limited liability partnership:  
Provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if—
  - (a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;



- (b) he is an undischarged insolvent; or
- (c) he has applied to be adjudicated as an insolvent and his application is pending.

Thus a partnership firm and an individual with above mentioned limitations cannot be partner of an LLP.

A HUF cannot be treated as a body corporate for the purposes of LLP Act, 2008. Therefore, a HUF or its karta can not become designated partner in LLP.

### **Minimum number of partners**

- 6. (1) Every limited liability partnership shall have at least two partners.
- (2) If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

### **Designated partners.**

- 7. (1) Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India:

Provided that in case of a limited liability partnership 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 limited liability partnership 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.

- (2) Subject to the provisions of sub-section (1), —
  - (i) if the incorporation document—
    - (a) specifies who are to be designated partners, such persons shall be designated partners on incorporation; or
    - (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every partner shall be a designated partner;
  - (ii) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.
- (3) An individual shall not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.
- (4) Every limited liability partnership shall file with the registrar the particulars of every individual who has given his consent to act as designated partner in such form and manner as may be prescribed within thirty days of his appointment.
- (5) An individual eligible to be a designated partner shall satisfy such conditions and requirements as may be prescribed.
- (6) Every designated partner of a limited liability partnership shall obtain a Designated Partner Identification Number (DPIN) from the Central Government and the provisions of sections

266A to 266G (both inclusive) of the Companies Act, 1956 shall apply mutatis mutandis for the said purpose.

As per rule 7 of LLP Rules 2009 an individual shall give his prior consent to act as a designated partner to the Limited liability partnership in **Form 9**.

**As per rule 7(3) of LLP Rules 2009** the particulars of an individual who has given his consent to act as designated partner shall be filed in **Form 4** along with fee as mentioned in Annexure 'A' to the LLP Rules 2009

#### **Liabilities of designated partners.**

8. Unless expressly provided otherwise in this Act, a designated partner shall be—
- (a) responsible for the doing of all acts, matters and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and
  - (b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

#### **Changes in designated partners**

9. A limited liability partnership may appoint a designated partner within thirty days of a vacancy arising for any reason and provisions of sub-section (4) and sub-section (5) of section 7 shall apply in respect of such new designated partner:

Provided that if no designated partner is appointed, or if at any time there is only one designated partner, each partner shall be deemed to be a designated partner.

Furthermore change in the particular of designated partner is required to be intimated to Central Government within a period of 30 days of such change(s) in **Form 10**:

#### **5.2.4 Punishment for Contravention of Sections 7, 8 And 9.**

10. (1) If the limited liability partnership contravenes the provisions of sub-section (1) of section 7, the limited liability partnership and its every partner shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to five lakh rupees.
- (2) If the limited liability partnership contravenes the provisions of sub-section (4) and sub-section (5) of section 7, section 8 or section 9, the limited liability partnership and its every partner shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.

#### **5.2.5 Incorporation of Limited Liability Partnership and Matters Incidental Thereto**

##### **Incorporation document**

- 11 (1) For a limited liability partnership to be incorporated,
- (a) two or more persons associated for carrying on a lawful business with a view to profit shall subscribe their names to an incorporation document;
  - (b) the incorporation document shall be filed in such manner and with such fees, as may be prescribed with the Registrar of the State in which the registered office of the limited liability partnership is to be situated; and
  - (c) there shall be filed along with the incorporation document, a statement in the prescribed form, made by either an advocate, or a Company Secretary or a Chartered Accountant or a Cost Accountant, who is engaged in the formation of the limited liability partnership and by anyone who subscribed his name to the incorporation document, that all the requirements of this Act and the rules made hereunder have been complied with, in respect of incorporation and matters precedent and incidental thereto.



It may be noted that as per Rule 11 of LLP Rules 2009 the incorporation document are required to be filed in Form 2 with the Registrar having jurisdiction over the State in which the registered office of the limited liability partnership is to be situated along with the fee as provided in Annexure 'A'.

- (2) The incorporation document shall—
  - (a) be in a form as may be prescribed;
  - (b) state the name of the limited liability partnership;
  - (c) state the proposed business of the limited liability partnership;
  - (d) state the address of the registered office of the limited liability partnership;
  - (e) state the name and address of each of the persons who are to be partners of the limited liability partnership on incorporation;
  - (f) state the name and address of the persons who are to be designated partners of the limited liability partnership on incorporation;
  - (g) contain such other information concerning the proposed limited liability partnership as may be prescribed.
- (3) If a person makes a statement under clause (c) of sub-section (1) which he
  - (a) knows to be false; or
  - (b) does not believe to be true,

Shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than ten thousand rupees but which may extend to five lakh rupees.

### **Incorporation by registration**

- (1) When the requirements imposed by clauses (b) and (c) of sub-section (1) of section 11 have been complied with, the Registrar shall retain the incorporation document and, unless the requirement imposed by clause (a) of that sub-section has not been complied with, he shall, within a period of fourteen days—
  - (a) Register the incorporation document; and
  - (b) Give a certificate that the limited liability partnership is incorporated by the name specified therein.
- (2) The Registrar may accept the statement delivered under clause (c) of sub-section (1) of section 11 as sufficient evidence that the requirement imposed by clause (a) of that sub-section has been complied with.
- (3) The certificate issued under clause (b) of sub-section (1) shall be signed by the Registrar and authenticated by his official seal.
- (4) The certificate shall be conclusive evidence that the limited liability partnership is incorporated by the name specified therein.

### **Registered office of limited liability partnership and change therein**

13. (1) Every limited liability partnership shall have a registered office to which all communications and notices may be addressed and where they shall be received.
- (2) A document may be served on a limited liability partnership or a partner or designated partner thereof by sending it by post under a certificate of posting or by registered post or by any other manner, as may be prescribed, at the registered office and any other address specifically declared by the limited liability partnership for the purpose in such form and manner as may be prescribed.

- (3) A limited liability partnership may change the place of its registered office and file the notice of such change with the Registrar in such form and manner and subject to such conditions as may be prescribed and any such change shall take effect only upon such filing.
- (4) If the limited liability partnership contravenes any provisions of this section, the limited liability partnership and its every partner shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.

Thus a limited liability partnership may change the place of its registered office and file the notice of such change with the Registrar in form 15 within 30 days. Reregistered office can be changed from one place to another place in the manner provided in the Partnership Agreement, if the agreement is silent then consent of all partners shall be required for changing the place of registered office of limited liability partnership to another place. Where the change in place of registered office is from one State to another State, the limited liability partnership having secured creditors shall also obtain consent of such secured creditors.

Where the change in place of registered office is from one state to another state, a general notice, not less than 21 days before filing any notice with Registrar, is required to be published in a daily newspaper published in English and in the principal language of the district in which the registered office of the limited liability partnership is situated and circulating in that district giving notice of change of registered office. However, there is just change in the jurisdiction of one Registrar to the jurisdiction of another Registrar; the limited liability Partnership shall file the notice in **Form 15** with the Registrar from where the limited liability partnership proposes to shift its registered office with a copy thereof for the information to the Registrar under whose Jurisdiction the registered office is proposed to be shifted. Failure to comply with the provision of this section the limited liability partnership and its every partner is liable to be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.

#### **Effect of registration**

14. On registration, a limited liability partnership shall, by its name, be capable of-
  - (a) Suing and being sued;
  - (b) Acquiring, owning, holding and developing or disposing of property, whether movable or immovable, tangible or intangible;
  - (c) Having a common seal, if it decides to have one; and
  - (d) Doing and suffering such other acts and things as bodies corporate may lawfully do and suffer.

#### **Name**

15. (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) No limited liability partnership shall be registered by a name which, in the opinion of the Central Government is —
  - (a) Undesirable; or
  - (b) 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 which is subject of an application for registration, of any other person under the Trade Marks Act, 1999.
- (3) No company should be allowed to be registered with the word "National" as part of its title unless it is a government company and the Central/State government(s) has a stake in it.



- (4) The word 'Bank' may be allowed in the name of an entity only when such entity produces a 'No Objection Certificate' from the RBI in this regard.
- (5) The word 'Stock Exchange' or 'Exchange' should be allowed in name of a company only where 'No Objection Certificate' from SEBI in this regards is produced by the Promoters.

#### **Reservation of name**

16. (1) A person may apply in such form and manner and accompanied by such fee as may be prescribed to the Registrar for the reservation of a name set out in the application as—
  - (a) The name of a proposed limited liability partnership; or
  - (b) The name to which a limited liability partnership proposes to change its name.
- (2) Upon receipt of an application under sub-section (1) and on payment of the prescribed fee, the Registrar may, if he is satisfied, subject to the rules prescribed by the Central Government in the matter, that the name to be reserved is not one which may be rejected on any ground referred to in sub-section (2) of section 15, reserve the name for a period of three months from the date of intimation by the Registrar.

#### **Change of name of limited liability partner-ship.**

17. (1) Notwithstanding anything contained in sections 15 and 16, where the Central Government is satisfied that a limited liability partnership has been registered (whether through inadvertence or otherwise and whether originally or by a change of name) under a name which —
  - (a) is a name referred to in sub-section (2) of section 15; or
  - (b) is identical with or too nearly resembles the name of any other limited liability partnership or body corporate or other name as to be likely to be mistaken for it, the Central Government may direct such limited liability partnership to change its name, and the limited liability partnership shall comply with the said direction within three months after the date of the direction or such longer period as the Central Government may allow.
- (2) Any limited liability partnership which fails to comply with a direction given under sub-section (1) shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to five lakh rupees and the designated partner of such limited liability partnership shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.

#### **Application for direction to change name in certain circumstances.**

18. (1) Any entity which already has a name similar to the name of a limited liability partnership which has been incorporated subsequently, may apply, in such manner as may be prescribed, to the Registrar to give a direction to any limited liability partnership, on a ground referred to in section 17 to change its name.
- (2) The Registrar shall not consider any application under sub-section (1) to give a direction to a limited liability partnership on the ground referred to in clause (b) of sub-section (1) of section 17 unless the Registrar receives the application within twenty-four months from the date of registration of the limited liability partnership under that name.

#### **Change of registered name.**

19. Any limited liability partnership may change its name registered with the Registrar, by filing with him a notice of such change in such form and manner and on payment of such fees as may be prescribed.

**Penalty for improper use of words “limited liability partnership” or “LLP”.**

20. If any person or persons carry on business under any name or title of which the words “Limited Liability Partnership” or “LLP” or any contraction or imitation thereof is or are the last word or words, that person or each of those persons shall, unless duly incorporated as limited liability partnership, be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

**Publication of name and limited liability.**

21. (1) Every limited liability partnership shall ensure that its invoices, official correspondence and publications bear the following, namely: -  
the name, address of its registered office and registration number of the limited liability partnership; and a statement that it is registered with limited liability.
- (2) Any limited liability partnership which contravenes the provisions of sub-section (1) shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.

**Rule 18 of the LLP Rules 2009 contains the following provisions regarding name of a Limited Liability Partnership which are required to be kept in mind while registering a LLP.**

- (1) The name of the limited liability partnership shall not be one prohibited under the Emblems and Names (Prevention of Improper Use) Act, 1950.
- (2) A name shall not generally be reserved, if -
- (i) it includes any word or words which are offensive to any section of the people;
  - (ii) the proposed name is the exact Hindi or English translation of the name of an existing limited liability partnership in English or Hindi, as the case may be;
  - (iii) the proposed name has a close phonetic resemblance to the name of a LLP in existence, for example, J.K. LLP., Jay Kay LLP;
  - (iv) it includes the word Co-operative, Sahakari or the equivalent of word ‘co-operative’ in the regional languages of the country;
  - (v) it connotes the participation or patronage of the Central or State Government, unless circumstances justify to, e.g., a name may be deemed undesirable in certain context if it includes any of the words such as National, Union, Central, Federal, Republic, President, Rashtrapati, etc;
  - (vi) the proposed name contains the words ‘British India’;
  - (vii) the proposed name implies association or connection with any Embassy or Consulate or of a foreign government which suggests connection with local authorities such as Municipal, Panchayat, Zila Parishad or any other body connected with the Union or State Government;
  - (viii) the proposed name is vague like D.I.M.O. Limited liability partnership or I.V.N.R. Limited liability partnership or S.S.R.P Limited liability partnership;
  - (ix) it is different from the name or names of the existing limited liability partnership only to the extent of having the name of a place within brackets before the word ‘limited liability partnership’, for example, Indian Press (Delhi) LLP should not be allowed in view of the existence of the LLP named Indian Press LLP;
  - (x) it includes name of registered Trade mark, unless the consent of the owner of the trade mark has been produced;

- (xi) the proposed name is identical with or too nearly resembles the name of a firm or LLP or company incorporated outside India and reserved by such firm, LLP or company with the registrar in accordance with these rules;
- (xii) it is identical with or too nearly resembles the name of the limited liability partnership or a company in liquidation or it is identical with or too nearly resembles names of the LLP or a company which is struck off, up to the period of 5 years;
- (xiii) it includes words like 'Bank', 'Insurance' and 'Banking', 'Venture capital' or 'mutual fund' or such similar names without the approval of the regulatory authority;
- (xiv) it is intended or likely to produce a misleading impression regarding the scope or scale of its activities which would be beyond the resources at its disposal;
- (xv) the proposed name includes words like French, British, German etc., unless the partners satisfy that there is some form of collaboration and connection with the foreigners of that particular country or place, the name of which is incorporated in the name;
- (xvi) the Proposed name of limited liability partnership includes the words company secretary, chartered accountant, advocates or such similar words as indicative of a profession, as part of the proposed name, the same shall be allowed only after obtaining approval from the Council governing such profession or such authority as may be nominated by the Central Government, in this behalf.

### **5.2.6 Partners and their Relations**

#### **Eligibility to be partners**

22. On the incorporation of a limited liability partnership, the persons who subscribed their names to the incorporation document shall be its partners and any other person may become a partner of the limited liability partnership by and in accordance with the limited liability partnership agreement.

#### **Relationship of partners**

23. (1) Save as otherwise provided by this Act, the mutual rights and duties of the partners of a limited liability partnership, and the mutual rights and duties of a limited liability partnership and its partners, shall be governed by the limited liability partnership agreement between the partners, or between the limited liability partnership and its partners.
- (2) The limited liability partnership agreement and any changes, if any, made therein shall be filed with the Registrar in such form, manner and accompanied by such fees as may be prescribed.
- (3) An agreement in writing made before the incorporation of a limited liability partnership between the persons who subscribe their names to the incorporation document may impose obligations on the limited liability partnership, provided such agreement is ratified by all the partners after the incorporation of the limited liability partnership.
- (4) In the absence of agreement as to any matter, the mutual rights and duties of the partners and the mutual rights and duties of the limited liability partnership and the partners shall be determined by the provisions relating to that matter as are set out in the First Schedule.

#### **Cessation of partnership interest**

24. (1) A person may cease to be a partner of a limited liability partnership in accordance with an agreement with the other partners or, in the absence of agreement with the other partners as to cessation of being a partner, by giving a notice in writing of not less than thirty days to the other partners of his intention to resign as partner.

- (2) A person shall cease to be a partner of a limited liability partnership—
  - (a) on his death or dissolution of the limited liability partnership; or
  - (b) if he is declared to be of unsound mind by a competent court; or
  - (c) if he has applied to be adjudged as an insolvent or declared as an insolvent.
- (3) Where a person has ceased to be a partner of a limited liability partnership (hereinafter referred to as "former partner"), the former partner is to be regarded (in relation to any person dealing with the limited liability partnership) as still being a partner of the limited liability partnership unless—
  - (a) the person has notice that the former partner has ceased to be a partner of the limited liability partnership; or
  - (b) notice that the former partner has ceased to be a partner of the limited liability partnership has been delivered to the Registrar,
- (4) The cessation of a partner from the limited liability partnership does not by itself discharge the partner from any obligation to the limited liability partnership or to the other partners or to any other person which he incurred while being a partner.
- (5) Where a partner of a limited liability partnership ceases to be a partner, unless otherwise provided in the limited liability partnership agreement, the former partner or a person entitled to his share in consequence of the death or insolvency of the former partner, shall be entitled to receive from the limited liability partnership —
  - (a) an amount equal to the capital contribution of the former partner actually made to the limited liability partnership; and
  - (b) his right to share in the accumulated profits of the limited liability partnership, after the deduction of accumulated losses of the limited liability partnership, determined as at the date the former partner ceased to be a partner.
- (6) A former partner or a person entitled to his share in consequence of the death or insolvency of the former partner shall not have any right to interfere in the management of the limited liability partnership.

#### **Registration of changes in partners**

25. (1) Every partner shall inform the limited liability partnership of any change in his name or address within a period of fifteen days of such change.
- (2) A limited liability partnership shall—
    - (a) where a person becomes or ceases to be a partner, file a notice with the Registrar within thirty days from the date he becomes or ceases to be a partner; and
    - (b) where there is any change in the name or address of a partner, file a notice with the Registrar within thirty days of such change.
  - (3) A notice filed with the Registrar under sub-section (2)—
    - (a) shall be in such form and accompanied by such fees as may be prescribed;
    - (b) shall be signed by the designated partner of the limited liability partnership and authenticated in a manner as may be prescribed; and
    - (c) if it relates to an incoming partner, shall contain a statement by such partner that he consents to becoming a partner, signed by him and authenticated in the manner as may be prescribed.



- (4) If the limited liability partnership contravenes the provisions of sub-section (2), the limited liability partnership and every designated partner of the limited liability partnership shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.
- (5) If any partner contravenes the provisions of sub-section (1), such partner shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.
- (6) Any person who ceases to be a partner of a limited liability partnership may himself file with the Registrar the notice referred to in sub-section (3) if he has reasonable cause to believe that the limited liability partnership may not file the notice with the Registrar and in case of any such notice filed by a partner, the Registrar shall obtain a confirmation to this effect from the limited liability partnership unless the limited liability partnership has also filed such notice:  
Provided that where no confirmation is given by the limited liability partnership within fifteen days, the registrar shall register the notice made by a person ceasing to be a partner under this section.

#### **5.2.6.1 Extent and Limitation of Liability of Limited Liability Partnership and Partners**

##### **Partner as Agent**

26. Every partner of a limited liability partnership is, for the purpose of the business of the limited liability partnership, the agent of the limited liability partnership, but not of other partners.

##### **Extent of liability of limited liability partnership is contained in section 26 which are as under;**

- 27 (1) A limited liability partnership is not bound by anything done by a partner in a dealing with a person if-
  - (a) the partner in fact has no authority to act for the limited liability partnership in doing a particular act; and
  - (b) the person knows that he has no authority or does not know or believe him to be a partner of the limited liability partnership.
- (2) The limited liability partnership is liable if a partner of a limited liability partnership is liable to any person as a result of a wrongful act or omission on his part in the course of the business of the limited liability partnership or with its authority.
- (3) An obligation of the limited liability partnership whether arising in contract or otherwise, shall be solely the obligation of the limited liability partnership.
- (4) The liabilities of the limited liability partnership shall be met out of the property of the limited liability partnership

##### **Extent of liability of partner**

- (1) A partner is not personally liable, directly or indirectly for an obligation referred to in sub-section (3) of section 27 solely by reason of being a partner of the limited liability partnership.
- (2) The provisions of sub-section (3) of section 27 and sub-section (1) of this section shall not affect the personal liability of a partner for his own wrongful act or omission, but a partner shall not be personally liable for the wrongful act or omission of any other partner of the limited liability partnership.

##### **Holding out**

- 29 (1) If any person has given any credit to the LLP on the representation of a Holding out partner the LLP is liable to that person whether the person representing himself or represented to be

a partner does or does not know that the representation has reached the person so giving credit:

If any credit is received by the limited liability partnership as a result of such representation, the limited liability partnership is liable to the extent of credit received by it or any financial benefit derived thereon.

- (2) Where after a partner's death the business is continued in the same limited liability partnership name, the continued use of that name or of the deceased partner's name as a part thereof shall not of itself make his legal representative or his estate liable for any act of the limited liability partnership done after his death.

### **Unlimited liability in case of fraud (Sec 30)**

In order to check the misuse of corporate veil by a LLP for the purpose of defrauding the creditors or any other person or for any fraudulent purpose the liability of the limited liability partnership and partners who 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 limited liability partnership;

If any such act is carried out by a partner, the limited liability partnership is liable to the same extent as the partner unless it is established by the limited liability partnership that such act was without the knowledge or the authority of the limited liability partnership.

Where the business of a LLP is carried out for fraudulent purpose every person who was knowingly a party to the carrying on of the business in the manner aforesaid shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees. Moreover, the limited liability partnership and any such partner or designated partner or employee shall be liable to pay compensation to any person who has suffered any loss or damage by reason of such conduct:

However, the limited liability partnership shall not be liable if any such partner or designated partner or employee has acted fraudulently without knowledge of the limited liability partnership.

### **Whistle blowing (Sec 31)**

**Whistle Blowing provision has also been introduced in the Act whereby the Court or Tribunal may reduce or waive any penalty leviable against any partner or employee** if it is satisfied that such partner or employee of a limited liability partnership has provided useful information during investigation of such limited liability partnership; or when any information given by any partner or employee (whether or not during investigation) leads to limited liability partnership or any partner or employee of such limited liability partnership being convicted under this Act or any other Act.

## **5.2.7 Contributions**

### **Form of contribution (Sec 32)**

- (1) A contribution of a partner may consist of tangible, movable or immovable or intangible property or other benefit to the limited liability partnership, including money, promissory notes, and other agreements to contribute cash or property, and contracts for services performed or to be performed.
- (2) The monetary value of contribution of each partner shall be accounted for and disclosed in the accounts of the limited liability partnership in the manner as may be prescribed.

These contributions will be given monetary value which shall be accounted for and disclosed in the accounts of the limited liability partnership in the manner as prescribe in LLP Rules 2009.



### **Obligation to contribute**

33. (1) The obligation of a partner to contribute money or other property or other benefit or to perform services for a limited liability partnership shall be as per the limited liability partnership agreement.
- (2) A creditor of a limited liability partnership, which extends credit or otherwise acts in reliance on an obligation described in that agreement, without notice of any compromise between partners, may enforce the original obligation against such partner.

### **5.2.8 Financial Disclosures**

#### **Maintenance of books of account, other records and audit etc. (Sec 34)**

Every limited liability partnership is required to maintain such proper books of account as prescribed in rule 24 of LLP Rules 2009 relating to its affairs for each year of its existence on cash basis or accrual basis and according to double entry system of accounting and shall maintain the same at its registered office for a period of 8 years from the date on which they are made (Rule 24 (3)). In addition to maintenance of proper books of accounts every LLP is required to prepare within a period of six months from the end of each financial year, prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year in such form as may be prescribed, and such statement shall be signed by the designated partners of the limited liability partnership. The Statement of Account and Solvency is required to be filed with the Registrar every year in Form 8 within 30 days (Rule 24(4) of LLP Rules 2009) from the end of six months of the financial year to which the Statement of Accounts and solvency relates. It may be noted that these provisions are similar to the provisions contained in Companies Act, 1956.

The accounts of limited liability partnerships are required to be audited in accordance with Rule 28 of LLP Rules 2009 (Rule 24(8) to 24(13) of LLP Rules 2009). Central Government has power to; exempt any class or classes of limited liability partnerships from the requirements of Audit of Accounts.

If any limited liability partnership fails to comply with the provisions of the Act regarding maintenance of Accounts and Audit thereof including filing copy of statement of Accounts and Solvency to Registrar will be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every designated partner of such limited liability partnership shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.

#### **Annual Return (Sec 35)**

As per section 35 of the Act every limited liability partnership shall file an annual return duly authenticated with the Registrar within sixty days of closure of its financial year in such form and manner and accompanied by such fee as may be prescribed failing which LLP shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees. If the limited liability partnership contravenes the provisions of section 35 relating to Annual Return, the designated partner of such limited liability partnership shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.

#### **Inspection of documents kept by Registrar**

36. The incorporation document, names of partners and changes, if any, made therein, Statement of Account and Solvency and annual return filed by each limited liability partnership with the Registrar shall be available for inspection by any person in such manner and on payment of such fee as may be prescribed.

**Penalty for false statement.**

37. If in any return, statement or other document required by or for the purposes of any of the provisions of this Act, any person makes a statement—
- (a) which is false in any material particular, knowing it to be false; or
  - (b) which omits any material fact knowing it to be material, he shall, save as otherwise expressly provided in this Act, be punishable with imprisonment for a term which may extend to two years, and shall also be liable to fine which may extend to five lakh rupees but which shall not be less than one lakh rupees.

**Power of Registrar to obtain information.**

38. (1) In order to obtain such information as the Registrar may consider necessary for the purposes of carrying out the provisions of this Act, the Registrar may require any person including any present or former partner or designated partner or employee of a limited liability partnership to answer any question or make any declaration or supply any details or particulars in writing to him within a reasonable period.
- (2) In case any person referred to in sub-section (1) does not answer such question or make such declaration or supply such details or particulars asked for by the Registrar within a reasonable time or time given by the Registrar or when the Registrar is not satisfied with the reply or declaration or details or particulars provided by such person, the Registrar shall have power to summon that person to appear before him or an inspector or any other public officer whom the Registrar may designate, to answer any such question or make such declaration or supply such details, as the case may be.
- (3) Any person who, without lawful excuse, fails to comply with any summons or requisition of the Registrar under this section shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees.

**Compounding of offences**

39. The Central Government may compound any offence under this Act which is punishable with fine only, by collecting from a person reasonably suspected of having committed the offence, a sum which may extend to the amount of the maximum fine prescribed for the offence.

**Destruction of old records.**

40. The Registrar may destroy any document filed or registered with him in physical form or in electronic form in accordance with such rules as may be prescribed.

**Enforcement of duty to make returns, etc.**

41. (1) If any limited liability partnership is in default in complying with—
- (a) any provisions of this Act or of any other law which requires the filing in any manner with the Registrar of any return, account or other document or the giving of notice to him of any matter; or
  - (b) any request of the Registrar to amend or complete and resubmit any document or to submit a fresh document, and fails to make good the default within fourteen days after the service on the limited liability partnership of a notice requiring it to be done, the Tribunal may, on application by the Registrar, make an order directing that limited liability partnership or its designated partners or its partners to make good the default within such time as specified in the order.
- (2) Any such order may provide that all the costs of and incidental to the applications shall be borne by that limited liability partnership.



- (3) Nothing in this section shall limit the operation of any other provision of this Act or any other law imposing penalties in respect of any default referred to in this section on that limited liability partnership.

### **5.2.9 Assignment and Transfer of Partnership Rights**

Partnership Act, 1932 does not permit transfer of interest by a partner to outsider without consent of all the partners, however, LLP Act vide section 42 acknowledge the rights of a partner to a share of the profits and losses of the limited liability partnership and to receive distributions in accordance with the limited liability partnership agreement are transferable either wholly or in part. Such transfer of interest by a partner) does not by itself cause the disassociation of the partner or a dissolution and winding up of the limited liability partnership. The transfer of right pursuant to this section does not, by itself, entitle the transferee or assignee to participate in the management or conduct of the activities of the limited liability partnership, or access information concerning the transactions of the limited liability partnership as provided in the Partnership Act also in case of a partnership firm.

### **5.2.10 Investigation**

#### **Investigating of the affairs of limited liability partnership**

43. (1) The Central Government shall appoint one or more competent persons as inspectors to investigate the affairs of a limited liability partnership and to report thereon in such manner as it may direct if—
- (a) the Tribunal, either suo motu, or on an application received from not less than one-fifth of the total number of partners of limited liability partnership, by order, declares that the affairs of the limited liability partnership ought to be investigated; or
  - (b) any Court, by order, declares that the affairs of a limited liability partnership ought to be investigated. (2) The Central Government may appoint one or more competent persons as inspectors to investigate the affairs of a limited liability partnership and to report on them in such manner as it may direct.
- (3) The appointment of inspectors pursuant to sub-section (2) may be made,—
- (a) if not less than one-fifth of the total number of partners of the limited liability partnership make an application along with supporting evidence and security amount as may be prescribed; or
  - (b) if the limited liability partnership makes an application that the affairs of the limited liability partnership ought to be investigated; or
  - (c) if, in the opinion of the Central Government, there are circumstances suggesting—
    - (i) that the business of the limited liability partnership is being or has been conducted with an intent to defraud its creditors, partners or any other person, or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive or unfairly prejudicial to some or any of its partners, or that the limited liability partnership was formed for any fraudulent or unlawful purpose; or
    - (ii) that the affairs of the limited liability partnership are not being conducted in accordance with the provisions of this Act; or
    - (iii) that, on receipt of a report of the Registrar or any other investigating or regulatory agency, there are sufficient reasons that the affairs of the limited liability partnership ought to be investigated.

#### **Application by partners for investigation**

44. An application by partners of the limited liability partnership under clause (a) of sub-section (1) of section 43 shall be supported by such evidence as the Tribunal may require for the purpose

of showing that the applicants have good reason for requiring the investigation and the Central Government may, before appointing an inspector, require the applicants to give security, of such amount as may be prescribed, for payment of costs of the investigation.

**Firm, body corporate or association not to be appointed as inspector**

45. No firm, body corporate or other association shall be appointed as an inspector.

**Power of inspectors to carry out investigation into affairs of related entities, etc.**

46. (1) If an inspector appointed by the Central Government to investigate the affairs of a limited liability partnership thinks it necessary for the purposes of his investigation to investigate also the affairs of an entity which has been associated in the past or is presently associated with the limited liability partnership or any present or former partner or designated partner of the limited liability partnership, the inspector shall have the power to do so and shall report on the affairs of the other entity or partner or designated partner, so far as he thinks that the results of his investigation thereof are relevant to the investigation of the affairs of the limited liability partnership.

(2) In the case of any entity or partner or designated partner referred to in sub-section (1), the inspector shall not exercise his power of investigating into, and reporting on, it's or his affairs without first having obtained the prior approval of the Central Government thereto:

Provided that before according approval under this sub-section, the Central Government shall give the entity or partner or designated partner a reasonable opportunity to show cause why such approval should not be accorded.

**Production of documents and evidence**

47. (1) It shall be the duty of the designated partner and partners of the limited liability partnership—  
(a) to preserve and to produce before an inspector or any person authorised by him in this behalf with the previous approval of the Central Government, all books and papers of, or relating to, the limited liability partnership or, as the case may be, the other entity, which are in their custody or power; and

(b) otherwise to give to the inspector all assistance in connection with the investigation which they are reasonably able to give.

(2) The inspector may, with the previous approval of the Central Government, require any entity other than an entity referred to in sub section (1) to furnish such information to, or produce such books and papers before him or any person authorised by him in this behalf, with the previous approval of that Government, as he may consider necessary, if the furnishing of such information or the production of such books and papers is relevant or necessary for the purposes of his investigation.

(3) The inspector may keep in his custody any books and papers produced under sub- section (1) or sub- section (2) for thirty days and thereafter shall return the same to the limited liability partnership, other entity or individual by whom or on whose behalf the books and papers are produced:

Provided that the inspector may call for the books and papers if they are needed again:

Provided further that if certified copies of the books and papers produced under sub-section (2) are furnished to the inspector, he shall return those books and papers to the entity or person concerned.

(4) An inspector may examine on oath—

(a) any of the persons referred to in sub-section (1);



- (b) with the previous approval of the Central Government, any other person in relation to the affairs of the limited liability partnership or any other entity, as the case may be; and
  - (c) may administer an oath accordingly and for that purpose may require any of those persons to appear before him personally.
- (5) If any person fails without reasonable cause or refuses—
- (a) to produce before an inspector or any person authorised by him in this behalf with the previous approval of the Central Government any book or paper which it is his duty under sub-section (1) or sub-section (2) to produce ; or
  - (b) to furnish any information which it is his duty under sub section (2) to furnish; or
  - (c) to appear before the inspector personally when required to do so under sub- section (4) or to answer any question which is put to him by the inspector in pursuance of that sub-section; or
  - (d) to sign the notes of any examination, he shall be punishable with fine which shall not be less than two thousand rupees but which may extend to twenty-five thousand rupees and with a further fine which shall not be less than fifty rupees but which may extend to five hundred rupees for every day after the first day after which the default continues.
- (6) The notes of any examination under sub-section (4) shall be taken down in writing and signed by the person whose examination was made on oath and a copy of such notes shall be given to the person so examined on oath and thereafter be used as an evidence by the inspector.

### **Seizure of documents by inspector**

48. (1) Where in the course of investigation, the inspector has reasonable ground to believe that the books and papers of, or relating to, the limited liability partnership or other entity or partner or designated partner of such limited liability partnership may be destroyed, mutilated, altered, falsified or secreted, the inspector may make an application to the Judicial Magistrate of the first class, or, as the case may be, the Metropolitan Magistrate, having jurisdiction, for an order for the seizure of such books and papers.
- (2) After considering the application and hearing the inspector, if necessary, the Magistrate may, by order, authorise the inspector —
- (a) to enter, with such assistance, as may be required, the place or places where such books and papers are kept;
  - (b) to search that place or those places in the manner specified in the order; and
  - (c) to seize books and papers which the inspector considers it necessary for the purposes of his investigation.
- (3) The inspector shall keep in his custody the books and papers seized under this section for such period not later than the conclusion of the investigation as he considers necessary and thereafter shall return the same to the concerned entity or person from whose custody or power they were seized and inform the Magistrate of such return:

Provided that the books and papers shall not be kept seized for a continuous period of more than six months:

Provided further that the inspector may, before returning such books and papers as aforesaid, place identification marks on them or any part thereof.

- (4) Save as otherwise provided in this section, every search or seizure made under this section shall be carried out in accordance with the provisions of the Code of Criminal Procedure, 1973 relating to searches or seizures made under that Code.

#### **Inspector's report**

49. (1) The inspectors may, and if so directed by the Central Government, shall make interim reports to that Government, and on the conclusion of the investigation, shall make a final report to the Central Government and any such report shall be written or printed, as the Central Government may direct.
- (2) The Central Government-
- (a) shall forward a copy of any report (other than an interim report) made by the inspectors to the limited liability partnership at its registered office, and also to any other entity or person dealt with or related to the report; and
- (b) may, if it thinks fit, furnish a copy thereof, on request and on payment of the prescribed fee, to any person or entity related to or affected by the report.

#### **Prosecution**

50. If, from the report under section 49, it appears to the Central Government that any person in relation to the limited liability partnership or in relation to any other entity whose affairs have been investigated, has been guilty of any offence for which he is liable, the Central Government may prosecute such person for the offence; and it shall be the duty of all partners, designated partners and other employees and agents of the limited liability partnership or other entity, as the case may be, to give the Central Government all assistance in connection with the prosecution which they are reasonably able to give.

#### **Application for winding up of limited liability partnership**

51. If any such limited liability partnership is liable to be wound up under this Act or any other law for the time being in force, and it appears to the Central Government from any such report under section 49 that it is expedient to do so by reason of any such circumstances as are referred to in sub-clause (i) or sub-clause (ii) of clause (c) of sub-section (3) of section 43, the Central Government may, unless the limited liability partnership is already being wound up by the Tribunal, cause to be presented to the Tribunal by any person authorised by the Central Government in this behalf, a petition for the winding up of the limited liability partnership on the ground that it is just and equitable that it should be wound up.

#### **Proceedings for recovery of damages or property**

52. If, from any report under section 49, it appears to the Central Government that proceedings ought, in the public interest, to be brought by the limited liability partnership or any entity whose affairs have been investigated,—
- (a) for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation, or the management of the affairs, of such limited liability partnership or such other entity; or
- (b) for the recovery of any property of such limited liability partnership or such other entity, which has been misapplied or wrongfully retained, the Central Government may itself bring proceedings for that purpose.

#### **Expenses of Investigation**

53. (1) The expenses of and incidental to an investigation by an inspector appointed by the Central Government under this Act shall be defrayed in the first instance by the Central Government;



but the following persons shall, to the extent mentioned below, be liable to reimburse the Central Government in respect of such expenses, namely:—

- (a) any person who is convicted on a prosecution, or who is ordered to pay damages or restore any property in proceedings brought by virtue of section 52, may, in the same proceedings, be ordered to pay the said expenses to such extent as may be specified by the court convicting such person, or ordering him to pay such damages or restore such property, as the case may be;
  - (b) any entity in whose name proceedings are brought as aforesaid shall be liable, to the extent of the amount or value of any sums or property recovered by it as a result of the proceedings; and
  - (c) unless, as a result of the investigation, a prosecution is instituted in pursuance of section 50,—
    - (i) any entity, a partner or designated partner or any other person dealt with by the report of the inspector shall be liable to reimburse the Central Government in respect of the whole of the expenses, unless and except in so far as, the Central Government otherwise directs; and
    - (ii) the applicants for the investigation, where the inspector was appointed in pursuance of the provisions of clause (a) of sub-section (1) of section 43, shall be liable to such extent, if any, as the Central Government may direct.
- (2) Any amount for which a limited liability partnership or other entity is liable by virtue of clause (b) of sub-section (1) shall be a first charge on the sums or property mentioned in that clause.
- (3) The amount of expenses in respect of which any limited liability partnership, other entity, a partner or designated partner or any other person is liable under sub-clause (i) of clause (c) of sub-section (1) to reimburse the Central Government shall be recoverable as arrears of land revenue.
- (4) For the purposes of this section, any costs or expenses incurred by the Central Government or in connection with the proceedings brought by virtue of section 52 shall be treated as expenses of the investigation giving rise to the proceedings.

#### **Inspector's report to be evidence**

54. A copy of any report of any inspector or inspectors appointed under the provision of this Act, authenticated in such manner, if any, as may be prescribed, shall be admissible in any legal proceeding as evidence in relation to any matter contained in the report.

#### **5.2.11 Conversion to Limited Liability Partnership**

##### **Conversion from firm into limited liability partnership.**

\* 55. A firm may convert into a limited liability partnership in accordance with the provisions of Chapter X and the Second Schedule.

##### **Conversion from private company into limited liability partnership.**

\* 56. A private company may convert into a limited liability partnership in accordance with the provisions of Chapter X and the Third Schedule.

##### **\* Conversion from unlisted public company into limited liability partnership**

57. An unlisted public company may convert into a limited liability partnership in accordance with the provisions of Chapter X and the Fourth Schedule

##### **\* Registration and effect of conversion**

58. (1) The Registrar, on satisfying that a firm, private company or an unlisted public company, as the case may be, has complied with the provisions of the Second Schedule, the Third Schedule or the Fourth Schedule, as the case may be, shall, subject to the provisions of this Act and the rules made thereunder, register the documents submitted under such Schedule and issue a certificate of registration in such form as the Registrar may determine stating that the limited liability partnership is, on and from the date specified in the certificate, registered under this Act:

Provided that the limited liability partnership shall, within fifteen days of the date of registration, inform the concerned Registrar of Firms or Registrar of Companies, as the case may be, with which it was registered under the provisions of the Indian Partnership Act, 1932 or the Companies Act, 1956, as the case may be, about the conversion and of the particulars of the limited liability partnership in such form and manner as may be prescribed.

- (2) Upon such conversion, the partners of the firm, the shareholders of private company or unlisted public company, as the case may be, the limited liability partnership to which such firm or such company has converted, and the partners of the limited liability partnership shall be bound by the provisions of the Second Schedule, the Third Schedule or the Fourth Schedule, as the case may be, applicable to them.
- (3) Upon such conversion, on and from the date of certificate of registration, the effects of the conversion shall be such as specified in the Second Schedule, the Third Schedule or the Fourth Schedule, as the case may be.
- (4) Notwithstanding anything contained in any other law for the time being in force, on and from the date of registration specified in the certificate of registration issued under the Second Schedule, the Third Schedule or the Fourth Schedule, as the case may be,—
- (a) there shall be a limited liability partnership by the name specified in the certificate of registration registered under this Act;
- (b) all tangible (movable or immovable) and intangible property vested in the firm or the company, as the case may be, all assets, interests, rights, privileges, liabilities, obligations relating to the firm or the company, as the case may be, and the whole of the undertaking of the firm or the company, as the case may be, shall be transferred to and shall vest in the limited liability partnership without further assurance, act or deed; and
- (c) The firm or the company, as the case may be, 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.

**\* Note:** Central Government vide SO 1323(D) dated 22nd May 2009, appointed 31st Day of May 2009 as the date on which the provisions of section 55 to 58, second schedule, third schedule and fourth schedule of LLP Act 2008 shall come into force.

### **5.2.12 Foreign Limited Liability Partnership**

#### **Foreign partnerships**

59. The Central Government may make rules for provisions in relation to establishment of place of business by foreign limited liability partnerships within India and carrying on their business therein by applying or incorporating, with such modifications, as appear appropriate, the provisions of the Companies Act, 1956 or such regulatory mechanism with such composition as may be prescribed.

### **5.2.15 Compromise, Arrangement or Reconstruction of Limited Liability Partnership**

60. (1) Where a compromise or arrangement is proposed—
- (a) between a limited liability partnership and its creditors; or

- (b) between a limited liability partnership and its partners, the Tribunal may, on the application of the limited liability partnership or of any creditor or partner of the limited liability partnership, or, in the case of a limited liability partnership which is being wound up, of the liquidator, order a meeting of the creditors or of the partners, as the case may be, to be called, held and conducted in such manner as may be prescribed or as the Tribunal directs.
- (2) If a majority representing three-fourths in value of the creditors, or partners, as the case may be, at the meeting, agree to any compromise or arrangement, the compromise or arrangement shall, if sanctioned by the Tribunal, by order be binding on all the creditors or all the partners, as the case may be, and also on the limited liability partnership, or in the case of a limited liability partnership which is being wound up, on the liquidator and contributories of the limited liability partnership:

Provided that no order sanctioning any compromise or arrangement shall be made by the Tribunal unless the Tribunal is satisfied that the limited liability partnership or any other person by whom an application has been made under sub-section (1) has disclosed to the Tribunal, by affidavit or otherwise, all material facts relating to the limited liability partnership, including the latest financial position of the limited liability partnership and the pendency of any investigation proceedings in relation to the limited liability partnership.

- (3) An order made by the Tribunal under sub-section (2) shall be filed by the limited liability partnership with the Registrar within thirty days after making such an order and shall have effect only after it is so filed.
- (4) If default is made in complying with sub-section (3), the limited liability partnership, and every designated partner of the limited liability partnership shall be punishable with fine which may extend to one lakh rupees.
- (5) The Tribunal may, at any time after an application has been made to it under this section, stay the commencement or continuation of any suit or proceeding against the limited liability partnership on such terms as the Tribunal thinks fit, until the application is finally disposed of.

#### **Power of Tribunal to enforce compromise or arrangement**

61. (1) Where the Tribunal makes an order under section 60 sanctioning a compromise or an arrangement in respect of a limited liability partnership, it
- (a) shall have power to supervise the carrying out of the compromise or an arrangement; and
- (b) may, at the time of making such order or at any time thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary' for the proper working of the compromise or arrangement.
- (2) If the Tribunal aforesaid is satisfied that a compromise or an arrangement sanctioned under section 60 cannot be worked satisfactorily with or without modifications, it may, either on its own motion or on the application of any person interested in the affairs of the limited liability partnership, make an order for winding up the limited liability partnership, and such an order shall be deemed to be an order made under section 64 of this Act.

#### **Provision for facilitating reconstruction or amalgamation of limited liability partnership**

62. (1) Where an application is made to the Tribunal under section 60 for sanctioning of a compromise or arrangement proposed between a limited liability partnership and any such persons as are mentioned in that section, and it is shown to the Tribunal that—
- (a) compromise or arrangement has been proposed for the purposes of, or in connection with, a scheme for the reconstruction of any limited liability partnership or limited

liability partnerships, or the amalgamation of any two or more limited liability partnerships; and

- (b) under the scheme the whole or any part of the undertaking, property or liabilities of any limited liability partnership concerned in the scheme (in this section referred to as a "transferor limited liability partnership") is to be transferred to another limited liability partnership (in this section referred to as the "transferee limited liability partnership"), the Tribunal may, either by the order sanctioning the compromise or arrangement or by a subsequent order, make provisions for all or any of the following matters, namely:—
- (i) the transfer to the transferee limited liability partnership of the whole or any part of the undertaking, property or liabilities of any transferor limited liability;
  - (ii) the continuation by or against the transferee limited liability partnership of any legal proceedings pending by or against any transferor limited liability partnership;
  - (iii) the dissolution, without winding up, of any transferor limited liability partnership;
  - (iv) the provision to be made for any person who, within such time and in such manner as the Tribunal directs, dissent from the compromise or arrangement; and
  - (v) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out

Provided that no compromise or arrangement proposed for the purposes of, or in connection with, a scheme for the amalgamation of a limited liability partnership, which is being wound up, with any other limited liability partnership or limited liability partnerships, shall be sanctioned by the Tribunal unless the Tribunal has received a report from the Registrar that the affairs of the limited liability partnership have not been conducted in a manner prejudicial to the interests of its partners or to public interest:

Provided further that no order for the dissolution of any transferor limited liability partnership under clause (iii) shall be made by the Tribunal unless the Official Liquidator has, on scrutiny of the books and papers of the limited liability partnership, made a report to the Tribunal that the affairs of the limited liability partnership have not been conducted in a manner prejudicial to the interests of its partners or to public interest.

- (2) Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to and vest in, and those liabilities shall be transferred to and become the liabilities of, the transferee limited liability partnership; and in the case of any property, if the order so directs, freed from any charge which is, by virtue of the compromise or arrangement, to cease to have effect.
- (3) Within thirty days after the making of an order under this section, every limited liability partnership in relation to which the order is made shall cause a certified copy thereof to be filed with the Registrar for registration.
- (4) If default is made in complying with the provisions of sub-section (3), the limited liability partnership, every designated partner of the limited liability partnership shall be punishable with fine which may extend to fifty thousand rupees.

**Explanation.** In this section "property" includes property, rights and powers of every description; and "liabilities" includes duties of every description.

### 5.2.13 Winding up and Dissolution of a Limited Liability Partnership

The Act provides two ways of winding up of a LLP

- (a) Voluntary or
- (b) by Tribunal and



And limited liability partnership so would up may be dissolved. **(sec 63)**

### **Circumstance in which Limited liability Partnership may be wound up by Tribunal (Sec 64)**

The circumstances in which a Limited Liability Partnership may be dissolved by Tribunal are provided in section 64 of the Act. Under section 64; - A limited liability partnership may be wound up by the Tribunal,—

- (a) the limited liability partnership decides that limited liability partnership be wound up by the Tribunal;
- (b) if , for a period of more than six month ,the number of partners of the limited liability partnership is reduced below two;
- (c) if the limited liability partnership is unable to pay its debts;
- (d) if the limited liability partnership has acted against the interests of the sovereignty and integrity of India, the security of the State or public order;
- (e) if the limited liability partnership has made a default in filing with the Registrar the Statement of Account and Solvency or annual return for any five consecutive financial years; or
- (f) if the Tribunal is of the opinion that it is just and equitable that the limited liability partnership be wound up.

### **Rules for winding up and dissolution**

Central Government has power to make rules for dissolution and winding up of a LLP

A perusal of the LLP Act 2008 shows that the provisions relating to dissolution of a LLP are more or less the same as Provided in the Partnership Act, 1932 for dissolution of a Partnership firm. (Sec 65)

A partner may lend money to and transact other business with the limited liability partnership and has the same rights and obligations with respect to the loan or other transactions as a person who is not a partner(sec66).

Application of the provisions of the Companies Act: As per section 67 the Central Government has power to direct by notification in the official gazette specify the provision of Companies Act,1956 which will be applicable to a LLP or applicable to a LLP with such modification or adaption as may be specified in the notification. A copy of such notification is required to be laid in draft before each house of Parliament, and such notification shall be issued only in such form as may be agreed upon by both the houses of Parliament.

By virtue of the power conferred upon the Central Government, the Central Government has from time to time issued order for application of various provisions of the Companies Act, 1956 as such of with some modification to the LLP.

Section 68 contains provisions regarding filing, recording or registered under this Act to be so filed,recorded or registered in such manner and subject to such conditions as may be prescribed.

A copy of or an extract from any document electronically filed with or submitted to the Registrar which is supplied or issued by the Registrar and certified through affixing digital signature as per the Information Technology Act,2000 to be a true copy of or extract from such document shall, in any proceeding, be admissible in evidence as of equal validity with the original document.

As per sub section 3 of section 68 any information supplied by the Registrar that is certified by the Registrar trough affixing digital signature to be true extract from any document filed with or submitted to the Registrar shall, in any proceeding, be admissible in evidence and be presumed, unless evidence to the contrary is adduced to be a true extract from such document.

Section 69 allow a LLP to file any belated document or return not filed or registered to be filed or registered within three hundred days from the date within which it should have been filed on payment

of additional fee of one hundred rupee for every day of such delay in addition to any fee as is payable for filing of such documents or returns. Such documents or return may without prejudice to any other action or liability under this Act, also be filed after such period of three hundred days on payment of fee and additional fee specified in this Act.

**Enhanced punishment:**

In order to prevent repeated and frequent violation of any provision of this Act, section 70 provides that in case a limited liability partnership or any partner or designated partner of such limited liability partnership commits any offence, the limited liability partnership or any partner or designated partner shall, for the second or subsequent offence, be punishable with imprisonment as provided, but in case of offences for which fine is prescribed either along with or exclusive of imprisonment, with fine which shall be twice the amount of fine for such offence **(Section 70)**.

**Application of other laws:**

The provision of this Act shall be in addition to and not in derogation of the provisions of any other law for the time being in force(71)

Jurisdiction of Tribunal and Appelaltic Tribunal:-The Tribunal shall exercise such powers and perform such functions as are, or may be, conferred on it by or under this Act or any law for the time being in force(72)

Any person aggrieved by an order or decision of Tribunal may prefer an appeal to the Appellate tribunal and the Provisions of sections 10FQ,10FZA,10G,10GD,10GE,10GF of the Companies Act,1956 shall be applicable in respect of such appeal.

Penalty for non compliance of the order of Tribunal:(73)

Any body failing to comply with any order made by the tribunal under any provisions of this Act is punishable with imprisonment which may extend to six months and also fine which shall not be less than fifty thousand rupees.

**General penalties:**

Any person guilty of an offence under this Act for which no punishment is expressly provided shall be liable to a fine which may extend to five lakh rupees but which shall not be less than five thousand rupees and with a further fine which may extend to fifty rupees for every day after the first day after which the default **(Sec 74)**

**Power of registrar to strike defunct limited liability partnership off register**

Under section 75 if the Registrar has reasonable cause to believe that a limited liability partnership is not carrying on business or its operation, in accordance with the provisions of this Act, the name of limited liability partnership may be struck off the register of limited liability partnerships in such manner as may be prescribed: However, the Registrar shall, before striking off the name of any limited liability partnership under this section, give such limited liability partnership a reasonable opportunity of being heard.

**Offence of limited liability partnerships**

76. Where an offence under this Act committed by a limited liability partnership is proved
- (a) to have been committed with the consent or connivance of a partner or partners or designated partner or designated partners of the limited liability partnership; or
  - (b) to be attributable to any neglect on the part of the partner or partners or designated partner or designated partners of that limited liability partnership, the partner or partners or designated partner or designated partners of the limited liability partnership, as the case may be, as well as that limited liability partnership shall be guilty of the offence and shall be liable to be proceeded against and punished accordingly.



## Jurisdiction of the court

77. Notwithstanding any provision to the contrary in any Act for the time being in force, the Judicial Magistrate of the first class or, as the case may be, the Metropolitan Magistrate shall have jurisdiction or try any offence under this Act and shall have power to impose punishment in respect of said offence.

### 5.2.14 Power of Central Government

**Under the Limited Liability Partnership Act, the Central Government has various powers under different sections. Some of these powers are summarized as under;**

- (1) Power to exempt any LLP or class of LLP for Audit of Accounts (34(4))
- (2) **Power to appoint one or more competent person as inspector to inspect the affairs of a LLP (43(1))**
- (3) **Power to prosecute any person found to be guilty** in relation to the limited liability partnership or in relation to any other entity whose affairs have been investigated.
- (4) If any such limited liability partnership is liable to be wound up under this Act or any other law for the time being in force, the Central Government may, cause to be presented to the Tribunal by any person authorised by the Central Government in this behalf, a petition for the winding up of the limited liability partnership on the ground that it is just and equitable that it should be wound up (sec 53).
- (5) Power to make rules under section 59 for provisions in relation to establishment of place of business by foreign limited liability partnerships within India and carrying on their business therein by applying or incorporating, with such modifications, as appear appropriate, the provisions of the Companies Act, 1956 or such regulatory mechanism with such composition as may be prescribed.
- (6) Power to make rules for the provisions in relation to winding up and dissolution of limited liability partnerships
- (7) The Central Government has power to direct application of the provision of the provision of companies Act 1956 to LLP (67(1))
- (8) Power to alter any of the provisions contained in any of the Schedules to this Act [78(1)].
- (9) Under section 79(1) power to make rules for carrying out the provisions of this Act. Such rules may provide for all or any of the following matters namely
  - (a) form and manner of prior consent to be given by designated partner under sub-section (3) of section 7;
  - (b) the form and manner of particulars of every individual agreeing to act as designated partner of limited liability partnership under sub-section (4) of section 7;
  - (c) the conditions and requirements relating to the eligibility of an individual to become a designated partner under sub-section (5) of section 7;
  - (d) the manner of filing the incorporation document and payment of fees payable thereof under clause (b) of sub-section (1) of section 11;
  - (e) the form of statement to be filed under clause (c) of sub-section (1) of section 11;
  - (f) the form of incorporation document under clause (a) of sub-section (2) of section 11;
  - (g) the information to be contained in the incorporation document concerning the proposed limited liability partnership under clause (g) of sub-section (2) of section 11;

- (h) the manner of serving the documents on a limited liability partnership or a partner or a designated partner and the form and manner in which any other address may be declared by the limited liability partnership under sub-section (2) of section 13;
- (i) the form and manner of notice to the Registrar and the conditions in respect of change of registered office under sub-section (3) of section 13;
- (j) the form and manner of application and amount of fee payable to the Registrar under sub-section (1) of section 16;
- (k) the manner in which names will be reserved by the Registrar under sub-section (2) of section 16;
- (l) the manner in which an application may be made by an entity under sub-section (1) section 18;
- (m) the form and manner of notice of change of name of limited liability partnership and the amount of fee payable under section 19;
- (n) the form and manner of the limited partnership agreement and the changes made therein and the amount of fee payable under sub-section (2) of section 23;
- (o) the form of notice, the amount of fee payable and the manner of authentication of the statement under clauses (a), (b) and (c) of sub-section (3) of section 25;
- (p) the manner of accounting and disclosure of monetary value of contribution of a partner under sub-section (2) of section 32;
- (q) the books of account and the period of their maintenance under sub-section (1) of section 34;
- (r) the form of Statement of Account and Solvency under sub-section (2) of section 34;
- (s) the form, manner, fee and time of filing of Statement of Account and Solvency under sub-section (3) of section 34;
- (t) the audit of accounts of a limited liability partnership under sub-section (4) of section 34;
- (u) the form and manner of annual return and fee payable under sub-section (1) of section 35;
- (v) the manner and amount of fee payable for inspection of incorporation documents, names of partners and changes made therein, Statement of Account and Solvency and annual return under section 36;
- (w) the destruction of documents by Registrar in any form under section 40;
- (x) the amount required as security under clause (a) of sub-section (3) of section 43;
- (y) the amount of security to be given under section 44;
- (z) the fee payable for furnishing a copy under clause (b) of sub-section (2) of section 49; (za) the manner of authentication of report of inspector under section 54;
- (zb) the form and manner of particulars about conversion under the proviso to sub-section (1) of section 58; (zc) in relation to establishment of place of business and carrying on business in India by foreign limited liability partnerships and regulatory mechanism and composition under section 59;
- (zd) the manner of calling, holding and conducting meeting under sub-section (1) of section 60;
- (ze) in relation to winding up and dissolution of limited liability partnerships under section 65;



- (zf) the manner and conditions for filing document electronically under sub-section (1) of section 68; (zg) the manner for striking off the names of limited partnership from the register under section 75;
- (zh) the form and manner of statement containing particulars and amount of fee payable under sub-paragraph (a) of paragraph 4 of the Second Schedule;
- (zi) the form and manner of particulars about conversion under the proviso to paragraph 5 of the Second Schedule;
- (zj) the form and manner of the statement and the amount of fee payable under sub-paragraph (a) of paragraph 3 of the Third Schedule;
- (zk) the form and manner of particulars about conversion under the proviso to paragraph 4 of the Third Schedule;
- (zl) the form and manner of the statement and amount of fee payable under sub-paragraph 4 of the Third Schedule;
- (zm) the form and manner of particulars about conversion under the proviso to paragraph 5 of the Fourth Schedule.

Every rule made by the Central Government under section 79 of LLP Act, shall be laid as soon as may be after it is made, before each House of the Parliament, while it is in session for total period of thirty days, which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both houses agree in making any modification to the rule or both the houses agree that the rule should not be made, the rule shall, thereafter, have effect only in such modified form or be of no effect, as the case may be, however that any such notification or annulment shall be without prejudice to the validity of anything previously done under that rule.

In order to remove any difficulty arising in giving effect to the provisions of the Act under section 80 the Central Government has power to make such provisions not inconsistent with the provisions of this Act as may appear to it to be necessary for removing the difficulty. Such order can be made only before the expiry of a period of two years from the commencement of this Act and not subsequently. Every such order is also required to be laid after it is made before each House of Parliament.

#### **Let us Recapitulate:**

- The Limited Liability Partnership Bill, 2008 was passed by the Parliament and received the assent of the President on 7th January, 2009 and it became Limited Liability Partnership Act, 2008.
- The LLP is a hybrid of corporate and partnership. It assimilates the features of the company and partnership form of business entity. As the name suggest the limited liability of partners is the key feature of this Act.
- Nature of limited liability partnership: Limited liability partnership to be body corporate; Non-applicability of the Indian Partnership Act, 1932; Every limited liability partnership shall have at least two partners; Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India;
- LLP needs incorporation.
- On registration, a limited liability partnership shall, by its name, be capable of-
  - (a) suing and being sued;
  - (b) acquiring, owning, holding and developing or disposing of property, whether movable or immovable, tangible or intangible;

- (c) having a common seal, if it decides to have one; and
  - (d) doing and suffering such other acts and things as bodies corporate may lawfully do and suffer.
- Save as otherwise provided by this Act, the mutual rights and duties of the partners of a limited liability partnership, and the mutual rights and duties of a limited liability partnership and its partners, shall be governed by the limited liability partnership agreement between the partners, or between the limited liability partnership and its partners.
  - Every partner of a limited liability partnership is, for the purpose of the business of the limited liability partnership, the agent of the limited liability partnership, but not of other partners.
  - The monetary value of contribution of each partner shall be accounted for and disclosed in the accounts of the limited liability partnership in the manner as may be prescribed.
  - Partnership Act, 1932 does not permit transfer of interest by a partner to outsider without consent of all the partners, however, LLP Act vide section 42 acknowledge the rights of a partner to a share of the profits and losses of the limited liability partnership and to receive distributions in accordance with the limited liability partnership agreement are transferable either wholly or in part.
  - Under the Limited Liability Partnership Act, the Central Government has various powers under different sections.
  - Dissolution of LLP so wound up either voluntarily or by order of Tribunal(sec 63).

# Study Note - 6

## THE PREVENTION OF MONEY LAUNDERING ACT, 2002 (PMLA)



### This Study Note includes

- 6.1 Extent and Commencement
- 6.2 Concepts and Definitions
- 6.3 Punishment for Money Laundering
- 6.4 Obligations of Banking Companies, Financial Institutions and Intermediaries
- 6.5 Burden of Proof
- 6.6 Appellate Tribunal
- 6.7 Offences to be Cognizable and Non-Bailable

### 6. THE PREVENTION OF MONEY LAUNDERING ACT, 2002 - INTRODUCTION

**Money laundering** poses a serious threat not only to the financial sector of country but also pose a serious threat to its integrity and sovereignty of the country. It may be a proxy war of the anti-national elements including alien enemies to sabotage the financial sector of the country if not tackled properly. It is the process by which criminals conceal the origin and ownership of the proceeds of crime, by legitimizing illegally obtained money, by channel sing surreptitiously through legitimate business channels and integrating those to financial system in a variety of ways like bank deposits, investments or through transfer from one place or person to another.

To achieve the objective of preventing laundering of money and other associate activities a comprehensive legislation was needed. Accordingly the Prevention Money Laundering Bill 1998 was introduced in the Parliament which was further referred to the Standing Committee on Finance which presented its report on 4<sup>th</sup> March 1999 to the Lok Sabha. The Central Government broadly accepted the recommendations of the Standing Committee and incorporated them in the said bill along with other desired changes. The Bill was passed by both the Houses of Parliament and received the assent of the President on 17<sup>th</sup> January 2003 and came to be known as **the Prevention of Money Laundering Act 2002(15<sup>th</sup> of 2003)(PMLA)**.

The act of money laundering has been criminalized in India through the enactment of the Prevention of Money Laundering Act, 2002. Persons and entities who indulge in or assist in the process or activity connected with the proceeds of scheduled crime as defined under the said Act and in projecting it as untainted property are guilty of the said offence of money laundering under **Section 3** of the Act. With money laundering becoming an international/global menace rocking the economic and financial edifice of various countries, India has become a member of Financial Action Task Force(FATF) in 2010.

The Act contains **75 sections** spread over **10 chapters** and **one schedule**. The Act was last amended vide **the Prevention of Money-laundering (Amendment) Act,2009** and another bill titled "**The Prevention of Money Laundering(Amendment) Bill 2011**" is lying pending in the Parliament [Note: the Prevention of Money Laundering(Amendment) Bill 2011 was introduced in the Lok Sabha 28th November 2012. The Act is yet to be notified by the Central Government]. The Amendment Act when passed and notified would widen the coverage of the law and makes it more stringent and bring it in line with the similar legislation of other countries. The bill extends the meaning of Money Laundering Act to include activities such as concealment and possession of proceeds of crime. The Amendment Bill(2011) also put onus on the banks, Financial Institutions, Intermediaries or person carrying on a specified business to report such instances by introducing the concept of a" Reporting Entity". Currently under PMLA fine upto five lakh can be imposed, the proposed amendment bill proposes to do away with the limit.

## 6.1 EXTENT AND COMMENCEMENT

**Date of enforcement of the Act: 1<sup>st</sup> July 2005**

**Coverage: The Act extends to whole of India.**

## 6.2 CONCEPTS AND DEFINITIONS

**Section 2** of the Prevention of Money Laundering Act, 2002 defines various terms.

- (1) In this Act unless the context otherwise requires,-
- (a) **“Adjudicating Authority”** means an Adjudicating Authority appointed under sub-section (1) of section 6;
  - (b) **“Appellate Tribunal”** means the Appellate Tribunal established under **section 25**;
  - (c) **“Assistant Director”** means an Assistant Director appointed under sub-section (1) of **section 49**;
  - (d) **“Attachment”** means prohibition of transfer, conversion, disposition or movement of property by an order issued under Chapter III;
  - (da) **“Authorised person”** means an authorised person as defined in clause (c) of **section 2 of the Foreign Exchange Management Act, 1999**;
  - (e) **“Banking company”** means a banking company or a co-operative bank to which **the Banking Regulation Act, 1949** applies and includes any bank or banking institution referred to in **section 51** of that Act;
  - (f) **“Bench”** means a Bench of the Appellate Tribunal;
  - (fa) **“Beneficial owner”** means an individual who ultimately owns or controls a client of a reporting entity or the person on whose behalf a transaction is being conducted and includes a person who exercises ultimate effective control over a juridical person.
  - (g) **“Chairperson”** means Chairperson of the Appellate Tribunal;
  - (h) **“Chit fund company”** means a company managing, conducting or supervising, as foreman, agent or in any other capacity, chits as defined in **section 2 of the Chit Funds Act, 1982**;
  - (ha) **“Client”** means a person who is engaged in a financial transaction or activity with a reporting entity and includes a person on whose behalf the person who engaged in the transaction or activity, is acting.
  - (i) **“Co-operative bank”** shall have the same meaning as assigned to it in clause (dd) of **section 2** of the Deposit Insurance and Credit Guarantee Corporation Act, 1961;
  - (ia) **“Corresponding law”** means any law of any foreign country corresponding to any of the provisions of this Act or dealing with offences in that country corresponding to any of the scheduled offences.
  - (ib) **“Dealer”** has the same meaning as assigned to it in clause (b) of section 2 of the Central Sales Tax Act, 1956.
  - (j) **“Deputy Director”** means a Deputy Director appointed under sub-section (1) of section 49;
  - (k) **“Director”** or **“Additional Director”** or **“Joint Director”** means a Director or Additional Director or Joint Director, as the case may be, appointed under sub-section (1) of section 49;



- (l) **“Financial institution”** means a financial institution as defined in clause (C) of section 45-I of the Reserve Bank of India Act, 1934 and includes a chit fund company, a housing finance institution, an authorized person, a payment system operator, a non-banking financial company and the Department of Posts in the GOI.
- (m) **“Housing finance institution”** shall have the meaning as assigned to it in clause (d) of section 2 of the National Housing Bank Act, 1987;
- (n) **“Intermediary”** means —
- (i) a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee to a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser or any other intermediary associated **with** securities market and registered under section 12 of the Securities and Exchange Board of India Act, 1992; or
  - (ii) an association recognised or registered under the Forward Contracts (Regulation) Act, 1952 or any member of such association; or
  - (iii) intermediary registered by the Pension Fund Regulatory and Development Authority; or
  - (iv) a recognised stock exchange referred to in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956;
- (o) **“Member”** means a Member of the Appellate Tribunal and includes the Chairperson;
- (p) “money-laundering” has the meaning assigned to it in section 3;
- (q) **“Non-banking financial company”** shall have the same meaning as assigned to it in clause (f) of section 45-I of the Reserve Bank of India Act, 1934.
- (r) **“Notification”** means a notification published in the Official Gazette;
- [(ra) **“Offence of cross border implications”**, means –
- (i) any conduct by a person at a place outside India which constitutes an offence at that place and which would have constituted an offence specified in Part A, Part B or Part C of the Schedule, had it been committed in India and if such person transfers in any manner the proceeds of such conduct or part thereof to India; or
  - (ii) any offence specified in Part A, Part B or Part C of the Schedule which has been committed in India and the proceeds of crime, or part thereof have been transferred to a place outside India or any attempt has been made to transfer the proceeds of crime, or part thereof from India to a place outside India.
- Explanation:-** Nothing contained in this clause shall adversely affect any investigation, enquiry, trial or proceeding before any authority in respect of the offences specified in Part A or Part B of the Schedule to the Act before the commencement of the Prevention of Money – Laundering (Amendment) Act 2009;
- (rb) **“Payment system”** means a system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them.
- Explanation-** For the purpose of this clause, “payment system” includes the systems enabling credit card operations, debit card operations, smart card operations, money transfer operations or similar operations;
- (rc) **“Payment system operator”** means a person who operates a payment system and such person includes his overseas principal.
- Explanation-** For the purpose of this clause, “overseas principal” means, -
- (A) In the case of a person, being an individual, such individual residing outside India, who owns or controls or manages, directly or indirectly, the activities or functions of payment system in India;

- (B) In the case of a Hindu undivided family, Karta of such Hindu undivided family residing outside India who owns or controls or manages, directly or indirectly, the activities or functions of payment system in India;
- (C) In the case of a company, a firm, an association of persons, a body of individuals, an artificial juridical person, whether incorporated or not, such company, firm, association of persons, body of individuals, artificial juridical person incorporated or registered outside India or existing as such and which owns or controls or manages, directly or indirectly, the activities or functions of payment system in India;]
- (s) **“Person”** includes;-
- (i) an individual
  - (ii) a Hindu undivided family,
  - (iii) a company,
  - (iv) firm,
  - (v) an association of persons or a body of individuals whether incorporated or not,
  - (vi) every artificial juridical person not falling within any of the preceding sub-clauses, and
  - (vii) any agency, office or branch owned or controlled by any of the above persons mentioned in the preceding sub-clauses;
- (sa) **“Person carrying on designated business or profession”** means,—
- (i) a person carrying on activities for playing games of chance for cash or kind, and includes such activities associated with casino;
  - (ii) a Registrar or Sub-Registrar appointed under section 6 of the Registration Act, 1908, as may be notified by the Central Government;
  - (iii) real estate agent, as may be notified by the Central Government;
  - (iv) dealer in precious metals, precious stones and other high value goods, as may be notified by the Central Government;
  - (v) person engaged in safekeeping and administration of cash and liquid securities on behalf of other persons, as may be notified by the Central Government; or
  - (vi) person carrying on such other activities as the Central Government may, by notification, so designate, from time to time.
- (sb) “precious metal” means gold, silver, platinum, palladium or rhodium or such other metal as may be notified by the Central Government.
- (sc) “precious stone” means diamond, emerald, ruby, sapphire or any such other stone as may be notified by the Central Government.
- (t) **“Prescribed”** means prescribed by rules made under this Act;
- (u) **“Proceeds of crime”** means any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property;
- (v) **“Property”** means any property or assets of every description, whether corporeal or incorporeal, movable or immovable, tangible or intangible and includes deeds and instruments evidencing title to, or interest in, such property or assets, wherever located;

**Explanation.**—For the removal of doubts, it is hereby clarified that the term “property” includes property of any kind used in the commission of an offence under this Act or any of the scheduled offences.



- (va) **“Real Estate Agent”** means a real estate agent as defined in clause (88) of section 65 of the Finance Act, 1994.
  - (w) **“Records”** include the records maintained in the form of books or stored in a computer or such other form as may be prescribed;
  - (wa) **“Reporting Entity”** means a banking company, financial institution, intermediary or a person carrying on a designated business or profession.
  - (x) **“Schedule”** means the Schedule to this Act;
  - (y) **“Scheduled offence”** means -
    - (i) the offences specified under Part A of the Schedule; or
    - [(ii) the offences specified under Part B of the Schedule if the total value involved in such offences is thirty lakh rupees or more; or
    - (iii) the offences specified under Part C of the Schedule.]
  - (z) **“Special Court”** means a Court of Session designated as Special Court under sub-section (1) of section 43;
  - (za) **“Transfer”** includes sale, purchase, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien.
  - (zb) **“Value”** means the fair market value of any property on the date of its acquisition by any person, or if such date cannot be determined, the date on which such property is possessed by such person.
- (2) Any reference, in this Act or the Schedule, to any enactment or any provision thereof shall, in relation to an area in which such enactment or such provision is not in force, be construed as a reference to the corresponding law or the relevant provisions of the corresponding law, if any, in force in that area.

### 6.2.1 What is Money Laundering?

Money Laundering is the generic term used to describe the process by which criminals disguise the original ownership and control of the proceeds of criminal conduct by making such process appear to have derived from the legitimate source. The term money laundering has not been defined in the Act any where, however, **Section 2** of the Act which defines various terms and expressions used in the Act in sub section (p) refer the meaning of money laundering to **section 3** of the Act.

**Section 3** of the Act says “Whosoever **directly or indirectly attempts to indulge or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money laundering**”. So we can say that activity or process by which tainted money of crime is projected as untainted property is money laundering. It is not necessary that the person should be directly involved in the process of legitimating the tainted money but also all those persons who assisted or were party to it or attempts to do will be guilty of money laundering activity.

## 6.3 PUNISHMENT FOR MONEY LAUNDERING

**Section 4** of the Act provide punishing of rigorous imprisonment ranging from 3 years to seven years for indulging in money laundering activity or process.

Where the proceeds of crime involved in money laundering relates to any offence specified under paragraph 2 of Part A of the schedule the maximum imprisonment can extend to 10 years instead of 7 years. Under paragraph 2 of Part A of the Schedule to the Act certain offences under various sections of the Narcotic Drugs Psychotropic Substances Act (NDPS), 1985 have been included for

which maximum imprisonment extend to 10 years. These offences includes contravention in relation to poppy straw(sec 15 of NDPS Act,1985,contravention in relation to coco plant and coca leaves(sec 16 of NDPS),contravention in relation to prepared opium(sec 17 of NDPS), contravention in relation to opium poppy and opium etc.

In order to prevent the process of money laundering activities Director or any other officer not below the rank of Deputy Director appointed under **section 49** of the Act has power to order in writing to attach property provisionally for a period not exceeding 150 days from the date of order where he has reasons to believe that on the basis of material in his possession, that –

- (a) Any person is in possession of any proceeds of crime
- (b) Such person has been charged of having committed a scheduled offence and
- (c) Such proceeds of crime are likely to be concealed, transferred or dealt with in any manner which may result in frustrating any proceedings relating to confiscation of such proceed.

No such order of attachment can be made unless in relation to the scheduled offence a report has been forwarded to a Magistrate under section 173 of the Code of Criminal Procedure 1973 or a complaint has been filed by a person, authorized to investigate the offence mentioned in the schedule, before a magistrate or court for taking cognizance of the scheduled offence as may be.

Despite attachment of the property the person interested in the property in the enjoyment of the immovable property attached under this Act. Interested person in relation to any immovable property includes all persons claiming or entitled to claim any interest in the property.

The officer attaching the property is required to file a complaint stating the fact of attachment of such property before the Adjudicating Authority within a period of 30 days from the date of such attachment.

In order to adjudicate the case of money laundering the Central Government shall by notification appoint an Adjudicating Authority to exercise jurisdiction powers and authority conferred by or under the Act. The Adjudicating Authority consists of a Chairman and two other members.

On receipt of complaint of attachment of the property of the proceeds of money laundering if the Adjudicating Authority has reasons to believe that any person has committed an offence under section 3 of the Act or is in possession of proceeds of crime, he may serve a notice of not less than 30 days on such person calling upon him to indicate the source of his income, earnings or assets out of which or by means of which he has acquired the property attached or seized under this Act., the evidence on which he relies and other relevant information and particulars and to show causes why all or any of such properties should not be declared to be the properties involved in money laundering and confiscated by the Central Government.

Where an order of confiscation has been made by the Special Court or the Adjudicating Authority in respect of any property of a person, all the rights and title in such property vests absolutely in the Central Government free from all encumbrances **(sec 9)**

Where the Adjudicating Authority is of the opinion that any encumbrance on the property or lease hold interest has been created with view to defeat the provisions of this Act, it may be order declare such encumbrances or lease hold interest to be void and thereupon the said property vest in the Central Government free from such encumbrances or lease hold interest.

Despite attachment of such property and vesting of its title with the Central Government, it does not discharge any person from any liability in respect of such encumbrances which may be enforced against such person by a suit of damages.

In order to manage the confiscated property the Central Government may by order published in the official gazette appoint as many of its officers not below the rank of Joint Secretary to the Government of India to perform the function of an Administrator.



The Administrator appointed by the Central Government is required to receive and manage the property in accordance with the rules made under this Act. He is also required to take such measures as the Central Government may direct to dispose of the property vested in the Central Government.

## 6.4 OBLIGATIONS OF BANKING COMPANIES, FINANCIAL INSTITUTIONS AND INTERMEDIARIES

### Reporting Entity to maintain Records [Section 12]

- (1) Every reporting entity shall—
  - (a) maintain a record of all transactions, including information relating to transactions covered under clause (b), in such manner as to enable it to reconstruct individual transactions;
  - (b) furnish to the Director within such time as may be prescribed, information relating to such transactions, whether attempted or executed, the nature and value of which may be prescribed;
  - (c) verify the identity of its clients in such manner and subject to such conditions, as may be prescribed;
  - (d) identify the beneficial owner, if any, of such of its clients, as may be prescribed;
  - (e) maintain record of documents evidencing identity of its clients and beneficial owners as well as account files and business correspondence relating to its clients.
- (2) Every information maintained, furnished or verified, save as otherwise provided under any law for the time being in force, shall be kept confidential.
- (5) The records referred to in clause (a) of sub-section (1) shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.
- (4) The records referred to in clause (e) of sub-section (1) shall be maintained for a period of five years after the business relationship between a client and the reporting entity has ended or the account has been closed, whichever is later.
- (5) The Central Government may, by notification, exempt any reporting entity or class of reporting entities from any obligation under this Chapter.

### Access to information [Section 12A]

- (1) The Director may call for from any reporting entity any of the records referred to in sub-section (1) of section 12 and any additional information as he considers necessary for the purposes of this Act.
- (2) Every reporting entity shall furnish to the Director such information as may be required by him under sub-section (1) within such time and in such manner as he may specify.
- (3) Save as otherwise provided under any law for the time being in force, every information sought by the Director under sub-section (1), shall be kept confidential.

### Powers of Director to impose fine (Sec 13)

- (1) The Director may, either of his own motion or on an application made by any authority, officer or person, "make such inquiry or cause such inquiry to be made, as he thinks fit to be necessary, with regard to the obligations of the reporting entity, under this Chapter.  
“(1A) If at any stage of inquiry or any other proceedings before him, the Director having regard to the nature and complexity of the case, is of the opinion that it is necessary to do so, he may direct the concerned reporting entity to get its records, as may be specified, audited by an accountant from amongst a panel of accountants, maintained by the Central Government for this purpose.  
(1B) The expenses of, and incidental to, any audit under sub-section (1A) shall be borne by the Central Government.”;

- (2) If the Director, in the course of any inquiry, finds that a reporting entity or its designated director on the Board or any of its employees has failed to comply with the obligations under this Chapter, then, without prejudice to any other action that may be taken under any other provisions of this Act, he may—
- (a) issue a warning in writing; or
  - (b) direct such reporting entity or its designated director on the Board or any of its employees, to comply with specific instructions; or
  - (c) direct such reporting entity or its designated director on the Board or any of its employees, to send reports at such interval as may be prescribed on the measures it is taking; or
  - (d) by an order, impose a monetary penalty on such reporting entity or its designated director on the Board or any of its employees, which shall not be less than ten thousand rupees but may extend to one lakh rupees for each failure.
- (3) The Director shall forward a copy of the order passed under sub-section (2) to every banking company, financial institution or intermediary or person who is a party to the proceedings under that sub-section.

**Explanation.**—For the purpose of this section, “accountant” shall mean a chartered accountant within the meaning of the Chartered Accountants Act, 1949.

**\*Section 73(2) (clause)** of the Act empowers the Central Government to make rules for carrying out the provisions of this Act. In pursuance of this power, the Central Government vide *GSR 444(E) dated 1st July 2005* notified the “The Prevention of Money Laundering (Maintenance of Records) Rules 2005 the prescribed value of transaction and nature of transaction required to be maintained by a Banking company, Financial Institution or Financial Intermediary are specified in rule 3 of the aforesaid rules. The value of all cash transactions is ₹10 lakh or its equivalent in foreign currency. In addition to all cash transactions records of all series of cash transactions integrally connected to each other which have been valued below ₹10 lakh or its equivalent in foreign currency where such series of transactions have taken place within a month are also required to be maintained **[Rule 3(b)]**

These records are to be maintained in the manner prescribed in **Rule 4** of the aforesaid Rules which includes information on—

- (a) Nature of the transactions;
- (b) The amount of the transaction and the currency in which it was denominated;
- (c) The date on which the transaction was conducted; and
- (d) The parties to the transaction.

The procedure and manner of maintaining the information are provided in **Rule 5**.

The information and records relating to such transactions are required to be maintained for a period of ten years from the date of transactions between the client and the banking company, financial institution or intermediary.

Every Banking Company, Financial Institution, Intermediary is required to communicate the name, designation and address of the Principal Officer to the Director.

It is the duty of every banking company, financial institution and intermediary to observe the procedure and the manner of furnishing the information.



### Furnishing of information to the director

S. No	Officer concerned	Institutions	Nature of transactions	When to report	Report to whom	Due date
1	Principal officer	Banking company, a financial institution, an intermediary	Referred to in clause (A),(B) and (BA) of sub-rule (1) of rule 3	Every month	Director	By 15th day of the succeeding month
2	Principal officer	Banking company, a financial institution, an intermediary	Referred to in clause (C) of sub-rule (1) of rule 3	Date of occurrence of such transaction	Director ( in writing or by fax or by electronic mail)	Not later than seven working days from date of occurrence
3	Principal officer	Banking company, a financial institution, an intermediary	Referred to in clause (D) of sub-rule (1) of rule 3	On being satisfied that the transaction is suspicious	Director ( in writing or by fax or by electronic mail)	Not later than seven working days on being satisfied of suspicion

As per **Rule 9**, every banking company, financial institution is required to verify the identity of clients and obtain information on the purpose and intended nature of business relationship, and in all other cases, verify identity while carrying out –

- (i) transactions of amount equal to or exceeding rupees fifty thousand, whether conducted as a single transaction or several transactions that appear to be connected, **or**
- (ii) any international money transfer operations.

As per **Rule 10**, every banking company, or financial institution or intermediary is required to maintain a record of identity of its clients in both hard and soft copies.

The record of identity of the client is required to be maintained for a time period of 10 years counting from the date of ceases of the transaction between the client and the banking company or financial institution or intermediary.

Financial institutions like banks, insurance companies, stock markets, etc are most vulnerable to money laundering activities of criminals and other anti social elements and therefore the need to insulate these institutions from the effect of laundered money. This is intended to be achieved by implementation of Know Your Customers (KYC) policy, and Customer Due Diligence guidelines across the financial sector. KYC instructions have been issued by the RBI to all the Banking companies, Financial Institutions and Intermediary to verify the identity of the clients and track the suspicious movement of illegitimate funds

The objective of KYC and CDD guidelines is to enable the managers to examine and assess their customer's financial dealings from anti-money laundering perspective, so as to make a proper risk assessment for preventing the tainted money from entering the institution and report the suspicious transaction immediately.

Formulation of KYC and CDD Guidelines and procedures specifying the objective of KYC framework by regulators like the RBI, the SEBI and IRDA are designed for appropriate customer identification, and to monitor transactions of suspicious nature. Risk Management and Monitoring Procedures have been specifically stated for having a system at ground level to exercise caution against the transaction suspected to be involving laundered money and for its identification and reporting to the FIU-IND through periodic reports.

Regulatory authorities on the basis of these guidelines and requirements under PMLA have issued instructions on KYC & CDD, to give proper effect to the said law in the financial sector. As already stated above as per the guidelines issued, financial institutions should undertake CDD measures, for establishing the identity of the customer by proper verification, particularly when initiating business relation, or carrying out occasional transaction, beyond the applicable threshold limit, or when there is a suspicion of money laundering or terrorist financing, or there is a doubt about the veracity or adequacy of previously obtained customer identification data.

Compliance with these standards of KYC and CDD by the financial institutions has been made mandatory through instructions issued by concerned regulators. These guidelines are essentially in the nature of filters having been introduced, and being operated at all the important entry points to the economy like bank, insurance, stock market. Penal provisions have made in the Act in case the Banks and Financial Institutions fails to maintain proper record of the client and send required information to the Regulating Agency.

As the offence of money laundering is a serious offence threatening not only the financial health of the country but also its integrity and unity, the Central Government has been mandated vide **section 43** of the Act to constitute special courts in consultation with the Chief Justice of High Court for speedy trial of money laundering cases.

In order to prevent vexatious search in the garb of preventing money laundering, any authority or officer exercising powers under this Act or any rules made there under, who without reasons recorded in writing-searches or cause to be searched any building or place or detains or searches or arrests any person, shall for every such offence be liable on conviction for imprisonment for a term which may extend to two years or fine which may extend to fifty thousand rupee or both.

#### **No Civil or Criminal Proceedings against reporting entity (Sec 14)**

Section 14 of the Prevention of Money Laundering Act, 2002 gives immunity to reporting entities against civil or criminal proceedings for furnishing information. Section 14 states,

"Save as otherwise provided in section 13, the reporting entity, its directors and employees shall not be liable to any civil or criminal proceedings against them for furnishing information under clause (b) of sub-section (1) of section 12."

### **6.5 BURDEN OF PROOF (SEC 24)**

#### **Burden of Proof [Section 24]**

In any proceeding relating to proceeds of crime under this Act,—

- (a) in the case of a person charged with the offence of money-laundering under section 3, the Authority or Court shall, unless the contrary is proved, presume that such proceeds of crime are involved in money-laundering; and
- (b) in the case of any other person the Authority or Court, may presume that such proceeds of crime are involved in money-laundering.

### **6.6 APPELLATE TRIBUNAL**

#### **Appeal to Appellate Tribunal [Sec 26]**

- (1) Save as otherwise provided in sub-section (3), the Director or any person aggrieved by an order made by the Adjudicating Authority under this Act, may prefer an appeal to the Appellate Tribunal.



- (2) Any reporting entity aggrieved by any order of the Director made under sub-section (2) of section 13, may prefer an appeal to the Appellate Tribunal.
- (3) Every appeal preferred under sub-section (1) or sub-section (2) shall be filed within a period of forty-five days from the date on which a copy of the order made by the Adjudicating Authority or Director is received and it shall be in such form and be accompanied by such fee as may be prescribed: Provided that the Appellate Tribunal may, after giving an opportunity of being heard, entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.
- (4) On receipt of an appeal under sub-section (1) or sub-section (2), the Appellate Tribunal may, after giving the parties to the appeal an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.
- (5) The Appellate Tribunal shall send a copy of every order made by it to the parties to the appeal and to the concerned Adjudicating Authority or the Director, as the case may be.
- (6) The appeal filed before the Appellate Tribunal under sub-section (1) or sub-section (2) shall be dealt with by it as expeditiously as possible and endeavor shall be made by it to dispose of the appeal finally within six months from the date of filing of the appeal.

#### **Procedure and powers of Appellate Tribunal (Sec 35)**

- (1) The Appellate Tribunal shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act, the Appellate Tribunal shall have powers to regulate its own procedure.
- (2) The Appellate Tribunal shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908) while trying a suit, in respect of the following matters, namely:-
  - (a) summoning and enforcing the attendance of any person and examining him on oath;
  - (b) requiring the discovery and production of documents;
  - (c) receiving evidence on affidavits;
  - (d) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872 (1 of 1872), requisitioning any public record or document or copy of such record or document from any office;
  - (e) issuing commissions for the examination of witnesses or documents;
  - (f) reviewing its decisions;
  - (g) dismissing a representation for default or deciding it ex parte;
  - (h) setting aside any order of dismissal of any representation for default or any order passed by it ex parte; and
  - (i) any other matter, which may be, prescribed by the Central Government.
- (3) An order made by the Appellate Tribunal under this Act shall be executable by the Appellate Tribunal as a decree of civil court and, for this purpose; the Appellate Tribunal shall have all the powers of a civil court.
- (4) Notwithstanding anything contained in sub-section (3), the Appellate Tribunal may transmit any order made by it to a civil court having local jurisdiction and such civil court shall execute the order as if it were a decree made by that court.

- (5) All proceedings before the Appellate Tribunal shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Indian Penal Code (45 of 1860) and the Appellate Tribunal shall be deemed to be a civil court for the purposes of sections 345 and 346 of the Code of Criminal Procedure, 1973 (2 of 1974).

**Right of appellant to take assistance of authorized representative and of Government to appoint presenting officers. (Sec 39)**

- (1) A person preferring an appeal to the Appellate Tribunal under this Act may either appear in person or take the assistance of an authorised representative of his choice to present his case before the Appellate Tribunal.

Explanation.-For the purposes of this sub-section, the expression "authorised representative" shall have the same meaning as assigned to it under sub-section (2) of section 288 of the Income-tax Act, 1961 (43 of 1961).

- (2) The Central Government or the Director may authorise one or more authorised representatives or any of its officers to act as presenting officers and every person so authorised may present the case with before the Appellate Tribunal. Members, etc., to be public servants.

**Civil court not to have jurisdiction (Sec 41)**

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Director, an Adjudicating Authority or the Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

**Appeal to High Court (Sec 42)**

Any person aggrieved by any decision or order of the Appellate Tribunal may file an appeal to the High Court within sixty days from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law or fact arising out of such order: Provided that the High Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

**Explanation.-** For the purposes of this section, "High Court" means-

- (i) the High Court within the jurisdiction of which the aggrieved party ordinarily resides or carries on business or personally works for gain; and
- (ii) where the Central Government is the aggrieved party, the High Court within the jurisdiction of which the respondent, or in a case where there are more than one respondent, any of the respondents, ordinarily resides or carries on business or personally works for gain.

**Special Courts(Sec 43)**

- (1) The Central Government, in consultation with the Chief Justice of the High Court, shall, for trial of offence punishable under section 4, by notification, designate one or more Courts of Session as Special Court or Special Courts or such area or areas or for such case or class or group of cases as may be specified in the notification.

**Explanation-** In this sub-section, "High Court" means the High Court of the State in which a Session Court designated as Special Court was functioning immediately before such designation.

- (2) While trying an offence under this Act, a Special Court shall also try an offence, other than an offence referred to in sub-section (1), with which the accused may, under the Code of Criminal Procedure, 1973 (2 of 1974), be charged at the same trial.



## 6.7 OFFENCES TO BE COGNIZABLE AND NON-BAILABLE.(SEC 45)

[(1) Notwithstanding anything contained in the Code of Criminal Procedure, 1973 (2 of 1974), no person accused of an offence punishable for a term of imprisonment of more than three years under Part A of the Schedule shall be released on bail or on his own bond unless:-

- (i) the Public Prosecutor has been given an opportunity to oppose the application for such release; and
- (ii) where the Public Prosecutor opposes the application, the court is satisfied that there are reasonable grounds for believing that he is not guilty of such offence and that he is not likely to commit any offence while on bail:

Provided that a person, who, is under the age of sixteen years, or is a woman or is sick or infirm, may be released on bail, if the Special Court so directs:

Provided further that the Special Court shall not take cognizance of any offence punishable under section 4 except upon a complaint in writing made by-

- (i) the Director; or
- (ii) any officer of the Central Government or a State Government authorised in writing in this behalf by the Central Government by a general or special order made in this behalf by that Government.

[(1A) Notwithstanding anything contained in the Code of Criminal Procedure, 1973 (2 of 1974), or any other provision of this Act, no police officer shall investigate into an offence under this Act unless specifically authorised, by the Central Government by a general or special order, and, subject to such conditions as may be prescribed."]

[(2) The limitation on granting of bail specified in sub-section (1) is in addition to the limitations under the Code of Criminal Procedure, 1973 (2 of 1974) or any other law for the time being in force on granting of bail.]

### **AUTHORITIES UNDER ACT (Sec 48)**

There shall be the following classes of authorities for the purposes of this Act, namely:-

- (a) Director or Additional Director or Joint Director, (b) Deputy Director, (c) Assistant Director, and (d) such other class of officers as may be appointed for the purposes of this Act.

### **OFFENCES BY COMPANIES (Sec 70)**

(1) Where a person committing a contravention of any of the provisions of this Act or of any rule, direction or order made there under is a company, every person who, at the time the contravention was committed, was in charge of and was responsible to the company, for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly:

Such person shall not be liable to punishment if he proves that the contravention took place without his knowledge or that he exercised all due diligence to prevent such contravention.

(2) Notwithstanding anything contained in sub-section (1), where a contravention of any of the provisions of this Act or of any rule, direction or order made there under has been committed by a company and it is proved that the contravention has taken place with the consent or connivance of, or is attributable to any neglect on the part of any director, manager, secretary or other officer of any company, such director, manager, secretary or other officer shall also be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly.

**Explanation 1** - For the purposes of this section,-

- (i) "company" means anybody corporate and includes a firm or other association of individuals; and
- (ii) "director", in relation to a firm, means a partner in the firm.

**Explanation 2** - For the removal of doubts, it is hereby clarified that a company may be prosecuted, notwithstanding whether the prosecution or conviction of any legal juridical person shall be contingent on the prosecution or conviction of any individual.

**Let Us Recapitulate:**

- The act of money laundering has been criminalized in India through the enactment of the Prevention of Money Laundering Act, 2002.
- Section 4 of the Act provide punishing of rigorous imprisonment ranging from 3 years to seven years for indulging in money laundering activity or process.
- Formulation of KYC and CDD Guidelines and procedures specifying the objective of KYC framework by regulators like the RBI, the SEBI and IRDA are designed for appropriate customer identification, and to monitor transactions of suspicious nature.
- When a person is accused of having committed the offence under section 3, the burden of proving that proceeds of crime are untainted property shall be on the accused.
- Right of appellant to take assistance of authorized representative and of Government to appoint presenting officers.
- Offences by companies are dealt in Section 70 of the Act.



# **Section B**

## **Corporate Laws and Governance**





# Study Note - 7

## ESSENTIALS OF CORPORATE LAWS



### This Study Note includes

- 7.1 Incorporation of Company and Matters Incidental Thereto
- 7.2 Prospectus and Allotment of Securities
- 7.3 Private Placement
- 7.4 Audit and Auditors
- 7.5 Appointment and Qualifications of Directors
- 7.6 Meetings of Board and its Powers
- 7.7 Appointment and Remuneration of Managerial Personnel
- 7.8 Companies Incorporated Outside India

### DEFINITIONS UNDER COMPANIES ACT, 2013

#### Short Title, Extent, Commencement and Application [Section 1]

- (1) This Act may be called the Companies Act, 2013.
- (2) It extends to the whole of India.
- (3) This section shall come into force at once and the remaining provisions of this Act shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint and different dates may be appointed for different provisions of this Act and any reference in any provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.
- (4) The provisions of this Act shall apply to—
  - (a) companies incorporated under this Act or under any previous company law;
  - (b) insurance companies, except in so far as the said provisions are inconsistent with the provisions of the Insurance Act, 1938 or the Insurance Regulatory and Development Authority Act, 1999;
  - (c) banking companies, except in so far as the said provisions are inconsistent with the provisions of the Banking Regulation Act, 1949;
  - (d) companies engaged in the generation or supply of electricity, except in so far as the said provisions are inconsistent with the provisions of the Electricity Act, 2003;
  - (e) any other company governed by any special Act for the time being in force, except in so far as the said provisions are inconsistent with the provisions of such special Act; and
  - (f) such body corporate, incorporated by any Act for the time being in force, as the Central Government may, by notification, specify in this behalf, subject to such exceptions, modifications or adaptation, as may be specified in the notification.

#### Definitions [Section 2]

In this Act, unless the context otherwise requires,—

- (1) “Abridged Prospectus” means a memorandum containing such salient features of a prospectus as may be specified by the Securities and Exchange Board by making regulations in this behalf;

- (2) "Accounting Standards" means the standards of accounting or any addendum thereto for companies or class of companies referred to in section 133;
- (3) "Alter" or "Alteration" includes the making of additions, omissions and substitutions;
- (4) "Appellate Tribunal" means the National Company Law Appellate Tribunal constituted under section 410;
- (5) "Articles" means the articles of association of a company as originally framed or as altered from time to time or applied in pursuance of any previous company law or of this Act;
- (6) "Associate Company", in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.  
**Explanation.**—For the purposes of this clause, "significant influence" means control of at least twenty per cent of total share capital, or of business decisions under an agreement;
- (7) "Auditing Standards" means the standards of auditing or any addendum thereto for companies or class of companies referred to in sub-section (10) of section 143;
- (8) "Authorised Capital" or "nominal capital" means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company;
- (9) "Banking Company" means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (10) "Board of Directors" or "Board", in relation to a company, means the collective body of the directors of the company;
- (11) "Body Corporate" or "Corporation" includes a company incorporated outside India, but does not include—
  - (i) a co-operative society registered under any law relating to co-operative societies; and
  - (ii) any other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf;
- (12) "Book and Paper" and "book or paper" include books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form;
- (13) "Books of Account" includes records maintained in respect of—
  - (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
  - (ii) all sales and purchases of goods and services by the company;
  - (iii) the assets and liabilities of the company; and
  - (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;
- (14) "Branch Office", in relation to a company, means any establishment described as such by the company;
- (15) "Called-up capital" means such part of the capital, which has been called for payment;
- (16) "Charge" means an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage;
- (17) "Chartered Accountant" means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 who holds a valid certificate of practice under sub-section (1) of section 6 of that Act;
- (18) "Chief Executive Officer" means an officer of a company, who has been designated as such by it;



- (19) "Chief Financial Officer" means a person appointed as the Chief Financial Officer of a company;
- (20) "Company" means a company incorporated under this Act or under any previous company law;
- (21) "Company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up;
- (22) "Company limited by shares" means 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;
- (23) "Company Liquidator", in so far as it relates to the winding up of a company, means a person appointed by—
- (a) the Tribunal in case of winding up by the Tribunal; or
  - (b) the company or creditors in case of voluntary winding up, as a Company Liquidator from a panel of professionals maintained by the Central Government under sub-section (2) of section 275;
- (24) "Company Secretary" or "secretary" means a company secretary as defined in clause (c) of sub-section (1) of section 2 of the Company Secretaries Act, 1980 who is appointed by a company to perform the functions of a company secretary under this Act;
- (25) "Company Secretary in practice" means a company secretary who is deemed to be in practice under sub-section (2) of section 2 of the Company Secretaries Act, 1980;
- (26) "Contributory" means a person liable to contribute towards the assets of the company in the event of its being wound up.
- Explanation** — For the purposes of this clause, it is hereby clarified that a person holding fully paid-up shares in a company shall be considered as a contributory but shall have no liabilities of a contributory under the Act whilst retaining rights of such a contributory;
- (27) "Control" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner;
- (28) "Cost Accountant" means a cost accountant as defined in clause (b) of subsection (1) of section 2 of the Cost and Works Accountants Act, 1959;
- (29) "Court" means—
- (i) the High Court having jurisdiction in relation to the place at which the registered office of the company concerned is situate, except to the extent to which jurisdiction has been conferred on any district court or district courts subordinate to that High Court under sub-clause (ii);
  - (ii) the district court, in cases where the Central Government has, by notification, empowered any district court to exercise all or any of the jurisdictions conferred upon the High Court, within the scope of its jurisdiction in respect of a company whose registered office is situate in the district;
  - (iii) the Court of Session having jurisdiction to try any offence under this Act or under any previous company law;
  - (iv) the Special Court established under section 435;
  - (v) any Metropolitan Magistrate or a Judicial Magistrate of the First Class having jurisdiction to try any offence under this Act or under any previous company law;
- (30) "Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not;

- (31) "Deposit" includes any receipt of money by way of deposit or loan or in any other form by a company, but does not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India;
- (32) "Depository" means a depository as defined in clause (e) of sub-section (1) of section 2 of the Depositories Act, 1996;
- (33) "Derivative" means the derivative as defined in clause (ac) of section 2 of the Securities Contracts (Regulation) Act, 1956;
- (34) "Director" means a director appointed to the Board of a company;
- (35) "Dividend" includes any interim dividend;
- (36) "Document" includes summons, notice, requisition, order, declaration, form and register, whether issued, sent or kept in pursuance of this Act or under any other law for the time being in force or otherwise, maintained on paper or in electronic form;
- (37) "Employees' Stock Option" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price;
- (38) "Expert" includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force;
- (39) "Financial Institution" includes a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934;
- (40) "Financial Statement" in relation to a company, includes—
- (i) a balance sheet as at the end of the financial year;
  - (ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
  - (iii) cash flow statement for the financial year;
  - (iv) a statement of changes in equity, if applicable; and
  - (v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):
- Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement;
- (41) "Financial Year", in relation to any company or body corporate, means the period ending on the 31st day of March every year, and where it has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up:
- Provided that on an application made by a company or body corporate, which is a holding company or a subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year:
- Provided further that a company or body corporate, existing on the commencement of this Act, shall, within a period of two years from such commencement, align its financial year as per the provisions of this clause;
- (42) "Foreign Company" means any company or body corporate incorporated outside India which—
- (a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and
  - (b) conducts any business activity in India in any other manner.



- (43) "Free Reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:  
Provided that—
- (i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or
  - (ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves;
- (44) "Global Depository Receipt" means any instrument in the form of a depository receipt, by whatever name called, created by a foreign depository outside India and authorised by a company making an issue of such depository receipts;
- (45) "Government Company" means any company in which not less than fifty-one per cent. of the 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 company of such a Government company;
- (46) "Holding Company", in relation to one or more other companies, means a company of which such companies are subsidiary companies;
- (47) "Independent Director" means an independent director referred to in sub-section (5) of section 149;
- (48) "Indian Depository Receipt" means any instrument in the form of a depository receipt created by a domestic depository in India and authorised by a company incorporated outside India making an issue of such depository receipts;
- (49) "Interested Director" means a director who is in any way, whether by himself or through any of his relatives or firm, body corporate or other association of individuals in which he or any of his relatives is a partner, director or a member, interested in a contract or arrangement, or proposed contract or arrangement, entered into or to be entered into by or on behalf of a company;
- (50) "Issued Capital" means such capital as the company issues from time to time for subscription;
- (51) "Key Managerial Personnel", in relation to a company, means—
- (i) the Chief Executive Officer or the managing director or the manager;
  - (ii) the Company Secretary;
  - (iii) the Whole-time Director;
  - (iv) the Chief Financial Officer; and
  - (v) such other officer as may be prescribed;
- (52) "Listed Company" means a company which has any of its securities listed on any recognised stock exchange;
- (53) "Manager" means an individual who, subject to the superintendence, control and direction of the Board of Directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, whether under a contract of service or not;
- (54) "Managing Director" means a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called.

**Explanation** — For the purposes of this clause, the power to do administrative acts of a routine nature when so authorised by the Board such as the power to affix the common seal of the

company to any document or to draw and endorse any cheque on the account of the company in any bank or to draw and endorse any negotiable instrument or to sign any certificate of share or to direct registration of transfer of any share, shall not be deemed to be included within the substantial powers of management;

- (55) "Member", in relation to a company, means—
- (i) the subscriber to the memorandum of the company who shall be deemed to have agreed to become member of the company, and on its registration, shall be entered as member in its register of members;
  - (ii) every other person who agrees in writing to become a member of the company and whose name is entered in the register of members of the company;
  - (iii) every person holding shares of the company and whose name is entered as a beneficial owner in the records of a depository;
- (56) "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 law or of this Act;
- (57) "Net Worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation;
- (58) "Notification" means a notification published in the Official Gazette and the expression "notify" shall be construed accordingly;
- (59) "Officer" includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act;
- (60) "Officer who is in default", for the purpose of any provision in this Act which enacts that an officer of the company who is in default shall be liable to any penalty or punishment by way of imprisonment, fine or otherwise, means any of the following officers of a company, namely:—
- (i) whole-time director;
  - (ii) key managerial personnel;
  - (iii) where there is no key managerial personnel, such director or directors as specified by the Board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all the directors, if no director is so specified;
  - (iv) any person who, under the immediate authority of the Board or any key managerial personnel, is charged with any responsibility including maintenance, filing or distribution of accounts or records, authorises, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default;
  - (v) any person in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act, other than a person who gives advice to the Board in a professional capacity;
  - (vi) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance;
  - (vii) in respect of the issue or transfer of any shares of a company, the share transfer agents, registrars and merchant bankers to the issue or transfer;
- (61) "Official Liquidator" means an Official Liquidator appointed under sub-section (1) of section 359;
- (62) "One Person Company" means a company which has only one person as a member;



- (63) "Ordinary or special resolution" means an ordinary resolution, or as the case may be, special resolution referred to in section 114;
- (64) "Paid-up share capital" or "share capital paid-up" means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called;
- (65) "Postal Ballot" means voting by post or through any electronic mode;
- (66) "Prescribed" means prescribed by rules made under this Act;
- (67) "Previous Company Law" means any of the laws specified below:—
- (i) Acts relating to companies in force before the Indian Companies Act, 1866;
  - (ii) the Indian Companies Act, 1866;
  - (iii) the Indian Companies Act, 1882;
  - (iv) the Indian Companies Act, 1913;
  - (v) the Registration of Transferred Companies Ordinance, 1942;
  - (vi) the Companies Act, 1956; and
  - (vii) any law corresponding to any of the aforesaid Acts or the Ordinances and in force—
    - (A) in the merged territories or in a Part B State (other than the State of Jammu and Kashmir), or any part thereof, before the extension thereto of the Indian Companies Act, 1913; or
    - (B) in the State of Jammu and Kashmir, or any part thereof, before the commencement of the Jammu and Kashmir (Extension of Laws) Act, 1956, in so far as banking, insurance and financial corporations are concerned, and before the commencement of the Central Laws (Extension to Jammu and Kashmir) Act, 1968, in so far as other corporations are concerned;
  - (viii) the Portuguese Commercial Code, in so far as it relates to sociedades anonimas; and
  - (ix) the Registration of Companies (Sikkim) Act, 1961;
- (68) "Private Company" means a company having a minimum paid-up share capital as may be prescribed, and which by its articles,—
- (i) restricts the right to transfer its shares;
  - (ii) except in case of One Person Company, limits the number of its members to two hundred:
- Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member:
- Provided further that—
- (A) persons who are in the employment of the company; and
  - (B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased,
- shall not be included in the number of members; and
- (iii) prohibits any invitation to the public to subscribe for any securities of the company;
- (69) "Promoter" means a person—
- (a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or

(b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

(c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act:

Provided that nothing in sub-clause (c) shall apply to a person who is acting merely in a professional capacity;

(70) "Prospectus" means any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate;

(71) "Public Company" means a company which—

(a) is not a private company;

(b) has a minimum paid-up share capital as may be prescribed:

Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles ;

(72) "Public Financial Institution" means—

(i) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956;

(ii) the Infrastructure Development Finance Company Limited, referred to in clause (vi) of sub-section (1) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;

(iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002;

(iv) institutions notified by the Central Government under sub-section (2) of section 4A of the Companies Act, 1956 so repealed under section 465 of this Act;

(v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

Provided that no institution shall be so notified unless—

(A) it has been established or constituted by or under any Central or State Act; or

(B) not less than fifty-one per cent. of the paid-up share capital is held or controlled 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;

(73) "Recognised Stock Exchange" means a recognised stock exchange as defined in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956;

(74) "Register of companies" means the register of companies maintained by the Registrar on paper or in any electronic mode under this Act;

(75) "Registrar" means a Registrar, an Additional Registrar, a Joint Registrar, a Deputy Registrar or an Assistant Registrar, having the duty of registering companies and discharging various functions under this Act;

(76) "Related party", with reference to a company, means—

(i) a director or his relative;

(ii) a key managerial personnel or his relative;



- (iii) a firm, in which a director, manager or his relative is a partner;
- (iv) a private company in which a director or manager is a member or director;
- (v) a public company in which a director or manager is a director or holds along with his relatives, more than two per cent. of its paid-up share capital;
- (vi) anybody corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
- (vii) any person on whose advice, directions or instructions a director or manager is accustomed to act:

Provided that nothing in sub-clauses (vi) and (vii) shall apply to the advice, directions or instructions given in a professional capacity;

- (viii) any company which is—
    - (A) a holding, subsidiary or an associate company of such company; or
    - (B) a subsidiary of a holding company to which it is also a subsidiary;
  - (ix) such other person as may be prescribed;
- (77) "Relative", with reference to any person, means anyone who is related to another, if—
- (i) they are members of a Hindu Undivided Family;
  - (ii) they are husband and wife; or
  - (iii) one person is related to the other in such manner as may be prescribed;
- (78) "Remuneration" means any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income-tax Act, 1961;
- (79) "Schedule" means a Schedule annexed to this Act;
- (80) "Scheduled Bank" means the scheduled bank as defined in clause (e) of section 2 of the Reserve Bank of India Act, 1934;
- (81) "Securities" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956;
- (82) "Securities and Exchange Board" means the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992;
- (83) "Serious Fraud Investigation Office(SFIO)" means the office referred to in section 211;
- (84) "Share" means a share in the share capital of a company and includes stock;
- (85) "Small company" means a company, other than a public company,—
- (i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; or
  - (ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees;
- Provided that nothing in this clause shall apply to—
- (A) a holding company or a subsidiary company;
  - (B) a company registered under section 8; or
  - (C) a company or body corporate governed by any special Act;
- (86) "Subscribed Capital" means such part of the capital which is for the time being subscribed by the members of a company;
- (87) "Subsidiary Company" or "subsidiary", in relation to any other company (that is to say the holding

company), means a company in which the holding company—

- (i) controls the composition of the Board of Directors; or
- (ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

**Explanation** — For the purposes of this clause,—

- (a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;
- (b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;
- (c) the expression "company" includes any body corporate;
- (d) "layer" in relation to a holding company means its subsidiary or subsidiaries;

**General Circular No. 20/2013**

**Clarification with regard to holding of shares or exercising power in a fiduciary capacity - Holding and Subsidiary relationship under Section 2(87) of the Companies Act, 2013.**

It is hereby clarified that the shares held by a company or power exercisable by it in another company in a 'fiduciary capacity' shall not be counted for the purpose of determining the holding-subsidiary relationship in terms of the provision of section 2(87) of the Companies Act, 2013.

**General Circular No. 24/2014**

**Clarification with regard to holding of shares in a fiduciary capacity by associate company under section 2(6) of the Companies Act, 2013.**

In continuation of the General circular No. 20/2013 dated 27/12/2013, it is clarified that the shares held by a company in another company in a 'fiduciary capacity' shall not be counted for the purpose of determining the relationship of 'associate company' under section 2(6) of the Companies Act, 2013.

**General Circular No. 23/2014**

**Clarification relating to incorporation of a company i.e. company incorporated outside India.**

It is clarified that there is no bar in the new Act for a company incorporated outside India to incorporate a subsidiary either as a public company or a private company. An existing company, being a subsidiary of a company incorporated outside India, registered under the Companies Act, 1956, either as private company or a public company by virtue of section 4(7) of that Act, will continue as a private company or public company as the case may be, without any change in the incorporation status of such company.

- (88) "Sweat Equity Shares" means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called;
- (89) "Total voting power", in relation to any matter, means the total number of votes which may be cast in regard to that matter on a poll at a meeting of a company if all the members thereof or their proxies having a right to vote on that matter are present at the meeting and cast their votes;
- (90) "Tribunal" means the National Company Law Tribunal constituted under section 408;
- (91) "Turnover" means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year;



- (92) “Unlimited company” means a company not having any limit on the liability of its members;
- (93) “Voting right” means the right of a member of a company to vote in any meeting of the company or by means of postal ballot;
- (94) “Whole-time director” includes a director in the whole-time employment of the company;
- (95) words and expressions used and not defined in this Act but defined in the Securities Contracts (Regulation) Act, 1956 or the Securities and Exchange Board of India Act, 1992 or the Depositories Act, 1996 shall have the meanings respectively assigned to them in those Acts.

### Some other Definitions

In exercise of the powers conferred under sub-clause (ix) of clause (76), sub-clause (iii) of clause (77) of section 2, read with sub-sections (1) and (2) of section 469 of the Companies Act, 2013, the Central Government has issued following definitions under the rules as notified by Notification G.S.R 238 (E) dated 31<sup>st</sup> March, 2014 -

### Definitions

(1) In these rules, unless the context otherwise requires,—

- (a) “Act” means the Companies Act, 2013 ;
- (b) “Certifying Authority” for the purpose of Digital Signature Certificate means a person who has been granted a licence to issue a Digital Signature Certificate under section 24 of the Information Technology Act, 2000 and the Certified Filing Center (CFC) under the Act;
- (c) “Digital Signature” means the digital signature as defined under clause (p) of sub-section (1) of section 2 of the Information Technology Act, 2000;
- (d) “Digital Signature Certificate” means a Digital Signature Certificate as defined under clause (q) of subsection (1) of section 2 of the Information Technology Act, 2000;
- (e) “Director Identification Number” (DIN) means an identification number allotted by the Central Government to any individual, intending to be appointed as director or to any existing director of a company, for the purpose of his identification as a director of a company;
- Provided that the Director Identification Number (DIN) obtained by the individuals prior to the notification of these rules shall be the DIN for the purpose of the Companies Act, 2013;
- Provided further that “Director Identification Number” (DIN) includes the Designated Partnership Identification Number (DPIN) issued under section 7 of the Limited Liability Partnership Act, 2008 and the rules made thereunder;
- (f) “e-Form” means a form in the electronic form as prescribed under the Act or the rules made thereunder and notified by the Central Government under the Act;
- (g) “Electronic Mail” means the message sent, received or forwarded in digital form using any electronic communication mechanism that the message so sent, received or forwarded is storable and retrievable;
- (h) “Electronic Mode”, for the purposes of clause (42) of section 2 of the Act, means carrying out electronically based, whether main server is installed in India or not, including, but not limited to -
- (i) business to business and business to consumer transactions, data interchange and other digital supply transactions;
  - (ii) offering to accept deposits or inviting deposits or accepting deposits or subscriptions in securities, in India or from citizens of India;
  - (iii) financial settlements, web based marketing, advisory and transactional services, database services and products, supply chain management;
  - (iv) online services such as telemarketing, telecommuting, telemedicine, education and information research; and
  - (v) all related data communication services,

whether conducted by e-mail, mobile devices, social media, cloud computing, document management, voice or data transmission or otherwise;

- (i) "Electronic Record" means the electronic record as defined under clause (t) of sub-section (1) of section 2 of the Information Technology Act, 2000;
  - (j) "Electronic Registry" means an electronic repository or storage system of the Central Government in which the information or documents are received, stored, protected and preserved in electronic form;
  - (k) "Executive Director" means a whole time director as defined in clause (94) of section 2 of the Act;
  - (l) "Fees" means the fees as specified in the Companies (Registration Offices and Fees) Rules, 2014;
  - (m) "Form" means a form set forth in the Act or the rules made thereunder which shall be used for the matter to which it relates;
  - (n) "Pre-fill" means the automated process of data input by the computer system from the database maintained in electronic registry of the Central Government;
  - (o) "Registrar's Front Office" means an office maintained by the Central Government or an agency authorised by it to facilitate e-filing of documents into the electronic registry and their inspection and viewing;
  - (p) "Regional Director" means the person appointed by the Central Government in the Ministry of Corporate Affairs as a Regional Director;
  - (q) "Section" means the section of the Act;
  - (r) "Total Share Capital", for the purposes of clause (6) and clause (87) of section 2, means the aggregate of the -
    - (a) paid-up equity share capital; and
    - (b) convertible preference share capital;
  - (s) For the purposes of clause (d) of sub-section (1) of Section 164 and clause (f) of sub-section (1) of section 167 of the Act, "or otherwise" means any offence in respect of which he has been convicted by a Court under this Act or the Companies Act, 1956;
- (2) The words and expressions used in these rules but not defined and defined in the Act or in (i) the Securities Contracts (Regulation) Act, 1956 or (ii) the Securities and Exchange Board of India Act, 1992 or (iii) the Depositories Act, 1996 or (iv) the Information Technology Act, 2000 or rules and regulations made thereunder shall have the meanings respectively assigned to them under the Act or those Acts.
- (3) **Related party** - For the purposes of sub-clause (ix) of clause (76) of section 2 of the Act, a director other than independent director or key managerial personnel of the holding company or his relative with reference to a company, shall be deemed to be a related party.
- (4) **List of relatives in terms of clause (77) of section 2** - A person shall be deemed to be the relative of another, if he or she is related to another in the following manner, namely:-
- (1) Father: Provided that the term "Father" includes step-father.
  - (2) Mother: Provided that the term "Mother" includes the step-mother.
  - (3) Son: Provided that the term "Son" includes the step-son.
  - (4) Son's wife.
  - (5) Daughter.
  - (6) Daughter's husband.
  - (7) Brother: Provided that the term "Brother" includes the step-brother;
  - (8) Sister: Provided that the term "Sister" includes the step-sister.



## 7.1 INCORPORATION OF COMPANY AND MATTERS INCIDENTAL THERETO

### 7.1.1 Formation of Company [Section 3]

- (1) A company may be formed for any lawful purpose by—
- (a) seven or more persons, where the company to be formed is to be a public company;
  - (b) two or more persons, where the company to be formed is to be a private company; or
  - (c) one person, where the company to be formed is to be One Person Company that is to say, a private company,

by subscribing their names or his name to a memorandum and complying with the requirements of this Act in respect of registration.

Provided that the memorandum of One Person Company shall indicate the name of the other person, with his prior written consent in the prescribed form, who shall, in the event of the subscriber's death or his incapacity to contract become the member of the company and the written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its memorandum and articles.

Provided further that such other person may withdraw his consent in such manner as may be prescribed.

Provided also that the member of One Person Company may at any time change the name of such other person by giving notice in such manner as may be prescribed.

Provided also that it shall be the duty of the member of One Person Company to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner as may be prescribed.

Provided also that any such change in the name of the person shall not be deemed to be an alteration of the memorandum.

- (2) A company formed under sub-section (1) may be either—
- (a) a company limited by shares; or
  - (b) a company limited by guarantee; or
  - (c) an unlimited company.

### 7.1.2 Nomination by the Subscriber or Member of One Person Company

The subscriber to the memorandum of a One Person Company shall nominate a person, after obtaining prior written consent of such person in the prescribed form, who shall, in the event of the subscriber's death or his incapacity to contract, become the member of that One Person Company and the written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its memorandum and articles.

The person nominated by the subscriber or member of a One Person Company may, withdraw his consent by giving a notice in writing to such sole member and to the One Person Company.

Provided that the sole member shall nominate another person as nominee within fifteen days of the receipt of the notice of withdrawal and shall send an intimation of such nomination in writing to the Company, along with the written consent of such other person so nominated.

Provided also that the member of One Person Company may at any time change the name of such other person by giving notice in such manner as may be prescribed.

Provided also that it shall be the duty of the member of One Person Company to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner as may be prescribed:

Provided also that any such change in the name of the person shall not be deemed to be an alteration of the memorandum.

### **7.1.3 Features of Incorporation of an One Person Company**

- (1) Only a natural person who is an Indian citizen and resident in India-
  - (a) shall be eligible to incorporate a One Person Company;
  - (b) shall be a nominee for the sole member of a One Person Company.

**Explanation.-** 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 calendar year.

- (2) No person shall be eligible to incorporate more than a One Person Company or become nominee in more than one such company.
- (3) Where a natural person, being member in One Person Company in accordance with this rule becomes a member in another such Company by virtue of his being a nominee in that One Person Company, such person shall meet the eligibility criteria specified in sub rule (2) within a period of one hundred and eighty days.
- (4) No minor shall become member or nominee of the One Person Company or can hold share with beneficial interest.
- (5) Such Company cannot be incorporated or converted into a company under section 8 of the Act.
- (6) Such Company cannot carry out Non-Banking Financial Investment activities including investment in securities of anybody corporate.
- (7) No such company can convert voluntarily into any kind of company unless two years have expired from the date of incorporation of One Person Company, except threshold limit (paid up share capital) is increased beyond fifty lakh rupees or its average annual turnover during the relevant period exceeds two crore rupees.

### **7.1.4 Effects of Failure to Comply with the Provision**

If One Person Company or any officer of such company contravenes the provisions relating to incorporation of One Person Company, One Person Company or any officer of the One Person Company shall be punishable with fine which may extend to ten thousand rupees and with a further fine which may extend to one thousand rupees for every day after the first during which such contravention continues.

### **7.1.5 One Person Company to Convert itself into a Public Company or a Private Company in Certain cases**

- (i) Where the paid up share capital of an One Person Company exceeds fifty lakh rupees or its average annual turnover during the relevant period exceeds two crore rupees, it shall cease to be entitled to continue as a One Person Company.



- (ii) Such One Person Company shall be required to convert itself, within six months of the date on which its paid up share capital is increased beyond fifty lakh rupees or the last day of the relevant period during which its average annual turnover exceeds two crore rupees as the case may be, into either a private company with minimum of two members and two directors or a public company with at least of seven members and three directors in accordance with the provisions of section 18 of the Act.
- (iii) The One Person Company shall alter its memorandum and articles by passing a resolution in accordance with sub-section (3) of section 122 of the Act to give effect to the conversion and to make necessary changes incidental thereto.
- (iv) The One Person Company shall within period of sixty days from the date of applicability of point (1), give a notice to the Registrar in Form No.INC. 5 informing that it has ceased to be a One Person Company and that it is now required to convert itself into a private company or a public company by virtue of its paid up share capital or average annual turnover, having exceeded the threshold limit laid down in point (1).  

Explanation.- "Relevant Period" means the period of immediately preceding three consecutive financial years;
- (v) If One Person Company or any officer of the One Person Company contravenes the provisions as stated above, One Person Company or any officer of the One Person Company shall be punishable with fine which may extend to ten thousand rupees and with a further fine which may extend to one thousand rupees for every day after the first during which such contravention continues.
- (vi) A One Person company can get itself converted into a Private or Public company after increasing the minimum number of members and directors to two or minimum of seven members and two or three directors as the case may be, and by maintaining the minimum paid-up capital as per requirements of the Act for such class of company and by making due compliance of section 18 of the Act for conversion.

#### **7.1.6 Conversion of Private Company into One Person Company**

- (i) A private company other than a company registered under section 8 of the Act having paid up share capital of fifty lakhs rupees or less or average annual turnover during the relevant period is two crore rupees or less may convert itself into one person company by passing a special resolution in the general meeting.
- (ii) Before passing such resolution, the company shall obtain No objection in writing from members and creditors.
- (iii) The one person company shall file copy of the special resolution with the Registrar of Companies within thirty days from the date of passing such resolution in Form No. MGT.14.
- (iv) The company shall file an application in Form No.INC.6 for its conversion into One Person Company along with fees as provided in in the Companies (Registration offices and fees) Rules, 2014, by attaching the following documents, namely:-
  - (a) The directors of the company shall give a declaration by way of affidavit duly sworn in confirming that all members and creditors of the company have given their consent for conversion, the paid up share capital company is fifty lakhs rupees or less or average annual turnover is less than two crores rupees, as the case may be;
  - (b) the list of members and list of creditors;
  - (c) the latest Audited Balance Sheet and the Profit and Loss Account; and
  - (d) the copy of No Objection letter of secured creditors.

- (v) On being satisfied and complied with requirements stated herein the Registrar shall issue the Certificate.

#### **7.1.7 Memorandum [Section 4]**

- (1) The memorandum of a company shall state—
  - (a) the name of the company with the last word "Limited" in the case of a public limited company, or the last words "Private Limited" in the case of a private limited company:  
Provided that nothing above shall apply to a company registered under section 8;
  - (b) the State in which the registered office of the company is to be situated;
  - (c) the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof;
  - (d) the liability of members of the company, whether limited or unlimited, and also state,—
    - (i) in the case of a company limited by shares, that liability of its members is limited to the amount unpaid, if any, on the shares held by them; and
    - (ii) in the case of a company limited by guarantee, the amount up to which each member undertakes to contribute—
      - (A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and
      - (B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves;
  - (e) in the case of a company having a share capital,—
    - (i) the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share; and
    - (ii) the number of shares each subscriber to the memorandum intends to take, indicated opposite his name;
  - (f) in the case of One Person Company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.
- (2) The name stated in the memorandum shall not—
  - (a) be identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or
  - (b) be such that its use by the company—
    - (i) will constitute an offence under any law for the time being in force; or
    - (ii) is undesirable in the opinion of the Central Government.
- (3) Without prejudice to the provisions of sub-section (2), a company shall not be registered with a name which contains—
  - (a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government, or any local authority, corporation or body constituted by the Central Government or any State Government under any law for the time being in force; or



- (b) such word or expression, as may be prescribed,  
unless the previous approval of the Central Government has been obtained for the use of any such word or expression.
- (4) A person may make an application, in such form and manner and accompanied by such fee, as may be prescribed, to the Registrar for the reservation of a name set out in the application as—
- (a) the name of the proposed company; or
- (b) the name to which the company proposes to change its name.
- (5) (i) Upon receipt of an application under sub-section (4), the Registrar may, on the basis of information and documents furnished along with the application, reserve the name for a period of sixty days from the date of the application.
- (ii) Where after reservation of name under clause (i), it is found that name was applied by furnishing wrong or incorrect information, then,—
- (a) if the company has not been incorporated, the reserved name shall be cancelled and the person making application under sub-section (4) shall be liable to a penalty which may extend to one lakh rupees;
- (b) if the company has been incorporated, the Registrar may, after giving the company an opportunity of being heard—
- (i) either direct the company to change its name within a period of three months, after passing an ordinary resolution;
- (ii) take action for striking off the name of the company from the register of companies; or
- (iii) make a petition for winding up of the company.
- (6) The memorandum of a company shall be in respective forms specified in Tables A, B, C, D and E in Schedule I as may be applicable to such company.
- (7) Any provision in the memorandum or articles, in the case of a company limited by guarantee and not having a share capital, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member, shall be void.

#### **7.1.8 Articles [Section 5]**

- (1) The articles of a company shall contain the regulations for management of the Articles. company.
- (2) The articles shall also contain such matters, as may be prescribed:  
Provided that nothing prescribed in this sub-section shall be deemed to prevent a company from including such additional matters in its articles as may be considered necessary for its management.
- (3) The articles may contain provisions for entrenchment to the effect that specified provisions of the articles may be altered only if conditions or procedures as that are more restrictive than those applicable in the case of a special resolution, are met or complied with.
- (4) The provisions for entrenchment referred to in sub-section (3) shall only be made either on formation of a company, or by an amendment in the articles agreed to by all the members of the company in the case of a private company and by a special resolution in the case of a public company.
- (5) Where the articles contain provisions for entrenchment, whether made on formation or by amendment, the company shall give notice to the Registrar of such provisions in such form and manner as may be prescribed.
- (6) The articles of a company shall be in respective forms specified in Tables, F, G, H, I and J in Schedule I as may be applicable to such company.

- (7) A company may adopt all or any of the regulations contained in the model articles applicable to such company.
- (8) In case of any company, which is registered after the commencement of this Act, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company.
- (9) Nothing in this section shall apply to the articles of a company registered under any previous company law unless amended under this Act.

#### **7.1.9 Act to Override Memorandum, Articles, etc. [Section 6]**

Save as otherwise expressly provided in this Act—

- (a) the provisions of this Act shall have effect notwithstanding anything to the contrary contained in the memorandum or articles of a company, or in any agreement executed by it, or in any resolution passed by the company in general meeting or by its Board of Directors, whether the same be registered, executed or passed, as the case may be, before or after the commencement of this Act; and
- (b) any provision contained in the memorandum, articles, agreement or resolution shall, to the extent to which it is repugnant to the provisions of this Act, become or be void, as the case may be.

#### **7.1.10 Affidavit from Subscribers and First Directors**

The affidavit shall be submitted by each of the subscribers to the memorandum and each of the first directors named in the articles in **Form No.INC.9**.

#### **7.1.11 Signing of Memorandum and Articles**

The Memorandum and Articles of Association of the company shall be signed in the following manner, namely:-

- (1) The memorandum and articles of association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any and the witness shall state that "I witness to subscriber/subscriber(s), who has/have subscribed and signed in my presence (date and place to be given); further I have verified his or their Identity Details (ID) for their identification and satisfied myself of his/her/their identification particulars as filled in".
- (2) Where a subscriber to the memorandum is illiterate, he shall affix his thumb impression or mark which shall be described as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature and he shall also write against the name of the subscriber, the number of shares taken by him.
- (3) Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.
- (4) Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorized in this behalf by a resolution of the board of directors of the body corporate and where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorized by a resolution approved by all the partners of the Limited Liability Partnership: Provided that in either case, the person so authorized shall not, at the same time, be a subscriber to the memorandum and articles of Association.



- (5) Where subscriber to the memorandum is a foreign national residing outside India-
- (a) in a country in any part of the Commonwealth, his signatures and address on the memorandum and articles of association and proof of identity shall be notarized by a Notary (Public) in that part of the Commonwealth.
  - (b) in a country which is a party to the Hague Apostille Convention, 1961, his signatures and address on the memorandum and articles of association and proof of identity shall be notarized before the Notary (Public) of the country of his origin and be duly apostilled in accordance with the said Hague Convention.
  - (c) in a country outside the Commonwealth and which is not a party to the Hague Apostille Convention, 1961, his signatures and address on the memorandum and articles of association and proof of identity, shall be notarized before the Notary (Public) of such country and the certificate of the Notary (Public) shall be authenticated by a Diplomatic or Consular Officer empowered in this behalf under section 3 of the Diplomatic and Consular Officers (Oaths and Fees) Act, 1948 or, where there is no such officer by any of the officials mentioned in section 6 of the Commissioners of Oaths Act, 1889 or in any Act amending the same;
  - (d) visited in India and intended to incorporate a company, in such case the incorporation shall be allowed if, he/she is having a valid Business Visa.

**Explanation.-** For the purposes of this clause, it is hereby clarified that, in case of Person is of Indian Origin or Overseas Citizen of India, requirement of business Visa shall not be applicable.

#### **7.1.12 Particulars of Every Subscriber to be filed with the Registrar at the time of Incorporation**

- (1) The following particulars of every subscriber to the memorandum shall be filed with the Registrar-
- (a) Name (including surname or family name) and recent Photograph affixed and scan with MOA and AOA:
  - (b) Father's/Mother's/ name:
  - (c) Nationality:
  - (d) Date of Birth:
  - (e) Place of Birth (District and State):
  - (f) Educational qualification:
  - (g) Occupation:
  - (h) Income-tax permanent account number:
  - (i) Permanent residential address and also Present address (Time since residing at present address and address of previous residence address (es) if stay of present address is less than one year) similarly the office/business addresses :
  - (j) Email id of Subscriber;
  - (k) Phone No. of Subscriber;
  - (l) Fax no. of Subscriber (optional)

Explanation.- information related to (i) to (l) shall be of the individual subscriber and not of the professional engaged in the incorporation of the company;

(m) Proof of Identity:

- For Indian Nationals:
  - PAN Card ( mandatory) and any one of the following
  - Voter's identity card
  - Passport copy
  - Driving License copy
  - Unique Identification Number (UIN)
- For Foreign nationals and Non Resident Indians
  - Passport

(n) Residential proof such as Bank Statement, Electricity Bill, Telephone / Mobile Bill:

Provided that Bank statement Electricity bill, Telephone or Mobile bill shall not be more than two months old;

(o) Proof of nationality in case the subscriber is a foreign national.

(p) If the subscriber is already a director or promoter of a company(s), the particulars relating to-

- (i) Name of the company;
- (ii) Corporate Identity Number;
- (iii) Whether interested as a director or promoter;

(q) the specimen signature and latest photograph duly verified by the banker or notary shall be in the prescribed Form No.INC.10.

(2) Where the subscriber to the memorandum is a body corporate, then the following particulars shall be filed with the Registrar -

- (a) Corporate Identity Number of the Company or Registration number of the body corporate, if any
- (b) GLN, if any;
- (c) the name of the body corporate
- (d) the registered office address or principal place of business;
- (e) E-mail Id;
- (f) if the body corporate is a company, certified true copy of the board resolution specifying inter alia the authorization to subscribe to the memorandum of association of the proposed company and to make investment in the proposed company, the number of shares proposed to be subscribed by the body corporate, and the name, address and designation of the person authorized to subscribe to the Memorandum;
- (g) if the body corporate is a limited liability partnership or partnership firm, certified true copy of the resolution agreed to by all the partners specifying inter alia the authorization to subscribe to the memorandum of association of the proposed company and to make investment in the proposed company, the number of shares proposed to be subscribed in the body corporate, and the name of the partner authorized to subscribe to the Memorandum;
- (h) the particulars as specified above for subscribers in terms of clause (e) of sub- section (1) of section 7 for the person subscribing for body corporate;



- (i) in case of foreign bodies corporate, the details relating to-
  - (i) the copy of certificate of incorporation of the foreign body corporate; and
  - (ii) the registered office address.

### **7.1.13 Incorporation of Companies [Section 7]**

- (1) There shall be filed with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the following documents and information for registration, namely:—
  - (a) the memorandum and articles of the company duly signed by all the subscribers to the memorandum in such manner as may be prescribed;
  - (b) a declaration in the prescribed form by an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, and by a person named in the articles as a director, manager or secretary of the company, 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;
  - (c) an affidavit from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles that he is not convicted of any offence in connection with the promotion, formation or management of any company, or 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 and 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;
  - (d) the address for correspondence till its registered office is established;
  - (e) 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, and in the case of a subscriber being a body corporate, such particulars as may be prescribed;
  - (f) the particulars of the persons mentioned in the articles as the first directors of the company, their names, including surnames or family names, the Director Identification Number, residential address, nationality and such other particulars including proof of identity as may be prescribed; and
  - (g) 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 along with their consent to act as directors of the company in such form and manner as may be prescribed.
- (2) The Registrar on the basis of documents and information filed under sub-section (1) shall register all the documents and information referred to in that sub section in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.
- (3) On and from the date mentioned in the certificate of incorporation issued under sub-section (2), the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate.
- (4) The company shall maintain and preserve at its registered office copies of all documents and information as originally filed under sub-section (1) till its dissolution under this Act.
- (5) If any person furnishes any false or incorrect particulars of any information or suppresses any material information, of which he is aware in any of the documents filed with the Registrar in relation to the registration of a company, he shall be liable for action under section 447.

- (6) Without prejudice to the provisions of sub-section (5) where, at any time after the incorporation of a company, it is proved that the company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company, or by any fraudulent action, the promoters, the persons named as the first directors of the company and the persons making declaration under clause (b) of subsection (1) shall each be liable for action under section 447.
- (7) Without prejudice to the provisions of sub-section (6), where a company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company or by any fraudulent action, the Tribunal may, on an application made to it, on being satisfied that the situation so warrants,—
- (a) pass such orders, as it may think fit, for regulation of the management of the company including changes, if any, in its memorandum and articles, in public interest or in the interest of the company and its members and creditors; or
  - (b) direct that liability of the members shall be unlimited; or
  - (c) direct removal of the name of the company from the register of companies; or
  - (d) pass an order for the winding up of the company; or
  - (e) pass such other orders as it may deem fit:
- Provided that before making any order under this sub-section,—
- (i) the company shall be given a reasonable opportunity of being heard in the matter; and
  - (ii) the Tribunal shall take into consideration the transactions entered into by the company, including the obligations, if any, contracted or payment of any liability.

#### **7.1.14 Application for Incorporation of Companies**

An application shall be filed, with the Registrar within whose jurisdiction the registered office of the company is proposed to be situated, in Form No.INC.2 (for One Person Company) and Form no. INC.7 (other than One Person Company) along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014 for registration of a company.

#### **General Circular No. 16/2014**

##### **Applicability of PAN Requirement for Foreign Nationals –**

In continuation of the General Circular No. 12/2014 dated 22.05.2014 regards the above subject, it is clarified that the provisions of the said Circular are applicable to a Foreign National who is a subscriber/promoter at the time of incorporation of the Company.

In case the said subscriber/promoter, does not possess Permanent Account Number (PAN), he/she shall furnish a declaration in the prescribed proforma, as an attachment to the Incorporation Form (INC -7).

Further, it is clarified that, in case of a Resident Director of the proposed company he/she shall be required to submit PAN details at the time of incorporation.

#### **7.1.15 Declaration by Professionals**

For the purposes of clause (b) of sub-section (1) of section 7, the declaration by an advocate, a Chartered Accountant, Cost accountant or Company Secretary in practice shall be in Form No. INC.8. Explanation (i) "chartered accountant" means a chartered accountant as defined in clause (b) of sub-section 1 of section 2 of the Chartered Accountants Act, 1949 (ii) "Cost Accountant" means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants



Act, 1959 and (iii) “company secretary” means a “company secretary” or “secretary” means as defined in clause (c) of sub-section (1) of section 2 of the Company Secretaries Act, 1980.

#### **7.1.16 Formation of Companies with Charitable Objects, etc. [Section 8]**

- (1) Where it is proved to the satisfaction of the Central Government that a person or an association of persons proposed to be registered under this Act as a limited company—
  - (a) has in its objects the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object;
  - (b) intends to apply its profits, if any, or other income in promoting its objects; and
  - (c) intends to prohibit the payment of any dividend to its members, the Central Government may, by licence issued in such manner as may be prescribed, and on such conditions as it deems fit, allow that person or association of persons to be registered as a limited company under this section without the addition to its name of the word “Limited”, or as the case may be, the words “Private Limited” , and thereupon the Registrar shall, on application, in the prescribed form, register such person or association of persons as a company under this section.
- (2) The company registered under this section shall enjoy all the privileges and be subject to all the obligations of limited companies.
- (3) A firm may be a member of the company registered under this section.
- (4)
  - (i) A company registered under this section shall not alter the provisions of its memorandum or articles except with the previous approval of the Central Government.
  - (ii) A company registered under this section may convert itself into company of any other kind only after complying with such conditions as may be prescribed.
- (5) Where it is proved to the satisfaction of the Central Government that a limited company registered under this Act or under any previous company law has been formed with any of the objects specified in clause (a) of sub-section (1) and with the restrictions and prohibitions as mentioned respectively in clauses (b) and (c) of that sub-section, it may, by licence, allow the company to be registered under this section subject to such conditions as the Central Government deems fit and to change its name by omitting the word “Limited”, or as the case may be, the words “Private Limited” from its name and thereupon the Registrar shall, on application, in the prescribed form, register such company under this section and all the provisions of this section shall apply to that company.
- (6) The Central Government may, by order, revoke the licence granted to a company registered under this section if the company contravenes any of the requirements of this section or any of the conditions subject to which a licence is issued or the affairs of the company are conducted fraudulently or in a manner violative of the objects of the company or prejudicial to public interest, and without prejudice to any other action against the company under this Act, direct the company to convert its status and change its name to add the word “Limited” or the words “Private Limited”, as the case may be, to its name and thereupon the Registrar shall, without prejudice to any action that may be taken under sub-section (7), on application, in the prescribed form, register the company accordingly.

Provided that no such order shall be made unless the company is given a reasonable opportunity of being heard.

Provided further that a copy of every such order shall be given to the Registrar.
- (7) Where a licence is revoked under sub-section (6), the Central Government may, by order, if it is satisfied that it is essential in the public interest, direct that the company be wound up under this Act or amalgamated with another company registered under this section.

Provided that no such order shall be made unless the company is given a reasonable opportunity of being heard.

- (8) Where a licence is revoked under sub-section (6) and where the Central Government is satisfied that it is essential in the public interest that the company registered under this section should be amalgamated with another company registered under this section and having similar objects, then, notwithstanding anything to the contrary contained in this Act, the Central Government may, by order, provide for such amalgamation to form a single company with such constitution, properties, powers, rights, interest, authorities and privileges and with such liabilities, duties and obligations as may be specified in the order.
- (9) If on the winding up or dissolution of a company registered under this section, there remains, after the satisfaction of its debts and liabilities, any asset, they may be transferred to another company registered under this section and having similar objects, subject to such conditions as the Tribunal may impose, or may be sold and proceeds thereof credited to the Rehabilitation and Insolvency Fund formed under section 269.
- (10) A company registered under this section shall amalgamate only with another company registered under this section and having similar objects.
- (11) If a company makes any default in complying with any of the requirements laid down in this section, the company shall, without prejudice to any other action under the provisions of this section, be punishable with fine which shall not be less than ten lakh rupees but which may extend to one crore rupees and the directors and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than twenty-five thousand rupees but which may extend to twenty-five lakh rupees, or with both.

Provided that when it is proved that the affairs of the company were conducted fraudulently, every officer in default shall be liable for action under section 447.

#### **7.1.17 License Under Section 8 for Existing Companies**

A limited company registered under this Act or under any previous company law, with any of the objects specified in clause (a) of sub-section (1) of section 8 and the restrictions and prohibitions as mentioned respectively in clause (b) and (c) of that sub-section, and which is desirous of being registered under section 8, without the addition to its name of the word "Limited" or as the case may be, the words "Private Limited", shall make an application in Form No.INC.12 along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014 to the Registrar for a licence under sub-section (5) of section 8.

The licence shall be in Form No.INC.16. or Form No.INC.17, as the case may be, and the Registrar shall have power to include in the licence such other conditions as may be deemed necessary by him.

The Registrar may direct the company to insert in its memorandum, or in its articles, or partly in one and partly in the other, such conditions of the license as may be specified by the Registrar in this behalf.

#### **7.1.18 Submission of Documents**

The application shall be accompanied by the following documents, namely:-

- (i) the memorandum and articles of association of the company;
- (ii) the declaration as given in Form No.INC.14 by an Advocate, a Chartered accountant, Cost Accountant or Company Secretary in Practice, that the memorandum and articles of association have been drawn up in conformity with the provisions of section 8 and rules made there under and that all the requirements of the Act and the rules made there under relating to registration of the company under section 8 and matters incidental or supplemental thereto have been complied with;



- (iii) For each of the two financial years immediately preceding the date of the application, or when the company has functioned only for one financial year, for such year (a) the financial statements, (b) the Board's reports, and (c) the audit reports, relating to existing companies
- (iv) a statement showing in detail the assets (with the values thereof), and the liabilities of the company, as on the date of the application or within thirty days preceding that date;
- (v) an estimate of the future annual income and expenditure of the company for next three years, specifying the sources of the income and the objects of the expenditure;
- (vi) the certified copy of the resolutions passed in general/ board meetings approving registration of the company under section 8; and
- (vii) a declaration by each of the persons making the application in Form No.INC.15.

#### **7.1.19 Conditions for Conversion of a Company Registered Under Section 8 into a Company of any other kind**

- (i) A company registered under section 8 which intends to convert itself into a company of any other kind shall pass a special resolution at a general meeting for approving such conversion.
- (ii) The explanatory statement annexed to the notice convening the general meeting shall set out in detail the reasons for opting for such conversion including the following, namely:-
  - (a) the date of incorporation of the company;
  - (b) the principal objects of the company as set out in the memorandum of association;
  - (c) the reasons as to why the activities for achieving the objects of the company cannot be carried on in the current structure i.e. as a section 8 company;
  - (d) if the principal or main objects of the company are proposed to be altered, what would be the altered objects and the reasons for the alteration;
  - (e) what are the privileges or concessions currently enjoyed by the company, such as tax exemptions, approvals for receiving donations or contributions including foreign contributions, land and other immovable properties, if any, that were acquired by the company at concessional rates or prices or gratuitously and, if so, the market prices prevalent at the time of acquisition and the price that was paid by the company, details of any donations or bequests received by the company with conditions attached to their utilization etc.;
  - (f) details of impact of the proposed conversion on the members of the company including details of any benefits that may accrue to the members as a result of the conversion.
- (iii) A certified true copy of the special resolution along with a copy of the Notice convening the meeting including the explanatory statement shall be filed with the Registrar in Form No.MGT.14 along with the fee.
- (iv) The company shall file an application in Form No.INC.18 with the Regional Director with the fee along with a certified true copy of the special resolution and a copy of the Notice convening the meeting including the explanatory statement for approval for converting itself into a company of any other kind and the company shall also attach the proof of serving of the notice served to all the authorities mentioned in sub-rule (2) of rule 22 of Companies (Incorporation) Rules, 2014.
- (v) A copy of the application with annexure as filed with the Regional Director shall also be filed with the Registrar.

#### **7.1.20 Intimation to Registrar of Revocation of License Issued Under Section 8**

Where the licence granted to a company registered under section 8 has been revoked, the company shall apply to the Registrar **in Form No.INC.20** along with the fee to convert its status and change of name accordingly.

### **7.1.21 Effect of Registration [Section 9]**

From the date of incorporation mentioned in the certificate of incorporation, such subscribers to the memorandum and all other persons, as may, from time to time, become members of the company, shall be a body corporate by the name contained in the memorandum, capable of exercising all the functions of an incorporated company under this Act and having perpetual succession with power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name.

### **7.1.22 Effect of Memorandum and Articles [Section 10]**

- (1) Subject to the provisions of this Act, the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed by the company and by each member, and contained covenants on its and his part to observe all the provisions of the memorandum and of the articles.
- (2) All monies payable by any member to the company under the memorandum or articles shall be a debt due from him to the company.

### **7.1.23 Commencement of Business, etc. [Section 11]**

Omitted w.e.f. 29.05.2015

### **7.1.24 Registered Office of Company [Section 12]**

- (1) A company shall, on and from the fifteenth day of its incorporation and at all times thereafter, have a registered office capable of receiving and acknowledging all communications and notices as may be addressed to it.
- (2) The company shall furnish to the Registrar verification of its registered office within a period of thirty days of its incorporation in such manner as may be prescribed.
- (3) Every company shall—
  - (a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried on, in a conspicuous position, in legible letters, and if the characters employed therefor are not those of the language or of one of the languages in general use in that locality, also in the characters of that language or of one of those languages;
  - (b) have its name engraved in legible characters on its seal, if any ;
  - (c) get its name, address of its registered office and the Corporate Identity Number along with telephone number, fax number, if any, e-mail and website addresses, if any, printed in all its business letters, billheads, letter papers and in all its notices and other official publications; and
  - (d) have its name printed on hundies, promissory notes, bills of exchange and such other documents as may be prescribed:

Provided that where a company has changed its name or names during the last two years, it shall paint or affix or print, as the case may be, along with its name, the former name or names so changed during the last two years as required under clauses (a) and (c).

Provided further that the words "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

- (4) Notice of every change of the situation of the registered office, verified in the manner prescribed, after the date of incorporation of the company, shall be given to the Registrar within fifteen days of the change, who shall record the same.



- (5) Except on the authority of a special resolution passed by a company, the registered office of the company shall not be changed,—
- (a) in the case of an existing company, outside the local limits of any city, town or village where such office is situated at the commencement of this Act or where it may be situated later by virtue of a special resolution passed by the company; and
  - (b) in the case of any other company, outside the local limits of any city, town or village where such office is first situated or where it may be situated later by virtue of a special resolution passed by the company:

Provided that no company shall change the place of its registered office from the jurisdiction of one Registrar to the jurisdiction of another Registrar within the same State unless such change is confirmed by the Regional Director on an application made in this behalf by the company in the prescribed manner.

- (6) The confirmation referred to in sub-section (5) shall be communicated within a period of thirty days from the date of receipt of application by the Regional Director to the company and the company shall file the confirmation with the Registrar within a period of sixty days of the date of confirmation who shall register the same and certify the registration within a period of thirty days from the date of filing of such confirmation.
- (7) The certificate referred to in sub-section (6) shall be conclusive evidence that all the requirements of this Act with respect to change of registered office in pursuance of subsection (5) have been complied with and the change shall take effect from the date of the certificate.
- (8) If any default is made in complying with the requirements of this section, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees.

#### **7.1.25 Shifting of Registered Office within the same State**

- (i) An application seeking confirmation from the Regional Director for shifting the registered office within the same State from the jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies, shall be filed by the company with the Regional Director in Form no.INC.23 along with the fee.
- (ii) The company shall, not less than one month before filing any application with the Regional Director for the change of registered office.—
  - (a) publish a notice, at least once in a daily newspaper published in English and in the principal language of that district in which the registered office of the company is situated and circulating in that district; and
  - (b) serve individual notice on each debenture holder, depositor and creditor of the company, clearly indicating the matter of application and stating that any person whose interest is likely to be affected by the proposed alteration of the memorandum may intimate his nature of interest and grounds of opposition to the Regional Director with a copy to the company within twenty one days of the date of publication of that notice:

Provided that in case no objection is received by the Regional Director within twenty one days from the date of service or publication of the notice, the person concerned shall be deemed to have given his consent to the change of registered office proposed in the application.

Provided further that the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

- (iii) The confirmation referred to in sub-section (5) of section 12 shall be communicated within a period of thirty days from the date of receipt of application by the Regional Director to the company and the company shall file the confirmation with the Registrar within a period of sixty days of the date of confirmation who shall register the same and certify the registration within a period of thirty days from the date of filing of such confirmation.

#### **7.1.26 Shifting of Registered Office from One State or Union Territory to Another State**

- (i) An application under sub-section (4) of section 13, for the purpose of seeking approval for alteration of memorandum with regard to the change of place of the registered office from one State Government or Union territory to another, shall be filed with the Central Government in Form No. INC.23 along with the fee and shall be accompanied by the following documents, namely:-
  - (a) a copy of the memorandum and articles of association;
  - (b) a copy of the notice convening the general meeting along with relevant Explanatory Statement;
  - (c) a copy of the special resolution sanctioning the alteration by the members of the company;
  - (d) a copy of the minutes of the general meeting at which the resolution authorizing such alteration was passed, giving details of the number of votes cast in favor or against the resolution;
  - (e) an affidavit verifying the application;
  - (f) the list of creditors and debenture holders entitled to object to the application;
  - (g) an affidavit verifying the list of creditors;
  - (h) the document relating to payment of application fee;
  - (i) a copy of board resolution or Power of Attorney or the executed Vakalatnama, as the case may be.
- (ii) There shall be attached to the application, a list of creditors and debenture holders, drawn up to the latest practicable date preceding the date of filing of application by not more than one month, setting forth the following details, namely:-
  - (a) the names and address of every creditor and debenture holder of the company;
  - (b) the nature and respective amounts due to them in respect of debts, claims or liabilities:

Provided that the applicant company shall file an affidavit, signed by the Company Secretary of the company, if any and not less than two directors of the company, one of whom shall be a managing director, where there is one, to the effect that they have made a full enquiry into the affairs of the company and, having done so, have formed an opinion that the list of creditors is correct, and that the estimated value as given in the list of the debts or claims payable on a contingency or not ascertained are proper estimates of the values of such debts and claims and that there are no other debts of or claims against the company to their knowledge.
- (iii) There shall also be attached to the application an affidavit from the directors of the company that no employee shall be retrenched as a consequence of shifting of the registered office from one state to another state and also there shall be an application filed by the company to the Chief Secretary of the concerned State Government or the Union territory.
- (iv) A duly authenticated copy of the list of creditors shall be kept at the registered office of the company and any person desirous of inspecting the same may, at any time during the ordinary hours of business, inspect and take extracts from the same on payment of a sum not exceeding ten rupees per page to the company.

- (v) There shall also be attached to the application a copy of the acknowledgment of service of a copy of the application with complete annexures to the Registrar and Chief Secretary of the



State Government or Union territory where the registered office is situated at the time of filing the application.

- (vi) The company shall at least fourteen days before the date of hearing-
  - (a) advertise the application in the Form No.INC.26 in a vernacular newspaper in the principal vernacular language in the district in which the registered office of the company is situated, and at least once in English language in an English newspaper circulating in that district;
  - (b) serve, by registered post with acknowledgement due, individual notice(s), to the effect set out in clause (a) on each debenture-holder and creditor of the company; and
  - (c) serve, by registered post with acknowledgement due, a notice together with the copy of the application to the Registrar and to the Securities and Exchange Board of India, in the case of listed companies and to the regulatory body, if the company is regulated under any special Act or law for the time being in force.
- (vii) Where any objection of any person whose interest is likely to be affected by the proposed application has been received by the applicant, it shall serve a copy thereof to the Central Government on or before the date of hearing.
- (viii) Where no objection has been received from any of the parties, who have been duly served, the application may be put up for orders without hearing.
- (ix) Before confirming the alteration, the Central Government shall ensure that, with respect to every creditor and debenture holder who, in the opinion of the Central government, is entitled to object to the alteration, and who signifies his objection in the manner directed by the Central government, either his consent to the alteration has been obtained or his debt or claim has been discharged or has determined, or has been secured to the satisfaction of the Central Government.
- (x) The Central Government may make an order confirming the alteration on such terms and conditions, if any, as it thinks fit, and may make such order as to costs as it thinks proper.

Provided that the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

#### **7.1.27 Alteration of Memorandum [Section 13]**

- (1) Save as provided in section 61, a company may, by a special resolution and Alteration of after complying with the procedure specified in this section, alter the provisions of its memorandum.
- (2) Any change in the name of a company shall be subject to the provisions of sub sections (2) and (3) of section 4 and shall not have effect except with the approval of the Central Government in writing.

Provided that no such approval shall be necessary where the only change in the name of the company is the deletion there from, or addition thereto, of the word "Private", consequent on the conversion of any one class of companies to another class in accordance with the provisions of this Act.

- (3) When any change in the name of a company is made under sub-section (2), the Registrar shall enter the new name in the register of companies in place of the old name and issue a fresh certificate of incorporation with the new name and the change in the name shall be complete and effective only on the issue of such a certificate.
- (4) The alteration of the memorandum relating to the place of the registered office from one State to another shall not have any effect unless it is approved by the Central Government on an application in such form and manner as may be prescribed.

- (5) The Central Government shall dispose of the application under sub-section (4) within a period of sixty days and before passing its order may satisfy itself that the alteration has the consent of the creditors, debenture-holders and other persons concerned with the company or that the sufficient provision has been made by the company either for the due discharge of all its debts and obligations or that adequate security has been provided for such discharge.
- (6) Save as provided in section 64, a company shall, in relation to any alteration of its memorandum, file with the Registrar—
  - (a) the special resolution passed by the company under sub-section (1);
  - (b) the approval of the Central Government under sub-section (2), if the alteration involves any change in the name of the company.
- (7) Where an alteration of the memorandum results in the transfer of the registered office of a company from one State to another, a certified copy of the order of the Central Government approving the alteration shall be filed by the company with the Registrar of each of the States within such time and in such manner as may be prescribed, who shall register the same, and the Registrar of the State where the registered office is being shifted to, shall issue a fresh certificate of incorporation indicating the alteration.
- (8) A company, which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution is passed by the company and—
  - (i) the details, as may be prescribed, in respect of such resolution shall also be published in the newspapers (one in English and one in vernacular language) which is in circulation at the place where the registered office of the company is situated and shall also be placed on the website of the company, if any, indicating therein the justification for such change;
  - (ii) the dissenting shareholders shall be given an opportunity to exit by the promoters and shareholders having control in accordance with regulations to be specified by the Securities and Exchange Board.
- (9) The Registrar shall register any alteration of the memorandum with respect to the objects of the company and certify the registration within a period of thirty days from the date of filing of the special resolution in accordance with clause (a) of sub-section (6) of this section.
- (10) No alteration made under this section shall have any effect until it has been registered in accordance with the provisions of this section.
- (11) Any alteration of the memorandum, in the case of a company limited by guarantee and not having a share capital, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member, shall be void.

#### **7.1.28 Alteration of Memorandum by Change of Name**

An application shall be filed in Form No.INC.24 along with the fee for change in the name of the company and a new certificate of incorporation in Form No.INC.25 shall be issued to the company consequent upon change of name.

The change of name shall not be allowed to a company which has defaulted in filing its annual returns or financial statements or any document due for filing with the Registrar or which has defaulted in repayment of matured deposits or debentures or interest on deposits or debentures.

#### **7.1.29 Alteration of Articles [Section 14]**

- (1) A company may, by a special resolution, alter its articles including alterations having the effect of



conversion of—

- (a) a private company into a public company; or
- (b) a public company into a private company.

Provided that where a company being a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the articles of a private company under this Act, the company shall, as from the date of such alteration, cease to be a private company.

Provided further that any alteration having the effect of conversion of a public company into a private company shall not take effect except with the approval of the Tribunal which shall make such order as it may deem fit.

- (2) Every alteration of the articles under this section and a copy of the order of the Tribunal approving the alteration as per sub-section (1) shall be filed with the Registrar, together with a printed copy of the altered articles, within a period of fifteen days in such manner as may be prescribed, who shall register the same.
- (3) Any alteration of the articles registered under sub-section (2) shall, subject to the provisions of this Act, be valid as if it were originally in the articles.

#### **7.1.30 Alteration of Articles**

For effecting the conversion of a private company into a public company or vice versa, the application shall be filed in Form No.INC.27 with fee.

A copy of order of the competent authority approving the alteration, shall be filed with the Registrar in Form No. INC.27 with fee together with the printed copy of the altered articles within fifteen days of the receipt of the order from the Central Government.

#### **7.1.31 Alteration of Memorandum or Articles to be noted in Every Copy [Section 15]**

- (1) Every alteration made in the memorandum or articles of a company shall be noted in every copy of the memorandum or articles, as the case may be.
- (2) If a company makes any default in complying with the provisions of sub-section (1), the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every copy of the memorandum or articles issued without such alteration.

#### **7.1.32 Rectification of Name of Company [Section 16]**

- (1) If, through inadvertence or otherwise, a company on its first registration or on its registration by a new name, is registered by a name which,—
  - (a) in the opinion of the Central Government, is identical with or too nearly resembles the name by which a company in existence had been previously registered, whether under this Act or any previous company law, it may direct the company to change its name and the company shall change its name or new name, as the case may be, within a period of three months from the issue of such direction, after adopting an ordinary resolution for the purpose;
  - (b) on an application by a registered proprietor of a trade mark that the name is identical with or too nearly resembles to a registered trade mark of such proprietor under the Trade Marks Act, 1999, made to the Central Government within three years of incorporation or registration or change of name of the company, whether under this Act or any previous company law, in the opinion of the Central Government, is identical with or too nearly resembles to an existing trade mark, it may direct the company to change its name and the company shall change its name or new name, as the case may be, within a period of six months from the issue of such direction, after adopting an ordinary resolution for the purpose.

- (2) Where a company changes its name or obtains a new name under sub-section (1), it shall within a period of fifteen days from the date of such change, give notice of the change to the Registrar along with the order of the Central Government, who shall carry out necessary changes in the certificate of incorporation and the memorandum.
- (3) If a company makes default in complying with any direction given under sub-section (1), the company shall be punishable with fine of one thousand rupees for every day during which the default continues and every officer who is in default shall be punishable with fine which shall not be less than five thousand rupees but which may extend to one lakh rupees.

#### **7.1.33 Copies of Memorandum, Articles, etc., to be given to Members [Section 17]**

- (1) A company shall, on being so requested by a member, send to him within seven days of the request and subject to the payment of such fees as may be prescribed, a copy of each of the following documents, namely:—
  - (a) the memorandum;
  - (b) the articles; and
  - (c) every agreement and every resolution referred to in sub-section (1) of section 117, if and in so far as they have not been embodied in the memorandum or articles.
- (2) If a company makes any default in complying with the provisions of this section, the company and every officer of the company who is in default shall be liable for each default, to a penalty of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

#### **7.1.34 Change of Objects for which Money is Raised through Prospectus**

Where the company has raised money from public through prospectus and has any unutilised amount out of the money so raised, it shall not change the objects for which the money so raised is to be applied unless a special resolution is passed through postal ballot and the notice in respect of the resolution for altering the objects shall contain the following particulars, namely:-

- (a) the total money received;
- (b) the total money utilized for the objects stated in the prospectus;
- (c) the unutilized amount out of the money so raised through prospectus,
- (d) the particulars of the proposed alteration or change in the objects;
- (e) the justification for the alteration or change in the objects;
- (f) the amount proposed to be utilised for the new objects;
- (g) the estimated financial impact of the proposed alteration on the earnings and cash flow of the company;
- (h) the other relevant information which is necessary for the members to take an informed decision on the proposed resolution;
- (i) the place from where any interested person may obtain a copy of the notice of resolution to be passed.

The advertisement giving details of each resolution to be passed for change in objects which shall be published simultaneously with the dispatch of postal ballot notices to shareholders. The notice shall also be placed on the website of the company, if any.



### **7.1.35 Conversion of Companies already Registered [Section 18]**

- (1) A company of any class registered under this Act may convert itself as a company of other class under this Act by alteration of memorandum and articles of the company in accordance with the provisions of the act.
- (2) Where the conversion is required to be done under this section, the Registrar shall on an application made by the company, after satisfying himself that the provisions as applicable to the transaction applicable for registration of companies have been complied with, close the former registration of the company and after registering the documents referred to in sub-section (1), issue a certificate of incorporation in the same manner as its first registration.
- (3) The registration of a company under this section shall not affect any debts, liabilities, obligations or contracts incurred or entered into, by or on behalf of the company before conversion and such debts, liabilities, obligations and contracts may be enforced in the manner as if such registration had not been done.

### **7.1.36 Subsidiary Company not to hold Shares in its Holding Company [Section 19]**

- (1) No company shall, either by itself or through its nominees, hold any shares in its holding company and no holding company shall allot or transfer its shares to any of its subsidiary companies and any such allotment or transfer of shares of a company to its subsidiary company shall be void.

Provided that nothing in this sub-section shall apply to a case—

- (a) where the subsidiary company holds such shares as the legal representative of a deceased member of the holding company; or
- (b) where the subsidiary company holds such shares as a trustee; or
- (c) where the subsidiary company is a shareholder even before it became a subsidiary company of the holding company:

Provided further that the subsidiary company referred to in the preceding proviso shall have a right to vote at a meeting of the holding company only in respect of the shares held by it as a legal representative or as a trustee, as referred to in clause (a) or clause (b) of the said proviso.

- (2) The reference in this section to the shares of a holding company which is a company limited by guarantee or an unlimited company, not having a share capital, shall be construed as a reference to the interest of its members, whatever be the form of interest.

### **7.1.37 Service of Documents [Section 20]**

- (1) A document may be served on a company or an officer thereof by sending it to the company or the officer at the registered office of the company by registered post or by speed post or by courier service or by leaving it at its registered office or by means of such electronic or other mode as may be prescribed.

Provided that where securities are held with a depository, the records of the beneficial ownership may be served by such depository on the company by means of electronic or other mode.

- (2) Save as provided in this Act or the rules made there under for filing of documents with the Registrar in electronic mode, a document may be served on Registrar or any member by sending it to him by post or by registered post or by speed post or by courier or by delivering at his office or address, or by such electronic or other mode as may be prescribed.

Provided that a member may request for delivery of any document through a particular mode, for which he shall pay such fees as may be determined by the company in its annual general meeting.

### **7.1.38 Authentication of Documents, Proceedings and Contracts [Section 21]**

Save as otherwise provided in this Act,—

- (a) a document or proceeding requiring authentication by a company; or
- (b) contracts made by or on behalf of a company,

may be signed by any key managerial personnel or an officer of the company duly authorised by the Board in this behalf.

### **7.1.39 Execution of Bills of Exchange, etc. [Section 22]**

- (1) A bill of exchange, hundi or promissory note shall be deemed to have been made, accepted, drawn or endorsed on behalf of a company if made, accepted, drawn, or endorsed in the name of, or on behalf of or on account of, the company by any person acting under its authority, express or implied.
- (2) A company may, by writing under its common seal, if any, authorise any person, either generally or in respect of any specified matters, as its attorney to execute other deeds on its behalf in any place either in or outside India.

Provided that in case a company does not have a common seal, the authorization under this subsection shall be made by two directors or by a director and the Company Secretary, wherever the company has appointed a Company Secretary.

- (3) A deed signed by such an attorney on behalf of the company and under his seal shall bind the company.

## **7.2 PROSPECTUS AND ALLOTMENT OF SECURITIES**

### **7.2.1 Public Officer and Private Placement [Section 23]**

- (1) A public company may issue securities—
  - (a) to public through prospectus; or
  - (b) through private placement; or
  - (c) through a rights issue or a bonus issue and in case of a listed company or a company which intends to get its securities listed also with the provisions of the Securities and Exchange Board of India Act, 1992 and the rules and regulations made thereunder.
- (2) A private company may issue securities—
  - (a) by way of rights issue or bonus issue; or
  - (b) through private placement.

**Explanation.**— For the purposes of this Chapter, “public offer” includes initial public offer or further public offer of securities to the public by a company, or an offer for sale of securities to the public by an existing shareholder, through issue of a prospectus.

### **7.2.2 Power of Securities and Exchange Board to Regulate Issue and Transfer of Securities, etc. [Section 24]**

- (1) The provisions contained in Chapter III, Chapter IV and in section 127 shall,—
  - (a) in so far as they relate to —
    - (i) issue and transfer of securities; and
    - (ii) non-payment of dividend,



by listed companies or those companies which intend to get their securities listed on any recognised stock exchange in India, except as provided under this Act, be administered by the Securities and Exchange Board by making regulations in this behalf;

(b) in any other case, be administered by the Central Government.

**Explanation.**— For the removal of doubts, it is hereby declared that all powers relating to all other matters relating to prospectus, return of allotment, redemption of preference shares and any other matter specifically provided in this Act, shall be exercised by the Central Government, the Tribunal or the Registrar, as the case may be.

- (2) The Securities and Exchange Board shall, in respect of matters specified in sub-section (1) and the matters delegated to it under proviso to sub-section (1) of section 458, exercise the powers conferred upon it under sub-sections (1), (2A), (3) and (4) of section 11, sections 11A, 11B and 11D of the Securities and Exchange Board of India Act, 1992.

### 7.2.3 Document Containing offer of Securities for Sale to be Deemed Prospectus [Section 25]

- (1) Where a company allots or agrees to allot any securities of the company with a view to all or any of those securities being offered for sale to the public, any document by which the offer for sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company; and all enactments and rules of law as to the contents of prospectus and as to liability in respect of mis-statements, in and omissions from, prospectus, or otherwise relating to prospectus, shall apply with the modifications specified in sub sections (3) and (4) and shall have effect accordingly, as if the securities had been offered to the public for subscription and as if persons accepting the offer in respect of any securities were subscribers for those securities, but without prejudice to the liability, if any, of the persons by whom the offer is made in respect of mis-statements contained in the document or otherwise in respect thereof.
- (2) For the purposes of this Act, it shall, unless the contrary is proved, be evidence that an allotment of, or an agreement to allot, securities was made with a view to the securities being offered for sale to the public if it is shown—
- (a) that an offer of the securities or of any of them for sale to the public was made within six months after the allotment or agreement to allot; or
- (b) that at the date when the offer was made, the whole consideration to be received by the company in respect of the securities had not been received by it.
- (3) Section 26 as applied by this section shall have effect as if —
- (i) it required a prospectus to state in addition to the matters required by that section to be stated in a prospectus—
- (a) the net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates; and
- (b) the time and place at which the contract where under the said securities have been or are to be allotted may be inspected;
- (ii) the persons making the offer were persons named in a prospectus as directors of a company.
- (4) Where a person making an offer to which this section relates is a company or a firm, it shall be sufficient if the document referred to in sub-section (1) is signed on behalf of the company or firm by two directors of the company or by not less than one-half of the partners in the firm, as the case may be.

#### 7.2.4 Matters to be Stated in Prospectus [Section 26]

- (1) Every prospectus issued by or on behalf of a public company either with reference to its formation or subsequently, or by or on behalf of any person who is or has been engaged or interested in the formation of a public company, shall be dated and signed and shall —
- (a) state the following information, namely:—
- (i) names and addresses of the registered office of the company, company secretary, Chief Financial Officer, auditors, legal advisers, bankers, trustees, if any, underwriters and such other persons as may be prescribed;
  - (ii) dates of the opening and closing of the issue, and declaration about the issue of allotment letters and refunds within the prescribed time;
  - (iii) a statement by the Board of Directors about the separate bank account where all monies received out of the issue are to be transferred and disclosure of details of all monies including utilised and unutilised monies out of the previous issue in the prescribed manner;
  - (iv) details about underwriting of the issue;
  - (v) consent of the directors, auditors, bankers to the issue, expert's opinion, if any, and of such other persons, as may be prescribed;
  - (vi) the authority for the issue and the details of the resolution passed there for;
  - (vii) procedure and time schedule for allotment and issue of securities;
  - (viii) capital structure of the company in the prescribed manner;
  - (ix) main objects of public offer, terms of the present issue and such other particulars as may be prescribed;
  - (x) main objects and present business of the company and its location, schedule of implementation of the project;
  - (xi) particulars relating to—
    - (A) management perception of risk factors specific to the project;
    - (B) gestation period of the project;
    - (C) extent of progress made in the project;
    - (D) deadlines for completion of the project; and
    - (E) any litigation or legal action pending or taken by a Government Department or a statutory body during the last five years immediately preceding the year of the issue of prospectus against the promoter of the company;
  - (xii) minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash;
  - (xiii) details of directors including their appointments and remuneration, and such particulars of the nature and extent of their interests in the company as may be prescribed; and
  - (xiv) disclosures in such manner as may be prescribed about sources of promoter's contribution;
- (b) set out the following reports for the purposes of the financial information, namely:—
- (i) reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other matters as may be prescribed;

- (ii) reports relating to profits and losses for each of the five financial years immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries and in such manner as may be prescribed

Provided that in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in such manner as may be prescribed, the reports relating to profits and losses for each of the financial years immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries;

- (iii) reports made in the prescribed manner by the auditors upon the profits and losses of the business of the company for each of the five financial years immediately preceding issue and assets and liabilities of its business on the last date to which the accounts of the business were made up, being a date not more than one hundred and eighty days before the issue of the prospectus:

Provided that in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in the prescribed manner, the reports made by the auditors upon the profits and losses of the business of the company for all financial years from the date of its incorporation, and assets and liabilities of its business on the last date before the issue of prospectus; and

- (iv) reports about the business or transaction to which the proceeds of the securities are to be applied directly or indirectly;
- (c) make a declaration about the compliance of the provisions of this Act and a statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under; and
  - (d) state such other matters and set out such other reports, as may be prescribed.

- (2) Nothing in sub-section (1) shall apply—

- (a) to the issue to existing members or debenture-holders of a company, of a prospectus or form of application relating to shares in or debentures of the company, whether an applicant has a right to renounce the shares or not under sub-clause (ii) of clause (a) of sub-section (1) of section 62 in favour of any other person; or

- (b) to the issue of a prospectus or form of application relating to shares or debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognised stock exchange.

- (3) Subject to sub-section (2), the provisions of sub-section (1) shall apply to a prospectus or a form of application, whether issued on or with reference to the formation of a company or subsequently.

**Explanation.**— The date indicated in the prospectus shall be deemed to be the date of its publication.

- (4) No prospectus shall be issued by or on behalf of a company or in relation to an intended company unless on or before the date of its publication, there has been delivered to the Registrar for registration, a copy thereof signed by every person who is named therein as a director or proposed director of the company or by his duly authorised attorney.

- (5) A prospectus issued under sub-section (1) shall not include a statement purporting to be made by an expert unless the expert is a person who is not, and has not been, engaged or interested in the formation or promotion or management, of the company and has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the

prospectus to the Registrar for registration and a statement to that effect shall be included in the prospectus.

- (6) Every prospectus issued under sub-section (1) shall, on the face of it,—
  - (a) state that a copy has been delivered for registration to the Registrar as required under sub-section (4); and
  - (b) specify any documents required by this section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents.
- (7) The Registrar shall not register a prospectus unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus.
- (8) No prospectus shall be valid if it is issued more than ninety days after the date on which a copy thereof is delivered to the Registrar under sub-section (4).
- (9) If a prospectus is issued in contravention of the provisions of this section, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees and every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both.

#### **7.2.5 Information Relating to Capital Structure of the Company Stated in Prospectus**

The capital structure of the company shall be presented in the following manner, namely:—

- (i)
  - (a) the authorised, issued, subscribed and paid up capital (number of securities, description and aggregate nominal value);
  - (b) the size of the present issue;
  - (c) the paid up capital-
    - (A) after the issue;
    - (B) after conversion of convertible instruments (if applicable);
  - (d) the share premium account (before and after the issue);
- (ii) the details of the existing share capital of the issuer company in a tabular form, indicating therein with regard to each allotment, the date of allotment, the number of shares allotted, the face value of the shares allotted, the price and the form of consideration.

Provided that in the case of an initial public offer of an existing company, the details regarding individual allotment shall be given from the date of incorporation of the issuer and in the case of a listed issuer company, the details shall be given for five years immediately preceding the date of filing of the prospectus.

Provided that the issuer company shall also disclose the number and price at which each of the allotments were made in the last two years preceding the date of the prospectus separately indicating the allotments made for considerations other than cash and the details of the consideration in each case.

#### **7.2.6 Information relating to details of Directors of the Company Stated in Prospectus**

The details of directors including their appointment and remuneration, and particulars of the nature and extent of their interests in the company shall be disclosed in the following manner, namely:—

- (i) the name, designation, Director Identification Number (DIN), age, address, period of directorship, details of other directorships;



- (ii) the remuneration payable or paid to the director by the issuer company, its subsidiary and associate company; shareholding of the director in the company including any stock options; shareholding in subsidiaries and associate companies; appointment of any relatives to an office or place of profit;
- (iii) the full particulars of the nature and extent of interest, if any, of every director:
  - (a) in the promotion of the issuer company; or
  - (b) in any immovable property acquired by the issuer company in the two years preceding the date of the Prospectus or any immovable property proposed to be acquired by it.
- (iv) where the interest of such a director consists in being a member of a firm or company, the nature and extent of his interest in the firm or company, with a statement of all sums paid or agreed to be paid to him or to the firm or company in cash or shares or otherwise by any person either to induce him to become, or to help him qualify as a director, or otherwise for services rendered by him or by the firm or company, in connection with the promotion or formation of the issuer company shall be disclosed.

### **7.2.7 Information relating to Sources of Promoter's Contribution Stated in Prospectus**

The sources of promoters' contribution, if any, shall be disclosed in the following manner, namely:—

- (i) the total shareholding of the promoters, clearly stating the name of the promoter, nature of issue, date of allotment, number of shares, face value, issue price or consideration, source of funds contributed, date when the shares were made fully paid up, percentage of the total pre and post issue capital;
- (ii) the proceeds out of the sale of shares of the company and shares of its subsidiary companies previously held by each of the promoters;
- (iii) the disclosure for sources of promoters contribution shall also include the particulars of name, address and the amount so raised as loan, financial assistance etc, if any, by promoters for making such contributions and in case of own sources, complete details thereof.

### **7.2.8 Other Matters and Reports to be Stated in the Prospectus**

The prospectus shall include the following other matters and reports, namely:—

- (1) If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly—
  - (a) in the purchase of any business; or
  - (b) in the purchase of an interest in any business and by reason of that purchase, or anything to be done in consequence thereof, or in connection therewith; the company shall become entitled to an interest in either the capital or profits and losses or both, in such business exceeding fifty per cent. thereof, a report made by a chartered accountant (who shall be named in the prospectus) upon—
    - (i) the profits or losses of the business for each of the five financial years immediately preceding the date of the issue of the prospectus; and
    - (ii) the assets and liabilities of the business as on the last date to which the accounts of the business were made up, being a date not more than one hundred and twenty days before the date of the issue of the prospectus;
  - (c) in purchase or acquisition of any immovable property including indirect acquisition of immovable property for which advances have been paid to even third parties, disclosures regarding—

- (i) the names, addresses, descriptions and occupations of the vendors;
  - (ii) the amount paid or payable in cash, to the vendor and, where there is more than one vendor, or the company is a sub-purchaser, the amount so paid or payable to each vendor, specifying separately the amount, if any, paid or payable for goodwill;
  - (iii) the nature of the title or interest in such property proposed to be acquired by the company; and
  - (iv) the particulars of every transaction relating to the property, completed within the two preceding years, in which any vendor of the property or any person who is, or was at the time of the transaction, a promoter, or a director or proposed director of the company had any interest, direct or indirect, specifying the date of the transaction and the name of such promoter, director or proposed director and stating the amount payable by or to such vendor, promoter, director or proposed director in respect of the transaction.
- (2) (a) If -
- (i) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or are to be applied directly or indirectly and in any manner resulting in the acquisition by the company of shares in any other body corporate; and
  - (ii) by reason of that acquisition or anything to be done in consequence thereof or in connection therewith, that body corporate shall become a subsidiary of the company, a report shall be made by a Chartered Accountant (who shall be named in the prospectus) upon -
    - (A) the profits or losses of the other body corporate for each of the five financial years immediately preceding the issue of the prospectus; and
    - (B) the assets and liabilities of the other body corporate as on the last date to which its accounts were made up.
- (b) The said report shall -
- (i) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the issuer company and what allowance would have been required to be made, in relation to assets and liabilities so dealt with for the holders of the balance shares, if the issuer company had at all material times held the shares proposed to be acquired; and
  - (ii) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner as provided in sub-clause (ii) of clause (a).
- (3) The matters relating to terms and conditions of the term loans including re-scheduling, prepayment, penalty, default.
- (4) The aggregate number of securities of the issuer company and its subsidiary companies purchased or sold by the promoter group and by the directors of the company which is a promoter of the issuer company and by the directors of the issuer company and their relatives within six months immediately preceding the date of filing the prospectus with the Registrar of Companies shall be disclosed.
- (5) The matters relating to -
- (A) Material contracts;
  - (B) Other material contracts;



(C) Time and place at which the contracts together with documents will be available for inspection from the date of prospectus until the date of closing of subscription list.

(6) The related party transactions entered during the last five financial years immediately preceding the issue of prospectus as under -

(a) all transactions with related parties with respect to giving of loans or, guarantees, providing securities in connection with loans made, or investments made ;

(b) all other transactions which are material to the issuer company or the related party, or any transactions that are unusual in their nature or conditions, involving goods, services, or tangible or intangible assets, to which the issuer company or any of its parent companies was a party.

Provided that the disclosures for related party transactions for the period prior to notification of these rules shall be to the extent of disclosure requirements as per the Companies Act, 1956 and the relevant accounting standards prevailing at the said time.

(7) The summary of reservations or qualifications or adverse remarks of auditors in the last five financial years immediately preceding the year of issue of prospectus and of their impact on the financial statements and financial position of the company and the corrective steps taken and proposed to be taken by the company for each of the said reservations or qualifications or adverse remarks.

(8) The details of any inquiry, inspections or investigations initiated or conducted under the Companies Act or any previous companies law in the last five years immediately preceding the year of issue of prospectus in the case of company and all of its subsidiaries; and if there were any prosecutions filed (whether pending or not); fines imposed or compounding of offences done in the last five years immediately preceding the year of the prospectus for the company and all of its subsidiaries.

(9) The details of acts of material frauds committed against the company in the last five years, if any, and if so, the action taken by the company.

(10) A fact sheet shall be included at the beginning of the prospectus which shall contain -

(a) the type of offer document ("Red Herring Prospectus" or "Shelf Prospectus" or "Prospectus").

(b) the name of the issuer company, date and place of its incorporation, its logo, address of its registered office, its telephone number, fax number, details of contact person, website address, e-mail address;

(c) the names of the promoters of the issuer company;

(d) the nature, number, price and amount of securities offered and issue size, as may be applicable;

(e) the aggregate amount proposed to be raised through all the stages of offers of specified securities made through the shelf prospectus;

(f) the name, logo and address of the registrar to the issue, along with its telephone number, fax number, website address and e-mail address;

(g) the issue schedule -

(i) date of opening of the issue;

(ii) date of closing of the issue;

(iii) date of earliest closing of the issue, if any.

(h) the credit rating, if applicable;

- (i) all the grades obtained for the initial public offer;
- (j) the name(s) of the recognised stock exchanges where the securities are proposed to be listed;
- (k) the details about eligible investors;
- (l) coupon rate, coupon payment frequency, redemption date, redemption amount and details of debenture trustee in case of debt securities.

#### **7.2.9 Variation in Terms of Contract or Objects in Prospectus [Section 27]**

- (1) A company shall not, at any time, vary the terms of a contract referred to in the prospectus or objects for which the prospectus was issued, except subject to the approval of, or except subject to an authority given by the company in general meeting by way of special resolution.

Provided that the details, as may be prescribed, of the notice in respect of such resolution to shareholders, shall also be published in the newspapers (one in English and one in vernacular language) in the city where the registered office of the company is situated indicating clearly the justification for such variation.

Provided further that such company shall not use any amount raised by it through prospectus for buying, trading or otherwise dealing in equity shares of any other listed company.

- (2) The dissenting shareholders being those shareholders who have not agreed to the proposal to vary the terms of contracts or objects referred to in the prospectus, shall be given an exit offer by promoters or controlling shareholders at such exit price, and in such manner and conditions as may be specified by the Securities and Exchange Board by making regulations in this behalf.

#### **7.2.10 Offer of Sale of Shares by Certain Members of Company [Section 28]**

- (1) Where certain members of a company propose, in consultation with the Board of Directors to offer, in accordance with the provisions of any law for the time being in force, whole or part of their holding of shares to the public, they may do so in accordance with such procedure as may be prescribed.
- (2) Any document by which the offer of sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company and all laws and rules made there under as to the contents of the prospectus and as to liability in respect of mis-statements in and omission from prospectus or otherwise relating to prospectus shall apply as if this is a prospectus issued by the company.
- (3) The members, whether individuals or bodies corporate or both, whose shares are proposed to be offered to the public, shall collectively authorise the company, whose shares are offered for sale to the public, to take all actions in respect of offer of sale for and on their behalf and they shall reimburse the company all expenses incurred by it on this matter.

#### **7.2.11 Public Offer of Securities to be in Dematerialised Form [Section 29]**

- (1) Notwithstanding anything contained in any other provisions of this Act,—

- (a) every company making public offer; and
- (b) such other class or classes of public companies as may be prescribed,

shall issue the securities only in dematerialised form by complying with the provisions of the Depositories Act, 1996 and the regulations made thereunder.

- (2) Any company, other than a company mentioned in sub-section (1), may convert its securities into dematerialised form or issue its securities in physical form in accordance with the provisions of this



Act or in dematerialised form in accordance with the provisions of the Depositories Act, 1996 and the regulations made thereunder.

### 7.2.12 Advertisement of Prospectus [Section 30]

Where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein the contents of its memorandum as regards the objects, the liability of members and the amount of share capital of the company, and the names of the signatories to the memorandum and the number of shares subscribed for by them, and its capital structure.

### 7.2.13 Shelf Prospectus [Section 31]

- (1) Any class or classes of companies, as the Securities and Exchange Board may provide by regulations in this behalf, may file a shelf prospectus with the Registrar at the stage of the first offer of securities included therein which shall indicate a period not exceeding one year as the period of validity of such prospectus which shall commence from the date of opening of the first offer of securities under that prospectus, and in respect of a second or subsequent offer of such securities issued during the period of validity of that prospectus, no further prospectus is required.
- (2) A company filing a shelf prospectus shall be required to file an information memorandum containing all material facts relating to new charges created, changes in the financial position of the company as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities and such other changes as may be prescribed, with the Registrar within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus.

Provided that where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, the company or other person shall intimate the changes to such applicants and if they express a desire to withdraw their application, the company or other person shall refund all the monies received as subscription within fifteen days thereof.

- (3) Where an information memorandum is filed, every time an offer of securities is made under sub-section (2), such memorandum together with the shelf prospectus shall be deemed to be a prospectus.

**Explanation.**—For the purposes of this section, the expression “shelf prospectus” means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

### 7.2.14 Red Herring Prospectus [Section 32]

- (1) A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.
- (2) A company proposing to issue a red herring prospectus under sub-section (1) shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer.
- (3) A red herring prospectus shall carry the same obligations as are applicable to a prospectus and any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus.
- (4) Upon the closing of the offer of securities under this section, the prospectus stating therein the total capital raised, whether by way of debt or share capital, and the closing price of the securities and any other details as are not included in the red herring prospectus shall be filed with the Registrar and the Securities and Exchange Board.

**Explanation.**—For the purposes of this section, the expression “red herring prospectus” means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

### **7.2.15 Issue of Application Forms for Securities [Section 33]**

- (1) No form of application for the purchase of any of the securities of a company shall be issued unless such form is accompanied by an abridged prospectus:  
Provided that nothing in this sub-section shall apply if it is shown that the form of application was issued—
  - (a) in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to such securities; or
  - (b) in relation to securities which were not offered to the public.
- (2) A copy of the prospectus shall, on a request being made by any person before the closing of the subscription list and the offer, be furnished to him.
- (3) If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

### **7.2.16 Refund of Application Money**

- (1) If the stated minimum amount has not been subscribed and the sum payable on application is not received within the period specified therein, then the application money shall be repaid within a period of fifteen days from the closure of the issue and if any such money is not so repaid within such period, the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of fifteen percent per annum.
- (2) The application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

### **7.2.17 Return of Allotment**

- (i) Whenever a company having a share capital makes any allotment of its securities, the company shall, within thirty days thereafter, file with the Registrar a return of allotment in Form PAS-3, along with the fee as specified in the Companies (Registration Offices and Fees) Rules, 2014.
- (ii) There shall be attached to the Form PAS-3 a list of allottees stating their names, address, occupation, if any, and number of securities allotted to each of the allottees and the list shall be certified by the signatory of the Form PAS-3 as being complete and correct as per the records of the company.
- (iii) In the case of securities (not being bonus shares) allotted as fully or partly paid up for consideration other than cash, there shall be attached to the Form PAS-3 a copy of the contract, duly stamped, pursuant to which the securities have been allotted together with any contract of sale if relating to a property or an asset, or a contract for services or other consideration.
- (iv) Where a contract referred to in sub-rule (3) of rule 12 of Companies (Prospectus and Allotment of Securities) Rules, 2014 is not reduced to writing, the company shall furnish along with the Form PAS-3 complete particulars of the contract stamped with the same stamp duty as would have been payable if the contract had been reduced to writing and those particulars shall be deemed to be an instrument within the meaning of the Indian Stamp Act, 1899, and the Registrar may, as a condition of filing the particulars, require that the stamp duty payable thereon be adjudicated under section 31 of the Indian Stamp Act, 1899.
- (v) A report of a registered valuer in respect of valuation of the consideration shall also be attached along with the contract as mentioned in sub-rule (3) and sub-rule (4).
- (vi) In the case of issue of bonus shares, a copy of the resolution passed in the general meeting authorizing the issue of such shares shall be attached to the Form PAS-3.
- (vii) In case the shares have been issued in pursuance of clause (c) of sub-section (1) of section 62 by a company other than a listed company whose equity shares or convertible preference shares are listed on any recognised stock exchange, there shall be attached to Form PAS-3, the valuation report of the registered valuer.



**Explanation.-** Pending notification of sub-section (1) of section 247 of the Act and finalisation of qualifications and experience of valuers, valuation of stocks, shares, debentures, securities etc. shall be conducted by an independent merchant banker who is registered with the Securities and Exchange Board of India or an independent chartered accountant in practice having a minimum experience of ten years.

### **7.2.18 Payment of Commission**

A company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions, namely:

- (a) the payment of such commission shall be authorized in the company's articles of association;
- (b) the commission may be paid out of proceeds of the issue or the profit of the company or both;
- (c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed two and a half per cent of the price at which the debentures are issued, or as specified in the company's articles, whichever is less;
- (d) the prospectus of the company shall disclose —
  - (i) the name of the underwriters;
  - (ii) the rate and amount of the commission payable to the underwriter; and
  - (iii) the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.
- (e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription;
- (f) a copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for registration.

### **7.2.19 Criminal Liability for Mis-Statements in Prospectus [Section 34]**

Where a prospectus, issued, circulated or distributed under this Chapter, includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorizes the issue of such prospectus shall be liable under section 447.

Provided that nothing in this section shall apply to a person if he proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

### **7.2.20 Civil Liability for Mis-Statements in Prospectus [Section 35]**

- (1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—
  - (a) is a director of the company at the time of the issue of the prospectus;
  - (b) has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;
  - (c) is a promoter of the company;
  - (d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of section 26,

shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves—

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in sub-section (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

#### **7.2.21 Punishment for Fraudulently Inducing Persons to Invest Money [Section 36]**

Any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into,—

(a) any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting securities; or

(b) any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or

(c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution, shall be liable for action under section 447.

#### **7.2.22 Action by Affected Persons [Section 37]**

A suit may be filed or any other action may be taken under section 34 or section 35 or section 36 by any person, group of persons or any association of persons affected by any misleading statement or the inclusion or omission of any matter in the prospectus.

#### **7.2.23 Punishment for Personation for Acquisition, etc., of Securities [Section 38]**

(1) Any person who—

(a) makes or abets making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or

(b) makes or abets making of multiple applications to a company in different names or in different combinations of his name or surname for acquiring or subscribing for its securities; or

(c) otherwise induces directly or indirectly a company to allot, or register any transfer of, securities to him, or to any other person in a fictitious name,

shall be liable for action under section 447.

(2) The provisions of sub-section (1) shall be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

(3) Where a person has been convicted under this section, the Court may also order disgorgement of gain, if any, made by, and seizure and disposal of the securities in possession of, such person.

(4) The amount received through disgorgement or disposal of securities under subsection (3) shall be credited to the Investor Education and Protection Fund.



#### **7.2.24 Allotment of Securities by Company [Section 39]**

- (1) No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.
- (2) The amount payable on application on every security shall not be less than five per cent. of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.
- (3) If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.
- (4) Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed.
- (5) In case of any default under sub-section (3) or sub-section (4), the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

#### **7.2.25 Securities to be Dealt with in Stock Exchanges [Section 40]**

- (1) Every company making public offer shall, before making such offer, make an application to one or more recognised stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges.
- (2) Where a prospectus states that an application under sub-section (1) has been made, such prospectus shall also state the name or names of the stock exchange in which the securities shall be dealt with.
- (3) All monies received on application from the public for subscription to the securities shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than—
  - (a) for adjustment against allotment of securities where the securities have been permitted to be dealt with in the stock exchange or stock exchanges specified in the prospectus; or
  - (b) for the repayment of monies within the time specified by the Securities and Exchange Board, received from applicants in pursuance of the prospectus, where the company is for any other reason unable to allot securities.
- (4) Any condition purporting to require or bind any applicant for securities to waive compliance with any of the requirements of this section shall be void.
- (5) If a default is made in complying with the provisions of this section, the company shall be punishable with a fine which shall not be less than five lakh rupees but which may extend to fifty lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both.
- (6) A company may pay commission to any person in connection with the subscription to its securities subject to such conditions as may be prescribed.

#### **7.2.26 Global Depository Receipt [Section 41]**

A company may, after passing a special resolution in its general meeting, issue depository receipts in any foreign country in such manner, and subject to such conditions as may be prescribed.

## 7.3 PRIVATE PLACEMENT

### 7.3.1 Offer or Invitation for Subscription of Securities on Private Placement [Section 42]

- (1) Without prejudice to the provisions of section 26, a company may, subject to the provisions of this section, make private placement through issue of a private placement offer letter.
- (2) Subject to sub-section (1), the offer of securities or invitation to subscribe securities, shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed, [excluding qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option as per provisions of clause (b) of sub-section (1) of section 62], in a financial year and on such conditions (including the form and manner of private placement) as may be prescribed.

**Explanation I.**—If a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than the prescribed number of persons, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public and shall accordingly be governed by the provisions of Part I of this Chapter.

**Explanation II.**— For the purposes of this section, the expression—

- (i) “qualified institutional buyer” means the qualified institutional buyer as defined in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 as amended from time to time.
  - (ii) “private placement” means any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in this section.
- (3) No fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.
  - (4) Any offer or invitation not in compliance with the provisions of this section shall be treated as a public offer and all provisions of this Act, and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with.
  - (5) All monies payable towards subscription of securities under this section shall be paid through cheque or demand draft or other banking channels but not by cash.
  - (6) A company making an offer or invitation under this section shall allot its securities within sixty days from the date of receipt of the application money for such securities and if the company is not able to allot the securities within that period, it shall repay the application money to the subscribers within fifteen days from the date of completion of sixty days and if the company fails to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of twelve per cent. per annum from the expiry of the sixtieth day.

Provided that monies received on application under this section shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than—

- (a) for adjustment against allotment of securities; or
  - (b) for the repayment of monies where the company is unable to allot securities.
- (7) All offers covered under this section shall be made only to such persons whose names are recorded by the company prior to the invitation to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company in such manner



as may be prescribed and complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.

- (8) No company offering securities under this section shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about such an offer.
- (9) Whenever a company makes any allotment of securities under this section, it shall file with the Registrar a return of allotment in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed.
- (10) If a company makes an offer or accepts monies in contravention of this section, the company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or two crore rupees, whichever is higher, and the company shall also refund all monies to subscribers within a period of thirty days of the order imposing the penalty.

## 7.4 AUDIT AND AUDITORS

### 7.4.1 Appointment of Auditors [Section 139]

- (1) Subject to the provisions of this Chapter, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed.

Provided that the company shall place the matter relating to such appointment for ratification by members at every annual general meeting.

Provided further that before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

Provided also that the certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.

Provided also that the company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed.

**Explanation.—** For the purposes of this Chapter, "appointment" includes re-appointment.

- (2) No listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or re-appoint—
  - (a) an individual as auditor for more than one term of five consecutive years; and
  - (b) an audit firm as auditor for more than two terms of five consecutive years:

Provided that—

- (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
- (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Provided further that as on the date of appointment no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Provided also that every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within three years from the date of commencement of this Act.

Provided also that, nothing contained in this sub-section shall prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

- (3) Subject to the provisions of this Act, members of a company may resolve to provide that—
  - (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
  - (b) the audit shall be conducted by more than one auditor.
- (4) The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of sub-section (2).

**Explanation.—** For the purposes of this Chapter, the word “firm” shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008.

- (5) Notwithstanding anything contained in sub-section (1), in the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.
- (6) Notwithstanding anything contained in sub-section (1), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within thirty days from the date of registration of the company and in the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.
- (7) Notwithstanding anything contained in sub-section (1) or sub-section (5), in the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.
- (8) Any casual vacancy in the office of an auditor shall—
  - (i) in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;



- (ii) in the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within thirty days.

Provided that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next thirty days.

- (9) Subject to the provisions of sub-section (1) and the rules made thereunder, a retiring auditor may be re-appointed at an annual general meeting, if—
- he is not disqualified for re-appointment;
  - he has not given the company a notice in writing of his unwillingness to be re-appointed; and
  - a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
- (10) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.
- (11) Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

### Summary at Glance

#### **First Auditor**

- First auditor of the company, other than a Government company, shall be appointed by the BOD within 30 days from the date of registration of the company;
- If BOD fails to appoint, by the member of the company within 90 days at an extraordinary general meeting appoint the first auditor;
- In case of Government company, first auditor shall be appointed by CAG within 60 days from the date of registration;
- If CAG fails to appoint, by the BOD of the company within next 30 days;
- If again BOD fails to appoint the first auditor of the company, by the member of the company within 60 days at an extraordinary general meeting;
- Tenure of the first auditor of the company in both the above cases till the conclusion of the first annual general meeting;

#### **Sub-Sequent Auditor**

- At the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting;
- Before such appointment, the written consent of the auditor to such appointment and a certificate from him shall be in accordance with the condition as may be prescribed;
- Within 15 days of the meeting the company shall file a notice of such appointment with the registrar;
- No listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or re-appoint—
  - (a) an individual as auditor for more than one term of five consecutive years; and
  - (b) an audit firm as auditor for more than two terms of five consecutive years:

### **Cooling Period**

- (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
  - (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.
- At the time of rotation of auditors, incoming audit firms/ auditor having common partner/s with the erstwhile audit firm shall not be eligible for appointment;
  - Firm shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008;
  - In the case of Government company, CAG in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of the company within a period of 180 days from the commencement of the financial year who shall hold the office till the conclusion of the AGM;

### **Re-appointment**

- A retiring auditor may be re-appointed at an annual general meeting, if—
  - (a) he is not disqualified for re-appointment;
  - (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
  - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed;
- Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company;
- Where provision of section 177 is applied, all appointments, including the filling of a casual vacancy of an auditor shall be made after taking into account the recommendations of such committee.

### **General Circular No. 33/2014**

#### **Clarification with Regard to Applicability of Provisions of Section 139(5) and 139(7) of the Companies Act, 2013**

1. it is clarified that the new Act does not alter the position with regard to audit of such deemed Government companies through C&AG and thus such companies are covered under sub-section (5) and (7) of section 139 of the New Act.
2. Clarification has also been sought about the manner in which the information about incorporation of a company subject to audit by an auditor to be appointed by the C&AG is to be communicated to the C&AG for the purpose of appointment of first auditors under section 139(7) of the New Act. It is hereby clarified that such responsibility rests with both, the Government concerned and the relevant company. To avoid any confusion it is further clarified that it will primarily be the responsibility of the company concerned to intimate to the C&AG about its incorporation along with name, location of registered office, capital structure of such a company immediately on its incorporation. It is also incumbent on such a company to share such intimation to the relevant Government so that such Government may also send a suitable request to the C&AG.

### 7.4.2 Class of Companies

For the purposes of sub-section (2) of section 139, the class of companies shall mean the following classes of companies excluding one person companies and small companies:-

- (a) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (b) all private limited companies having paid up share capital of rupees twenty crore or more;
- (c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

### 7.4.3 Manner of Rotation of Auditors by the Companies on Expiry of their Term

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
  - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;
  - (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

**Explanation. I** - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

**Explanation. II** - For the purpose of rotation of auditors,-

- (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;
- (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

### Illustration Explaining Rotation in Case of Individual Auditor

#### Illustration 1:-

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

**Note:**

1. Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
2. Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

**Illustration Explaining Rotation in Case of Audit Firm****Illustration 2:-**

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 years (or more than 10 years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 years	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 years	7 years	10 years
2 years	8 years	10 years
1 year	9 years	10 years

**Note:**

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
2. Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

**7.4.4 Removal, Resignation of Auditor and giving of Special Notice [Section 140]**

- (1) The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner.

Provided that before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard.

- (2) The auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar, and in case of companies referred to in sub-section (5) of section 139, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation.



- (3) If the auditor does not comply with sub-section (2), he or it shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.
- (4) (i) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139.
- (ii) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (iii) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—
- (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
- (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,

and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Provided that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Provided further that if the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by this sub-section are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

- (5) Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

**Explanation I.**—It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

**Explanation II.**—For the purposes of this Chapter the word “auditor” includes a firm of auditors.

## Summary at Glance

### **Removal**

- By a special resolution of the company and after obtaining the previous approval of the central Government, the auditor appointed under section 139 may be removed from his office before the expiry of his term;

### **Resignation**

- The auditor shall file within 30 days from the date of resignation, a statement in prescribed form with the company and the registrar;
- In case of Government company, the auditor shall send such statement with the CAG, indicating the reason and other facts with regards to his resignation;
- If fails to comply with sub-section (2), punishable with fine not less than ₹50,000 but may extend to ₹5,00,000;

### **Special notice**

- Special notice for resolution at an annual general meeting for appointment of auditor other than a retiring auditor;
- On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor;
- Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—
  - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
  - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,
- If a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting.

## **7.4.5 Eligibility, Qualifications and Disqualifications of Auditors [Section 141]**

- (1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.  
Provided that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.
- (2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.
- (3) The following persons shall not be eligible for appointment as an auditor of a company, namely:—
  - (a) a body corporate other than a limited liability partnership registered under 6 of 2009. the Limited Liability Partnership Act, 2008;
  - (b) an officer or employee of the company;
  - (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;



- (d) a person who, or his relative or partner—
- (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.  
Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;
  - (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or
  - (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;
- (e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;
- (f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;
- (h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
- (i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.
- (4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

#### **7.4.6 Remuneration of Auditors [Section 142]**

- (1) The remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.  
Provided that the Board may fix remuneration of the first auditor appointed by it.
- (2) The remuneration under sub-section (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

#### **7.4.7 Powers and Duties of Auditors and Auditing Standards [Section 143]**

- (1) Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:—
- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
  - (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

- (2) The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.
- (3) The auditor's report shall also state—
  - (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
  - (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
  - (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
  - (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
  - (e) whether, in his opinion, the financial statements comply with the accounting standards;
  - (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
  - (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
  - (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
  - (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
  - (j) such other matters as may be prescribed.

- (4) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.
- (5) In the case of a Government company, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.
- (6) The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to,—
  - (a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
  - (b) comment upon or supplement such audit report.

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

- (7) Without prejudice to the provisions of this Chapter, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.
- (8) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

- (9) Every auditor shall comply with the auditing standards.
- (10) The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

- (11) The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.
- (12) Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving an amount of rupees one crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed by the Companies (Audit and Auditors) Amendment Rules, 2015 dated vide notification dated 14.12.2015.
- Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter in such manner as prescribed by the Companies (Audit and Auditors) Amendment Rules, 2015 dated vide notification dated 14.12.2015.
- Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.
- (13) No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.
- (14) The provisions of this section shall mutatis mutandis apply to—
- (a) the cost accountant in practice conducting cost audit under section 148; or
  - (b) the company secretary in practice conducting secretarial audit under section 204.
- (15) If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

#### **7.4.8 Other Matters to be included in Auditor's Report**

The auditor's report shall also include their views and comments on the following matters, namely:-

- (a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (b) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- (c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

#### **7.4.9 Duties and Powers of the Company's Auditor with reference to the Audit of the Branch and the Branch Auditor**

- (1) For the purposes of sub-section (8) of section 143, the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in sub-sections (1) to (4) of section 143.
- (2) The branch auditor shall submit his report to the company's auditor.
- (3) The provisions of sub-section (12) of section 143 read with rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

#### **7.4.10 Reporting of Frauds by Auditor**

- (1) For the purpose of sub-section (12) of section 143, in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company



by officers or employees of the company, he shall report the matter to the Central Government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below.

- (i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;
  - (ii) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;
  - (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.
- (2) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.
  - (3) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number.
  - (4) The report shall be in the form of a statement as specified in Form ADT-4.
  - (5) The provision of this rule shall also, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively.

#### **7.4.11 Auditor not to render Certain Services [Section 144]**

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case maybe, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company, namely:—

- (a) accounting and book keeping services;
- (b) internal audit;
- (c) design and implementation of any financial information system;
- (d) actuarial services;
- (e) investment advisory services;
- (f) investment banking services;
- (g) rendering of outsourced financial services;
- (h) management services; and
- (i) any other kind of services as may be prescribed.

Provided that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

**Explanation.—**For the purposes of this sub-section, the term "directly or indirectly" shall include rendering of services by the auditor,—

- (i) in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;

- (ii) in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

#### **7.4.12 Auditor to Sign Audit Reports, etc. [Section 145]**

The person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of section 141, and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

#### **7.4.13 Auditors to attend General Meeting [Section 146]**

All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

#### **7.4.14 Punishment for Contravention [Section 147]**

- (1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.
- (2) If an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

- (3) Where an auditor has been convicted under sub-section (2), he shall be liable to—
  - (i) refund the remuneration received by him to the company; and
  - (ii) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- (4) The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- (5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

#### 7.4.15 Central Government to Specify Audit of Items of Cost in respect of Certain Companies [Section 148]

- (1) Notwithstanding anything contained in this Chapter, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

Provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

- (2) If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.
- (3) The audit under sub-section (2) shall be conducted by a Cost Accountant in practice who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards.

**Explanation.—** For the purposes of this sub-section, the expression “cost auditing standards” mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.

- (4) An audit conducted under this section shall be in addition to the audit conducted under section 143.
- (5) The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

- (6) A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (2) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.
- (7) If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (6), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.
- (8) If any default is made in complying with the provisions of this section,—
  - (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;
  - (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

#### 7.4.16 Remuneration of the Cost Auditor

For the purpose of sub-section (3) of section 148,—

- (a) in the case of companies which are required to constitute an audit committee—
  - (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;
  - (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

### 7.5 APPOINTMENT AND QUALIFICATIONS OF DIRECTORS

#### 7.5.1 Company to have Board of Directors [Section 149]

- (1) Every company shall have a Board of Directors consisting of individuals as directors and shall have—
  - (a) a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and
  - (b) a maximum of fifteen directors.

Provided that a company may appoint more than fifteen directors after passing a special resolution.

Provided further that such class or classes of companies as may be prescribed, shall have at least one woman director.

- (2) Every company existing on or before the date of commencement of this Act shall within one year from such commencement comply with the requirements of the provisions of sub-section (1).
- (3) Every company shall have at least one director who has stayed in India for a total period of not less than one hundred and eighty-two days in the previous calendar year.
- (4) Every listed public company shall have at least one-third of the total number of directors as independent directors and the Central Government may prescribe the minimum number of independent directors in case of any class or classes of public companies.

**Explanation.—** For the purposes of this sub-section, any fraction contained in such one-third number shall be rounded off as one.

- (5) Every company existing on or before the date of commencement of this Act shall, within one year from such commencement or from the date of notification of the rules in this regard as may be applicable, comply with the requirements of the provisions of sub-section (4).
- (6) An independent director in relation to a company, means a director other than a managing director or a whole-time director or a nominee director,—
  - (a) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
  - (b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;



- (ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
  - (c) who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
  - (d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;
  - (e) who, neither himself nor any of his relatives—
    - (i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;
    - (ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of—
      - (A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or
      - (B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent. or more of the gross turnover of such firm;
    - (iii) holds together with his relatives two per cent. or more of the total voting power of the company; or
    - (iv) is a Chief Executive or director, by whatever name called, of any nonprofit organisation that receives twenty-five per cent. or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent. or more of the total voting power of the company; or
  - (f) who possesses such other qualifications as may be prescribed.
- (7) Every independent director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, give a declaration that he meets the criteria of independence as provided in sub-section (6).

**Explanation.—** For the purposes of this section, "nominee director" means a director nominated by any financial institution in pursuance of the provisions of any law for the time being in force, or of any agreement, or appointed by any Government, or any other person to represent its interests.

- (8) The company and independent directors shall abide by the provisions specified in Schedule IV.
- (9) Notwithstanding anything contained in any other provision of this Act, but subject to the provisions of sections 197 and 198, an independent director shall not be entitled to any stock option and may receive remuneration by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.
- (10) Subject to the provisions of section 152, an independent director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for re-appointment on passing of a special resolution by the company and disclosure of such appointment in the Board's report.

- (11) Notwithstanding anything contained in sub-section (10), no independent director shall hold office for more than two consecutive terms, but such independent director shall be eligible for appointment after the expiration of three years of ceasing to become an independent director.

Provided that an independent director shall not, during the said period of three years, be appointed in or be associated with the company in any other capacity, either directly or indirectly.

**Explanation.—** For the purposes of sub-sections (10) and (11), any tenure of an independent director on the date of commencement of this Act shall not be counted as a term under those sub-sections.

- (12) Notwithstanding anything contained in this Act,—

- (i) an independent director;
- (ii) a non-executive director not being promoter or key managerial personnel, shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.

- (13) The provisions of sub-sections (6) and (7) of section 152 in respect of retirement of directors by rotation shall not be applicable to appointment of independent directors.

### Summary at Glance

#### **(1) Minimum no. of Directors**

Public Company : 3 directors

Private Company : 2 directors

One Person Company : 1 director

#### **(2) Maximum no. of Directors** : 15 directors

A company may appoint more than 15 directors after passing a special resolution.

#### **(3)** Such class or classes of companies as may be prescribed, shall have at least 1 woman director.

A transitional period of 1 year from the date of commencement of the Act has been provided to comply with the provision related to appointment of woman director.

#### **(4)** Every company shall have at least one director who has stayed in India for a total period of not less than 182 days in the previous calendar year.

#### **(5) Independent Director**

(i) In every listed company =  $\frac{1}{3}$  of the total number of directors;

(ii) An independent director means a director other than a managing director or a whole-time director or a nominee director;

(i) At the first meeting of the board or first meeting of the board of any financial year, give a declaration that he meets the criteria of independence;

(ii) An independent director shall not be entitled to any stock option, remuneration by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members;

(iii) An independent director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for re-appointment on passing of a special resolution by the company;

(iv) No independent director shall hold office for more than two consecutive terms, but such independent director shall be eligible for appointment after the expiration of three years of ceasing to become an independent director;

(v) Provision relating to retirement of directors by rotation shall not be applicable to appointment of independent directors.

### **General Circular No. 25/2014**

#### **Clarification on Applicability of Requirement for Resident Director**

- (i) It is clarified that the residency requirement' would be reckoned from the date of commencement of section 149 of the Act i.e. 1<sup>st</sup> April, 2014. The first ,previous calendar year, for compliance with these provisions would, therefore, be Calendar year 2014. The period to be taken into account for compliance with these provisions will be the remaining period of calendar year 2014 (i.e. 1<sup>st</sup> April to 31<sup>st</sup> December). Therefore, on a proportionate basis, the number of days for which the director(s) would need to be resident in India, during Calendar year 2014, shall exceed 136 days.
- (ii) Regarding newly incorporated companies it is clarified that companies incorporated between 1.4.2014 to 30.9.2014 should have a resident director either at the incorporation stage itself or within six months of their incorporation. Companies incorporated after 30.9.2014 need to have the resident director from the date of incorporation itself.

#### **7.5.2 Woman Director on the Board**

The following class of companies shall appoint at least one woman director-

- (i) every listed company;
- (ii) every other public company having -
  - (a) paid-up share capital of one hundred crore rupees or more; or
  - (b) turnover of three hundred crore rupees or more.

Provided that a company, which has been incorporated under the Act and is covered under provisions of second proviso to sub-section (1) of section 149 shall comply with such provisions within a period of six months from the date of its incorporation.

Provided further that any intermittent vacancy of a woman director shall be filled-up by the Board at the earliest but not later than immediate next Board meeting or three months from the date of such vacancy whichever is later.

**Explanation.-** For the purposes of this rule, it is hereby clarified that the paid up share capital or turnover, as the case may be, as on the last date of latest audited financial statements shall be taken into account.

#### **7.5.3 Number of Independent Directors**

The following class or classes of companies shall have at least two directors as independent directors -

- (i) the Public Companies having paid up share capital often crore rupees or more; or
- (ii) the Public Companies having turnover of one hundred crore rupees or more; or
- (iii) the Public Companies which have, in aggregate, outstanding loans, debentures and deposits, exceeding fifty crore rupees.

Provided that in case a company covered under this rule is required to appoint a higher number of independent directors due to composition of its audit committee, such higher number of independent directors shall be applicable to it.

Provided further that any intermittent vacancy of an independent director shall be filled-up by the Board at the earliest but not later than immediate next Board meeting or three months from the date of such vacancy, whichever is later.

Provided also that where a company ceases to fulfil any of three conditions laid down in sub-rule (1) for three consecutive years, it shall not be required to comply with these provisions until such time as it meets any of such conditions.

**Explanation** - For the purposes of this rule, it is here by clarified that, the paid up share capital or turnover or outstanding loans, debentures and deposits, as the case may be, as existing on the last date of latest audited financial statements shall be taken into account.

Provided that a company belonging to any class of companies for which a higher number of independent directors has been specified in the law for the time being in force shall comply with the requirements specified in such law.

#### **7.5.4 Manner of Selection of Independent Directors and Maintenance of Databank of Independent Directors [Section 150]**

(1) Subject to the provisions contained in sub-section (5) of section 149, an independent director may be selected from a data bank containing names, addresses and qualifications of persons who are eligible and willing to act as independent directors, maintained by any body, institute or association, as may be notified by the Central Government, having expertise in creation and maintenance of such data bank and put on their website for the use by the company making the appointment of such directors.

Provided that responsibility of exercising due diligence before selecting a person from the data bank referred to above, as an independent director shall lie with the company making such appointment.

(2) The appointment of independent director shall be approved by the company in general meeting as provided in sub-section (2) of section 152 and the explanatory statement annexed to the notice of the general meeting called to consider the said appointment shall indicate the justification for choosing the appointee for appointment as independent director.

(3) The data bank referred to in sub-section (1), shall create and maintain data of persons willing to act as independent director in accordance with such rules as may be prescribed.

(4) The Central Government may prescribe the manner and procedure of selection of independent directors who fulfill the qualifications and requirements specified under section 149.

#### **General Circular No. 14/2014**

#### **Matters relating to appointment and qualifications of directors and Independent Directors - reg.**

Clarifications on the following points are hereby given:-

#### **(i) Section 149(6)(c): "Pecuniary Interest in Certain transactions" :**

(a) This provision inter alia requires that an Independent Director (ID) should have no 'pecuniary relationship' with the company concerned or its holding/ subsidiary/ associate company and certain other categories specified therein during the current and last two preceding financial years. Clarifications have been sought whether a transaction entered into by an 'ID' with the company concerned at par with any member of the general public and at the same price as is payable/paid by such member of public would attract the bar of 'pecuniary relationship' under section 149(6)(c). The matter has been examined and it is hereby clarified that in view of the provisions of section 188 which take away transactions in the ordinary course of business at arm's length price from the purview of related party transactions, an 'ID' will not be said to have 'pecuniary relationship' under section 149(6)(c) in such cases.

(b) Whether receipt of remuneration, (in accordance with the provisions of the Act) by an 'ID' from a company would be considered as having pecuniary interest while considering his appointment in the holding company, subsidiary company or associate company of such company.

The matter has been examined in consultation with SEBI and it is clarified that 'pecuniary relationship' provided in section 149(6)(c) of the Act does not include receipt of remuneration, from one or more companies, by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission approved by the members, in accordance with the provisions of the Act.

**(ii) Section 149: Appointment of “IPs” :**

Clarification has been sought if IDs' appointed prior to April 1, 2014 may continue and complete their remaining tenure, under the provisions of the Companies Act, 1956 or they should demit office and be re-appointed (should the company so decide) in accordance with the provisions of the new Act.

The matter has been examined in the light of the relevant provisions of the Act, particularly section 149(5) and 149(10) & (11). Explanation to section 149(11) clearly provides that any tenure of an ID' on the date of commencement of the Act shall not be counted for his appointment/holding office of director under the Act. In view of the transitional period of one year provided under section 149(5), it is hereby clarified that it would be necessary that if it is intended to appoint existing 'IDs' under the new Act, such appointment shall be made expressly under section 149(10)/(11) read with Schedule IV of the Act within one year from 1<sup>st</sup> April, 2014, subject to compliance with eligibility and other prescribed conditions.

**(iii) Section 149(10)&(11) - Appointment of IDs' for less than 5 years:**

Clarification has been sought as to whether it would be possible to appoint an individual as an ID for a period less than five years.

It is clarified that section 149(10) of the Act provides for a term of “upto five consecutive years” for an 'ID'. As such while appointment of an 'ID' for a term of less than five years would be permissible, appointment for any term (whether for five years or less) is to be treated as a one term under section 149(10) of the Act. Further, under section 149(11) of the Act, no person can hold office of 'ID' for more than 'two consecutive terms'. Such a person shall have to demit office after two consecutive terms even if the total number of years of his appointment in such two consecutive terms is less than 10 years. In such a case the person completing 'consecutive terms of less than ten years' shall be eligible for appointment only after the expiry of the requisite cooling-off period of three years.

**(iv) Appointment of 'IDs' through letter of appointment:-**

With reference to Para IV(4) of Schedule IV of the Act (Code for IDs) which requires appointment of IDs' to be formalized through a letter of appointment, clarification has been sought if such requirement would also be applicable for appointment of existing 'IDs'?

The matter has been examined. In view of the specific provisions of Schedule IV, appointment of 'IDs' under the new Act would need to be formalized through a letter of appointment.

**7.5.5 Appointment of Director Elected by Small Shareholders [Section 151]**

A listed company may have one director elected by such small shareholders in such manner and with such terms and conditions as may be prescribed.

**Explanation.—** For the purposes of this section “small shareholders” means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

**7.5.6 Small Shareholders' Director**

- (1) A listed company, may upon notice of not less than one thousand small shareholders or one-tenth of the total number of such shareholders, whichever is lower, have a small shareholder's director elected by the small shareholders.

Provided that nothing in this sub-rule shall prevent a listed company to opt to have a director representing small shareholders suo - motu and in such a case the provisions of sub-rule (2) shall not apply for appointment of such director.

- (2) The small shareholders intending to propose a person as a candidate for the post of small shareholders' director shall leave a notice of their intention with the company at least fourteen days before the meeting under their signatures verifying the name, address, shares held and folio number of the person whose name is being proposed for the post of director and of the small shareholders who are proposing such person for the office of director.

Provided that if the person being proposed does not hold any shares in the company, the details of shares held and folio number need not be specified in the notice.

- (3) The notice shall be accompanied by a statement signed by the person whose name is being proposed for the post of small shareholders' director stating —
  - (a) his Director Identification Number;
  - (b) that he is not disqualified to become a director under the Act; and
  - (c) his consent to act as a director of the company
- (4) Such director shall be considered as an independent director subject to, his being eligible under sub-section (6) of section 149 and his giving a declaration of his independence in accordance with sub-section (7) of section 149 of the Act.
- (5) The appointment of small shareholders' director shall be subject to the provisions of section 152 except that—
  - (a) such director shall not be liable to retire by rotation;
  - (b) such director's tenure as small shareholders' director shall not exceed a period of three consecutive years; and
  - (c) on the expiry of the tenure, such director shall not be eligible for re-appointment.
- (6) A person shall not be appointed as small shareholders' director of a company, if the person is not eligible for appointment in terms of section 164.
- (7) A person appointed as small shareholders' director shall vacate the office if—
  - (a) the director incurs any of the disqualifications specified in section 164;
  - (b) the office of the director becomes vacant in pursuance of section 167;
  - (c) the director ceases to meet the criteria of independence as provided in sub-section (6) of section 149.
- (8) No person shall hold the position of small shareholders' director in more than two companies at the same time.

Provided that the second company in which he has been appointed shall not be in a business which is competing or is in conflict with the business of the first company.

- (9) A small shareholders' director shall not, for a period of three years from the date on which he ceases to hold office as a small shareholders' director in a company, be appointed in or be associated with such company in any other capacity, either directly or indirectly.

#### **7.5.7 Appointment of Directors [Section 152]**

- (1) Where no provision is made in the articles of a company for the appointment of the first director, the subscribers to the memorandum who are individuals shall be deemed to be the first directors of the company until the directors are duly appointed and in case of a One Person Company an individual being member shall be deemed to be its first director until the director or directors are duly appointed by the member in accordance with the provisions of this section.
- (2) Save as otherwise expressly provided in this Act, every director shall be appointed by the company in general meeting.
- (3) No person shall be appointed as a director of a company unless he has been allotted the Director Identification Number under section 154.
- (4) Every person proposed to be appointed as a director by the company in general meeting or otherwise, shall furnish his Director Identification Number and a declaration that he is not disqualified to become a director under this Act.



- (5) A person appointed as a director shall not act as a director unless he gives his consent to hold the office as director and such consent has been filed with the Registrar within thirty days of his appointment in such manner as may be prescribed.

Provided that in the case of appointment of an independent director in the general meeting, an explanatory statement for such appointment, annexed to the notice for the general meeting, shall include a statement that in the opinion of the Board, he fulfils the conditions specified in this Act for such an appointment.

- (6) (a) Unless the articles provide for the retirement of all directors at every annual general meeting, not less than two-thirds of the total number of directors of a public company shall—
- (i) be persons whose period of office is liable to determination by retirement of directors by rotation; and
  - (ii) save as otherwise expressly provided in this Act, be appointed by the company in general meeting.
- (b) The remaining directors in the case of any such company shall, in default of, and subject to any regulations in the articles of the company, also be appointed by the company in general meeting.
- (c) At the first annual general meeting of a public company held next after the date of the general meeting at which the first directors are appointed in accordance with clauses (a) and (b) and at every subsequent annual general meeting, one-third of such of the directors for the time being as are liable to retire by rotation, or if their number is neither three nor a multiple of three, then, the number nearest to one-third, shall retire from office.
- (d) The directors to retire by rotation at every annual general meeting shall be those who have been longest in office since their last appointment, but as between persons who became directors on the same day, those who are to retire shall, in default of and subject to any agreement among themselves, be determined by lot.
- (e) At the annual general meeting at which a director retires as aforesaid, the company may fill up the vacancy by appointing the retiring director or some other person thereto.

**Explanation.—** For the purposes of this sub-section, "total number of directors" shall not include independent directors, whether appointed under this Act or any other law for the time being in force, on the Board of a company.

- (7) (a) If the vacancy of the retiring director is not so filled-up and the meeting has not expressly resolved not to fill the vacancy, the meeting shall stand adjourned till the same day in the next week, at the same time and place, or if that day is a national holiday, till the next succeeding day which is not a holiday, at the same time and place.
- (b) If at the adjourned meeting also, the vacancy of the retiring director is not filled up and that meeting also has not expressly resolved not to fill the vacancy, the retiring director shall be deemed to have been re-appointed at the adjourned meeting, unless—
- (i) at that meeting or at the previous meeting a resolution for the re-appointment of such director has been put to the meeting and lost;
  - (ii) the retiring director has, by a notice in writing addressed to the company or its Board of directors, expressed his unwillingness to be so re-appointed;
  - (iii) he is not qualified or is disqualified for appointment;
  - (iv) a resolution, whether special or ordinary, is required for his appointment or re-appointment by virtue of any provisions of this Act; or
  - (v) section 162 is applicable to the case.

**Explanation.**—For the purposes of this section and section 160, the expression “retiring director” means a director retiring by rotation.

### **7.5.8 Consent to Act as Director**

Every person who has been appointed to hold the office of a director shall on or before the appointment furnish to the company a consent in writing to act as such in Form DIR-2.

Provided that the company shall, within thirty days of the appointment of a director, file such consent with the Registrar in Form DIR-12 along with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014.

### **7.5.9 Application for Allotment of Director Identification Number [Section 153]**

Every individual intending to be appointed as director of a company shall make an application for allotment of Director Identification Number to the Central Government in such form and manner and along with such fees as may be prescribed.

#### **7.5.10 Form and Manner of Application for Allotment of Director Identification Number**

- (1) Every individual, who is to be appointed as director of a company shall make an application electronically in Form DIR-3, to the Central Government for the allotment of a Director Identification Number (DIN) along with such fees as provided in the Companies (Registration Offices and Fees) Rules, 2014.
- (2) The Central Government shall provide an electronic system to facilitate submission of application for the allotment of DIN through the portal on the website of the Ministry of Corporate Affairs.
- (3) (a) The applicant shall download Form DIR-3 from the portal, fill in the required particulars sought therein and sign the form and after attaching copies of the following documents, scan and file the entire set of documents electronically—
  - (i) photograph;
  - (ii) proof of identity;
  - (iii) proof of residence;
  - (iv) verification by the applicant for applying for allotment of DIN in Form DIRi-4; and
  - (v) specimen signature duly verified.
- (b) Form DIR-3 shall be signed and submitted electronically by the applicant using his or her own Digital Signature Certificate and shall be verified digitally by -
  - (i) a chartered accountant in practice or a company secretary in practice or a cost accountant in practice; or
  - (ii) a company secretary in full time employment of the company or by the managing director or director of the company in which the applicant is to be appointed as director.

#### **7.5.11 Allotment of Director Identification Number [Section 154]**

The Central Government shall, within one month from the receipt of the application under section 153, allot a Director Identification Number to an applicant in such manner as may be prescribed.

#### **7.5.12 Manner of Allotment of DIN**

- (1) On the submission of the Form DIR-3 on the portal and payment of the requisite amount of fees through online mode the provisional DIN shall be generated by the system automatically which shall not be utilized till the DIN is confirmed by the Central Government.
- (2) After generation of the provisional DIN, the Central Government shall process the applications received for allotment of DIN under sub-rule (2) of rule 9, decide on the approval or rejection



thereof and communicate the same to the applicant along with the DIN allotted in case of approval by way of a letter by post or electronically or in any other mode, within a period of one month from the receipt of such application.

- (3) If the Central Government, on examination, finds such application to be defective or incomplete in any respect, it shall give intimation of such defect or incompleteness, by placing it on the website and by email to the applicant who has filed such application, directing the applicant to rectify such defects or incompleteness by resubmitting the application within a period of fifteen days of such placing on the website and email.

Provided that the Central Government shall -

- (a) reject the application and direct the applicant to file fresh application with complete and correct information, where the defect has been rectified partially or the information given is still found to be defective;
  - (b) treat and label such application as invalid in the electronic record in case the defects are not removed within the given time; and
  - (c) inform the applicant either by way of letter by post or electronically or in any other mode.
- (4) In case of rejection or invalidation of application, the provisional DIN so allotted by the system shall get lapsed automatically and the fee so paid with the application shall neither be refunded nor adjusted with any other application.
  - (5) All Director Identification Numbers allotted to individual(s) by the Central Government before the commencement of these rules shall be deemed to have been allotted to them under these rules.
  - (6) The Director Identification Number so allotted under these rules is valid for the life-time of the applicant and shall not be allotted to any other person.

#### **7.5.13 Prohibition to Obtain more than one Director Identification Number [Section 155]**

No individual, who has already been allotted a Director Identification Number under section 154, shall apply for, obtain or possess another Director Identification Number.

#### **7.5.14 Director to intimate Director Identification Number [Section 156]**

Every existing director shall, within one month of the receipt of Director Identification Number from the Central Government, intimate his Director Identification Number to the company or all companies wherein he is a director.

#### **7.5.15 Company to inform Director Identification Number to Registrar [Section 157]**

- (1) Every company shall, within fifteen days of the receipt of intimation under section 156, furnish the Director Identification Number of all its directors to the Registrar or any other officer or authority as may be specified by the Central Government with such fees as may be prescribed or with such additional fees as may be prescribed within the time specified under section 403 and every such intimation shall be furnished in such form and manner as may be prescribed.
- (2) If a company fails to furnish Director Identification Number under sub-section (1), before the expiry of the period specified under section 403 with additional fee, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

#### **7.5.16 Obligation to Indicate Director Identification Number [Section 158]**

Every person or company, while furnishing any return, information or particulars as are required to be furnished under this Act, shall mention the Director Identification Number in such return, information or particulars in case such return, information or particulars relate to the director or contain any reference of any director.

### 7.5.17 Cancellation or Surrender or Deactivation of DIN

The Central Government or Regional Director (Northern Region), Noida or any officer authorised by the Regional Director may, upon being satisfied on verification of particulars or documentary proof attached with the application received from any person, cancel or deactivate the DIN in case —

- (a) the DIN is found to be duplicated in respect of the same person provided the data related to both the DIN shall be merged with the validly retained number;
- (b) the DIN was obtained in a wrongful manner or by fraudulent means;
- (c) of the death of the concerned individual;
- (d) the concerned individual has been declared as a person of unsound mind by a competent Court;
- (e) if the concerned individual has been adjudicated an insolvent:

Provided that before cancellation or deactivation of DIN pursuant to clause (b), an opportunity of being heard shall be given to the concerned individual;

- (f) on an application made in Form DIR-5 by the DIN holder to surrender his or her DIN along with declaration that he has never been appointed as director in any company and the said DIN has never been used for filing of any document with any authority, the Central Government may deactivate such DIN.

Provided that before deactivation of any DIN in such case, the Central Government shall verify e-records.

**Explanation.-** For the purposes of clause (b) -

- (i) the term "wrongful manner" means if the DIN is obtained on the strength of documents which are not legally valid or incomplete documents are furnished or on suppression of material information or on the basis of wrong certification or by making misleading or false information or by misrepresentation;
- (ii) the term "fraudulent means" means if the DIN is obtained with an intent to deceive any other person or any authority including the Central Government.

### 7.5.18 Intimation of Changes in Particulars Specified in DIN Application

- (1) Every individual who has been allotted a Director Identification Number under these rules shall, in the event of any change in his particulars as stated in Form DIR-3, intimate such change(s) to the Central Government within a period of thirty days of such change(s) in Form DIR-6 in the following manner, namely;-
  - (i) the applicant shall download Form DIR-6 from the portal and fill in the relevant changes, attach copy of the proof of the changed particulars and verification in the Form DIR-7 all of which shall be scanned and submitted electronically;
  - (ii) the form shall be digitally signed by a chartered accountant in practice or a company secretary in practice or a cost accountant in practice;
  - (iii) the applicant shall submit the Form DIR-6;
- (2) The Central Government, upon being satisfied, after verification of such changed particulars from the enclosed proofs, shall incorporate the said changes and inform the applicant by way of a letter by post or electronically or in any other mode confirming the effect of such change in the electronic database maintained by the Ministry.
- (3) The DIN cell of the Ministry shall also intimate the change(s) in the particulars of the director submitted to it in Form DIR-6 to the concerned Registrar(s) under whose jurisdiction the registered office of the company(s) in which such individual is a director is situated.



- (4) The concerned individual shall also intimate the change(s) in his particulars to the company or companies in which he is a director within fifteen days of such change.

#### **7.5.19 Punishment for Contravention [Section 159]**

If any individual or director of a company, contravenes any of the provisions of section 152, section 155 and section 156, such individual or director of the company shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to fifty thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which the contravention continues.

#### **7.5.20 Right of Persons other than Retiring Directors to Stand for Directorship [Section 160]**

- (1) A person who is not a retiring director in terms of section 152 shall, subject to the provisions of this Act, be eligible for appointment to the office of a director at any general meeting, if he, or some member intending to propose him as a director, has, not less than fourteen days before the meeting, left at the registered office of the company, a notice in writing under his hand signifying his candidature as a director or, as the case may be, the intention of such member to propose him as a candidate for that office, along with the deposit of one lakh rupees or such higher amount as may be prescribed which shall be refunded to such person or, as the case may be, to the member, if the person proposed gets elected as a director or gets more than twenty-five per cent. of total valid votes cast either on show of hands or on poll on such resolution.
- (2) The company shall inform its members of the candidature of a person for the office of director under sub-section (1) in such manner as may be prescribed.

#### **7.5.21 Appointment of Additional Director, Alternate Director and Nominee Director [Section 161]**

- (1) The articles of a company may confer on its Board of Directors the power to appoint any person, other than a person who fails to get appointed as a director in a general meeting, as an additional director at any time who shall hold office up to the date of the next annual general meeting or the last date on which the annual general meeting should have been held, whichever is earlier.
- (2) The Board of Directors of a company may, if so authorised by its articles or by a resolution passed by the company in general meeting, appoint a person, not being a person holding any alternate directorship for any other director in the company, to act as an alternate director for a director during his absence for a period of not less than three months from India.

Provided that no person shall be appointed as an alternate director for an independent director unless he is qualified to be appointed as an independent director under the provisions of this Act.

Provided further that an alternate director shall not hold office for a period longer than that permissible to the director in whose place he has been appointed and shall vacate the office if and when the director in whose place he has been appointed returns to India.

Provided also that if the term of office of the original director is determined before he so returns to India, any provision for the automatic re-appointment of retiring directors in default of another appointment shall apply to the original, and not to the alternate director.

- (3) Subject to the articles of a company, the Board may appoint any person as a director nominated by any institution in pursuance of the provisions of any law for the time being in force or of any agreement or by the Central Government or the State Government by virtue of its shareholding in a Government company.
- (4) In the case of a public company, if the office of any director appointed by the company in general meeting is vacated before his term of office expires in the normal course, the resulting casual vacancy may, in default of and subject to any regulations in the articles of the company, be filled by the Board of Directors at a meeting of the Board.

Provided that any person so appointed shall hold office only up to the date up to which the director in whose place he is appointed would have held office if it had not been vacated.

#### **7.5.22 Appointment of Directors to be Voted Individually [Section 162]**

- (1) At a general meeting of a company, a motion for the appointment of two or more persons as directors of the company by a single resolution shall not be moved unless a proposal to move such a motion has first been agreed to at the meeting without any vote being cast against it.
- (2) A resolution moved in contravention of sub-section (1) shall be void, whether or not any objection was taken when it was moved.
- (3) A motion for approving a person for appointment, or for nominating a person for appointment as a director, shall be treated as a motion for his appointment.

#### **7.5.23 Notice of Candidature of a Person for Directorship**

The company shall, at least seven days before the general meeting, inform its members of the candidature of a person for the office of a director or the intention of a member to propose such person as a candidate for that office -

- (1) by serving individual notices, on the members through electronic mode to such members who have provided their email addresses to the company for communication purposes, and In writing to all other members; and
- (2) by placing notice of such candidature or intention on the website of the company, if any.

Provided that it shall not be necessary for the company to serve individual notices upon the members as aforesaid, if the company advertises such candidature or intention, not less than seven days before the meeting at least once in a vernacular newspaper in the principal vernacular language of the district in which the registered office of the company is situated, and circulating in that district, and at least once in English language in an English newspaper circulating in that district.

#### **7.5.24 Option to Adopt Principle of Proportional Representation for Appointment of Directors [Section 163]**

Notwithstanding anything contained in this Act, the articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a company in accordance with the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise and such appointments may be made once in every three years and casual vacancies of such directors shall be filled as provided in sub-section (4) of section 161.

#### **7.5.25 Disqualifications for Appointment of Director [Section 164]**

- (1) A person shall not be eligible for appointment as a director of a company, if —
  - (a) he is of unsound mind and stands so declared by a competent court;
  - (b) he is an undischarged insolvent;
  - (c) he has applied to be adjudicated as an insolvent and his application is pending;
  - (d) he has been convicted by a court of any offence, whether involving moral turpitude or otherwise, and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of expiry of the sentence.

Provided that if a person has been convicted of any offence and sentenced in respect thereof to imprisonment for a period of seven years or more, he shall not be eligible to be appointed as a director in any company;

- (e) an order disqualifying him for appointment as a director has been passed by a court or Tribunal and the order is in force;



- (f) he has not paid any calls in respect of any shares of the company held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call;
  - (g) he has been convicted of the offence dealing with related party transactions under section 188 at any time during the last preceding five years; or
  - (h) he has not complied with sub-section (3) of section 152.
- (2) No person who is or has been a director of a company which—
- (a) has not filed financial statements or annual returns for any continuous period of three financial years; or
  - (b) has failed to repay the deposits accepted by it or pay interest thereon or to redeem any debentures on the due date or pay interest due thereon or pay any dividend declared and such failure to pay or redeem continues for one year or more,
- shall be eligible to be re-appointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.
- (3) A private company may by its articles provide for any disqualifications for appointment as a director in addition to those specified in sub-sections (1) and (2).
- Provided that the disqualifications referred to in clauses (d), (e) and (g) of sub-section (1) shall not take effect—
- (i) for thirty days from the date of conviction or order of disqualification;
  - (ii) where an appeal or petition is preferred within thirty days as aforesaid against the conviction resulting in sentence or order, until expiry of seven days from the date on which such appeal or petition is disposed off; or
  - (iii) where any further appeal or petition is preferred against order or sentence within seven days, until such further appeal or petition is disposed off.

#### **7.5.26 Number of Directorships [Section 165]**

- (1) No person, after the commencement of this Act, shall hold office as a director, including any alternate directorship, in more than twenty companies at the same time.
- Provided that the maximum number of public companies in which a person can be appointed as a director shall not exceed ten.
- Explanation.—** For reckoning the limit of public companies in which a person can be appointed as director, directorship in private companies that are either holding or subsidiary company of a public company shall be included.
- (2) Subject to the provisions of sub-section (1), the members of a company may, by special resolution, specify any lesser number of companies in which a director of the company may act as directors.
- (3) Any person holding office as director in companies more than the limits as specified in sub-section (1), immediately before the commencement of this Act shall, within a period of one year from such commencement,—
- (a) choose not more than the specified limit of those companies, as companies in which he wishes to continue to hold the office of director;
  - (b) resign his office as director in the other remaining companies; and
  - (c) intimate the choice made by him under clause (a), to each of the companies in which he was holding the office of director before such commencement and to the Registrar having jurisdiction in respect of each such company.

- (4) Any resignation made in pursuance of clause (b) of sub-section (3) shall become effective immediately on the despatch thereof to the company concerned.
- (5) No such person shall act as director in more than the specified number of companies,—
  - (a) after despatching the resignation of his office as director or non-executive director thereof, in pursuance of clause (b) of sub-section (3); or
  - (b) after the expiry of one year from the commencement of this Act,whichever is earlier.
- (6) If a person accepts an appointment as a director in contravention of sub-section (1), he shall be punishable with fine which shall not be less than five thousand rupees but which may extend to twenty-five thousand rupees for every day after the first during which the contravention continues.

#### **7.5.27 Duties of Directors [Section 166]**

- (1) Subject to the provisions of this Act, a director of a company shall act in accordance with the articles of the company.
- (2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.
- (3) A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.
- (4) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.
- (5) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.
- (6) A director of a company shall not assign his office and any assignment so made shall be void.
- (7) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

#### **7.5.28 Vacation of Office of Director [Section 167]**

- (1) The office of a director shall become vacant in case—
  - (a) he incurs any of the disqualifications specified in section 164;
  - (b) he absents himself from all the meetings of the Board of Directors held during a period of twelve months with or without seeking leave of absence of the Board;
  - (c) he acts in contravention of the provisions of section 184 relating to entering into contracts or arrangements in which he is directly or indirectly interested;
  - (d) he fails to disclose his interest in any contract or arrangement in which he is directly or indirectly interested, in contravention of the provisions of section 184;
  - (e) he becomes disqualified by an order of a court or the Tribunal;
  - (f) he is convicted by a court of any offence, whether involving moral turpitude or otherwise and sentenced in respect thereof to imprisonment for not less than six months.

Provided that the office shall be vacated by the director even if he has filed an appeal against the order of such court;



- (g) he is removed in pursuance of the provisions of this Act;
  - (h) he, having been appointed a director by virtue of his holding any office or other employment in the holding, subsidiary or associate company, ceases to hold such office or other employment in that company.
- (2) If a person, functions as a director even when he knows that the office of director held by him has become vacant on account of any of the disqualifications specified in subsection (1), he shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.
  - (3) Where all the directors of a company vacate their offices under any of the disqualifications specified in sub-section (1), the promoter or, in his absence, the Central Government shall appoint the required number of directors who shall hold office till the directors are appointed by the company in the general meeting.
  - (4) A private company may, by its articles, provide any other ground for the vacation of the office of a director in addition to those specified in sub-section (1).

#### **7.5.29 Resignation of Director [Section 168]**

- (1) A director may resign from his office by giving a notice in writing to the company and the Board shall on receipt of such notice take note of the same and the company shall intimate the Registrar in such manner, within such time and in such form as may be prescribed and shall also place the fact of such resignation in the report of directors laid in the immediately following general meeting by the company.

Provided that a director shall also forward a copy of his resignation along with detailed reasons for the resignation to the Registrar within thirty days of resignation in such manner as may be prescribed.

- (2) The resignation of a director shall take effect from the date on which the notice is received by the company or the date, if any, specified by the director in the notice, whichever is later.

Provided that the director who has resigned shall be liable even after his resignation for the offences which occurred during his tenure.

- (3) Where all the directors of a company resign from their offices, or vacate their offices under section 167, the promoter or, in his absence, the Central Government shall appoint the required number of directors who shall hold office till the directors are appointed by the company in general meeting.

#### **7.5.30 Removal of Directors [Section 169]**

- (1) A company may, by ordinary resolution, remove a director, not being a director appointed by the Tribunal under section 242, before the expiry of the period of his office after giving him a reasonable opportunity of being heard.

Provided that nothing contained in this sub-section shall apply where the company has availed itself of the option given to it under section 163 to appoint not less than two-thirds of the total number of directors according to the principle of proportional representation.

- (2) A special notice shall be required of any resolution, to remove a director under this section, or to appoint somebody in place of a director so removed, at the meeting at which he is removed.
- (3) On receipt of notice of a resolution to remove a director under this section, the company shall forthwith send a copy thereof to the director concerned, and the director, whether or not he is a member of the company, shall be entitled to be heard on the resolution at the meeting.
- (4) Where notice has been given of a resolution to remove a director under this section and the director concerned makes with respect thereto representation in writing to the company and requests its notification to members of the company, the company shall, if the time permits it to do

so,—

- (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
- (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent (whether before or after receipt of the representation by the company),

and if a copy of the representation is not sent as aforesaid due to insufficient time or for the company's default, the director may without prejudice to his right to be heard orally require that the representation shall be read out at the meeting.

Provided that copy of the representation need not be sent out and the representation need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the Tribunal is satisfied that the rights conferred by this sub-section are being abused to secure needless publicity for defamatory matter; and the Tribunal may order the company's costs on the application to be paid in whole or in part by the director notwithstanding that he is not a party to it.

- (5) A vacancy created by the removal of a director under this section may, if he had been appointed by the company in general meeting or by the Board, be filled by the appointment of another director in his place at the meeting at which he is removed, provided special notice of the intended appointment has been given under sub-section (2).
- (6) A director so appointed shall hold office till the date up to which his predecessor would have held office if he had not been removed.
- (7) If the vacancy is not filled under sub-section (5), it may be filled as a casual vacancy in accordance with the provisions of this Act.

Provided that the director who was removed from office shall not be re-appointed as a director by the Board of Directors.

- (8) Nothing in this section shall be taken—
  - (a) as depriving a person removed under this section of any compensation or damages payable to him in respect of the termination of his appointment as director as per the terms of contract or terms of his appointment as director, or of any other appointment terminating with that as director; or
  - (b) as derogating from any power to remove a director under other provisions of this Act.

#### **7.5.31 Register of Directors and Key Managerial Personnel and their Shareholding [Section 170]**

- (1) Every company shall keep at its registered office a register containing such particulars of its directors and key managerial personnel as may be prescribed, which shall include the details of securities held by each of them in the company or its holding, subsidiary, subsidiary of company's holding company or associate companies.
- (2) A return containing such particulars and documents as may be prescribed, of the directors and the key managerial personnel shall be filed with the Registrar within thirty days from the appointment of every director and key managerial personnel, as the case may be, and within thirty days of any change taking place.

#### **7.5.32 Particulars of Register of Directors and Key Managerial Personnel**

- (1) Every company shall keep at its registered office a register of its directors and key managerial personnel containing the following particulars, namely:-
  - (a) Director Identification Number (optional for key managerial personnel);
  - (b) present name and surname in full;



- (c) any former name or surname in full;
  - (d) father's name, mother's name and spouse's name(if married) and surnames in full;
  - (e) date of birth;
  - (f) residential address (present as well as permanent);
  - (g) nationality (including the nationality of origin, if different);
  - (h) occupation;
  - (i) date of the board resolution in which the appointment was made;
  - (j) date of appointment and reappointment in the company;
  - (k) date of cessation of office and reasons therefor;
  - (l) office of director or key managerial personnel held or relinquished in any other body corporate;
  - (m) membership number of the Institute of Company Secretaries of India in case of Company Secretary, if applicable; and
  - (n) Permanent Account Number (mandatory for key managerial personnel if not having DIN);
- (2) In addition to the details of the directors or key managerial personnel, the company shall also include in the aforesaid Register the details of securities held by them in the company, its holding company, subsidiaries, subsidiaries of the company's holding company and associate companies relating to-
- (a) the number, description and nominal value of securities;
  - (b) the date of acquisition and the price or other consideration paid;
  - (c) date of disposal and price and other consideration received;
  - (d) cumulative balance and number of securities held after each transaction;
  - (e) mode of acquisition of securities;
  - (f) mode of holding - physical or in dematerialized form; and
  - (g) whether securities have been pledged or any encumbrance has been created on the securities.

#### **7.5.33 Members' Right to Inspect [Section 171]**

- (1) The register kept under sub-section (1) of section 170,—
- (a) shall be open for inspection during business hours and the members shall have a right to take extracts therefrom and copies thereof, on a request by the members, be provided to them free of cost within thirty days; and
  - (b) shall also be kept open for inspection at every annual general meeting of the company and shall be made accessible to any person attending the meeting.
- (2) If any inspection as provided in clause (a) of sub-section (1) is refused, or if any copy required under that clause is not sent within thirty days from the date of receipt of such request, the Registrar shall on an application made to him order immediate inspection and supply of copies required thereunder.

#### **7.5.34 Punishment [Section 172]**

If a company contravenes any of the provisions of this Chapter and for which no specific punishment is provided therein, the company and every officer of the company who is in default shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

## 7.6 MEETINGS OF BOARD AND ITS POWERS

### 7.6.1 Meetings of Board [Section 173]

- (1) Every company shall hold the first meeting of the Board of Directors within thirty days of the date of its incorporation and thereafter hold a minimum number of four meetings of its Board of Directors every year in such a manner that not more than one hundred and twenty days shall intervene between two consecutive meetings of the Board.

Provided that the Central Government may, by notification, direct that the provisions of this sub-section shall not apply in relation to any class or description of companies or shall apply subject to such exceptions, modifications or conditions as may be specified in the notification.

- (2) The participation of directors in a meeting of the Board may be either in person or through video conferencing or other audio visual means, as may be prescribed, which are capable of recording and recognising the participation of the directors and of recording and storing the proceedings of such meetings along with date and time.

Provided that the Central Government may, by notification, specify such matters which shall not be dealt with in a meeting through video conferencing or other audio visual means.

- (3) A meeting of the Board shall be called by giving not less than seven days' notice in writing to every director at his address registered with the company and such notice shall be sent by hand delivery or by post or by electronic means.

Provided that a meeting of the Board may be called at shorter notice to transact urgent business subject to the condition that at least one independent director, if any, shall be present at the meeting.

Provided further that in case of absence of independent directors from such a meeting of the Board, decisions taken at such a meeting shall be circulated to all the directors and shall be final only on ratification thereof by at least one independent director, if any.

- (4) Every officer of the company whose duty is to give notice under this section and who fails to do so shall be liable to a penalty of twenty-five thousand rupees.
- (5) A One Person Company, small company and dormant company shall be deemed to have complied with the provisions of this section if at least one meeting of the Board of Directors has been conducted in each half of a calendar year and the gap between the two meetings is not less than ninety days.

Provided that nothing contained in this sub-section and in section 174 shall apply to One Person Company in which there is only one director on its Board of Directors.

### 7.6.2 Meetings of Board through Video Conferencing or Other Audio Visual Means

A company shall comply with the following procedure, for convening and conducting the Board meetings through video conferencing or other audio visual means.

- (1) Every Company shall make necessary arrangements to avoid failure of video or audio visual connection.
- (2) The Chairperson of the meeting and the company secretary, if any, shall take due and reasonable care-
  - (a) to safeguard the integrity of the meeting by ensuring sufficient security and identification procedures;
  - (b) to ensure availability of proper video conferencing or other audio visual equipment or facilities for providing transmission of the communications for effective participation of the directors and other authorised participants at the Board meeting;

- (c) to record proceedings and prepare the minutes of the meeting;
  - (d) to store for safekeeping and marking the tape recording(s) or other electronic recording mechanism as part of the records of the company at least before the time of completion of audit of that particular year.
  - (e) to ensure that no person other than the concerned director are attending or have access to the proceedings of the meeting through video conferencing mode or other audio visual means; and
  - (f) to ensure that participants attending the meeting through audio visual means are able to hear and see the other participants clearly during the course of the meeting.  
Provided that the persons, who are differently abled, may make request to the Board to allow a person to accompany him.
- (3) (a) The notice of the meeting shall be sent to all the directors in accordance with the provisions of sub-section (3) of section 173 of the Act.
- (b) The notice of the meeting shall inform the directors regarding the option available to them to participate through video conferencing mode or other audio visual means, and shall provide all the necessary information to enable the directors to participate through video conferencing mode or other audio visual means.
  - (c) A director intending to participate through video conferencing or audio visual means shall communicate his intention to the Chairperson or the company secretary of the company.
  - (d) If the director intends to participate through video conferencing or other audio visual means, he shall give prior intimation to that effect sufficiently in advance so that company is able to make suitable arrangements in this behalf.
  - (e) The director, who desire, to participate may intimate his intention of participation through the electronic mode at the beginning of the calendar year and such declaration shall be valid for one calendar year.
  - (f) In the absence of any intimation under clause (c), it shall be assumed that the director shall attend the meeting in person.
- (4) At the commencement of the meeting, a roll call shall be taken by the Chairperson when every director participating through video conferencing or other audio visual means shall state, for the record, the following namely:-
- (a) name;
  - (b) the location from where he is participating;
  - (c) that he has received the agenda and all the relevant material for the meeting; and
  - (d) that no one other than the concerned director is attending or having access to the proceedings of the meeting at the location mentioned in clause (b);
- (5) (a) After the roll call, the Chairperson or the Company Secretary shall inform the Board about the names of persons other than the directors who are present for the said meeting at the request or with the permission of the Chairperson and confirm that the required quorum is complete.  
Explanation.- A director participating in a meeting through video conferencing or other audio visual means shall be counted for the purpose of quorum, unless he is to be excluded for any items of business under any provisions of the Act or the rules.
- (b) The Chairperson shall ensure that the required quorum is present throughout the meeting.
- (6) With respect to every meeting conducted through video conferencing or other audio visual means authorised under these rules, the scheduled venue of the meeting as set forth in the notice convening the meeting, shall be deemed to be the place of the said meeting and all recordings of the proceedings at the meeting shall be deemed to be made at such place.

- (7) The statutory registers which are required to be placed in the Board meeting as per the provisions of the Act shall be placed at the scheduled venue of the meeting and where such registers are required to be signed by the directors, the same shall be deemed to have been signed by the directors participating through electronic mode, if they have given their consent to this effect and it is so recorded in the minutes of the meeting.
- (8)
  - (a) Every participant shall identify himself for the record before speaking on any item of business on the agenda.
  - (b) If a statement of a director in the meeting through video conferencing or other audio visual means is interrupted or garbled, the Chairperson or Company Secretary shall request for a repeat or reiteration by the Director.
- (9) If a motion is objected to and there is a need to put it to vote, the Chairperson shall call the roll and note the vote of each director who shall identify himself while casting his vote.
- (10) From the commencement of the meeting and until the conclusion of such meeting, no person other than the Chairperson, Directors, Company Secretary and any other person whose presence is required by the Board shall be allowed access to the place where any director is attending the meeting either physically or through video conferencing without the permission of the Board.
- (11)
  - (a) At the end of discussion on each agenda item, the Chairperson of the meeting shall announce the summary of the decision taken on such item along with names of the directors, if any, who dissented from the decision taken by majority.
  - (b) The minutes shall disclose the particulars of the directors who attended the meeting through video conferencing or other audio visual means.
- (12)
  - (a) The draft minutes of the meeting shall be circulated among all the directors within fifteen days of the meeting either in writing or in electronic mode as may be decided by the Board.
  - (b) Every director who attended the meeting, whether personally or through video conferencing or other audio visual means, shall confirm or give his comments in writing, about the accuracy of recording of the proceedings of that particular meeting in the draft minutes, within seven days or some reasonable time as decided by the Board, after receipt of the draft minutes failing which his approval shall be presumed.
  - (c) After completion of the meeting, the minutes shall be entered in the minute book as specified under section 118 of the Act and signed by the Chairperson.

**Explanation.**-For the purposes of this rule, "video conferencing or other audio visual means" means audio- visual electronic communication facility employed which enables all the persons participating in a meeting to communicate concurrently with each other without an intermediary and to participate effectively in the meeting.

### **7.6.3 Matters not to be Dealt with in a Meeting through Video Conferencing or Other Audio Visual Means**

The following matters shall not be dealt with in any meeting held through video conferencing or other audio visual means.-

- (i) the approval of the annual financial statements;
- (ii) the approval of the Board's report;
- (iii) the approval of the prospectus;
- (iv) the Audit Committee Meetings for consideration of financial statements including consolidated financial statement, if any, to be approved by the Board under sub-section (1) of section 134 of the Act; and
- (v) the approval of the matter relating to amalgamation, merger, demerger, acquisition and takeover.



#### 7.6.4 Quorum for Meetings of Board [Section 174]

- (1) The quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength or two directors, whichever is higher, and the participation of the directors by video conferencing or by other audio visual means shall also be counted for the purposes of quorum under this sub-section.
- (2) The continuing directors may act notwithstanding any vacancy in the Board; but, if and so long as their number is reduced below the quorum fixed by the Act for a meeting of the Board, the continuing directors or director may act for the purpose of increasing the number of directors to that fixed for the quorum, or of summoning a general meeting of the company and for no other purpose.
- (3) Where at any time the number of interested directors exceeds or is equal to two-thirds of the total strength of the Board of Directors, the number of directors who are not interested directors and present at the meeting, being not less than two, shall be the quorum during such time.

**Explanation.—**For the purposes of this sub-section, “interested director” means a director within the meaning of sub-section (2) of section 184.

- (4) Where a meeting of the Board could not be held for want of quorum, then, unless the articles of the company otherwise provide, the meeting shall automatically stand adjourned to the same day at the same time and place in the next week or if that day is a national holiday, till the next succeeding day, which is not a national holiday, at the same time and place.

**Explanation.—** For the purposes of this section,—

- (i) any fraction of a number shall be rounded off as one;
- (ii) “total strength” shall not include directors whose places are vacant.

#### 7.6.5 Passing of Resolution by Circulation [Section 175]

- (1) No resolution shall be deemed to have been duly passed by the Board or by a committee thereof by circulation, unless the resolution has been circulated in draft, together with the necessary papers, if any, to all the directors, or members of the committee, as the case may be, at their addresses registered with the company in India by hand delivery or by post or by courier, or through such electronic means as may be prescribed and has been approved by a majority of the directors or members, who are entitled to vote on the resolution.

Provided that, where not less than one-third of the total number of directors of the company for the time being require that any resolution under circulation must be decided at a meeting, the chairperson shall put the resolution to be decided at a meeting of the Board.

- (2) A resolution under sub-section (1) shall be noted at a subsequent meeting of the Board or the committee thereof, as the case may be, and made part of the minutes of such meeting.

#### **General Circular No. 32/2014**

#### **Clarification on Transitional Period for Resolutions Passed Under the Companies Act, 1956.**

It is clarified that resolutions approved or passed by companies under relevant applicable provisions of the Old Act during the period from 1<sup>st</sup> September, 2013 to 31<sup>st</sup> March, 2014, can be implemented, in accordance with provisions of the Old Act, notwithstanding the repeal of the relevant provision subject to the conditions (a) that the implementation of the resolution actually commenced before 1<sup>st</sup> April, 2014 and (b) that this transitional arrangement will be available upto expiry of one year from the passing of the resolution or six months from the commencement of the corresponding provision in New Act whichever is later. It is also clarified that any amendment of the resolution must be in accordance with the relevant provision of the New Act.

### 7.6.6 Special Resolution

- (1) Where the aggregate of the loans and investment so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceed the limits specified under section 186, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting.

Explanation.-For the purpose of this sub-rule, it is clarified that it would sufficient compliance if such special resolution is passed within one year from the date of notification of this section.

- (2) A resolution passed at a general meeting in terms of sub-section (3) of section 186 to give any loan or guarantee or investment or providing any security or the acquisition under sub section (2) of section 186 shall specify the total amount up to which the Board of Directors are authorised to give such loan or guarantee, to provide such security or make such acquisition.

Provided, that the company shall disclose to the members in the financial statement the full particulars in accordance with the provision of sub-section (4) of section 186.

### 7.6.7 Defects in Appointment of Directors not to Invalidate Actions taken [Section 176]

No act done by a person as a director shall be deemed to be invalid, notwithstanding that it was subsequently noticed that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles of the company.

Provided that nothing in this section shall be deemed to give validity to any act done by the director after his appointment has been noticed by the company to be invalid or to have terminated.

### 7.6.8 Committees of the Board

The Board of directors of every listed companies and the following classes of companies shall constitute an Audit Committee and a Nomination and Remuneration Committee of the Board-

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

**Explanation.-** The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes.

Provided that public companies covered under this rule which were not required to constitute Audit Committee under section 292A of the Companies Act, 1956 shall constitute their Audit Committee within one year from the commencement of these rules or appointment of independent directors by them, whichever is earlier.

Provided further that public companies covered as above shall constitute their Nomination and Remuneration Committee within one year from the commencement of these rules or appointment of independent directors by them, whichever is earlier.

### 7.6.9 Audit Committee [Section 177]

- (1) The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed, shall constitute an Audit Committee.
- (2) The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority.

Provided that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.

- (3) Every Audit Committee of a company existing immediately before the commencement of this Act shall, within one year of such commencement, be reconstituted in accordance with sub-section (2).



- (4) Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include,—
- (i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;
  - (ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;
  - (iii) examination of the financial statement and the auditors' report thereon;
  - (iv) approval or any subsequent modification of transactions of the company with related parties;  
Provided that the Audit Committee may make omnibus approval for related party transactions proposed to be entered into by the company subject to such conditions as may be prescribed.
  - (v) scrutiny of inter-corporate loans and investments;
  - (vi) valuation of undertakings or assets of the company, wherever it is necessary;
  - (vii) evaluation of internal financial controls and risk management systems;
  - (viii) monitoring the end use of funds raised through public offers and related matters.
- (5) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.
- (6) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.
- (7) The auditors of a company and the key managerial personnel shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.
- (8) The Board's report under sub-section (3) of section 134 shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefor.
- (9) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.
- (10) The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.

Provided that the details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board's report.

#### **7.6.10 Nomination and Remuneration Committee and Stakeholders Relationship Committee [Section 178]**

- (1) The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed shall constitute the Nomination and Remuneration Committee consisting of three or more non-executive directors out of which not less than one-half shall be independent directors.

Provided that the chairperson of the company (whether executive or non-executive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such Committee.

- (2) The Nomination and Remuneration Committee shall identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, recommend to the Board their appointment and removal and shall carry out evaluation of every director's performance.
- (3) The Nomination and Remuneration Committee shall formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees.
- (4) The Nomination and Remuneration Committee shall, while formulating the policy under sub-section (3) ensure that—
  - (a) the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required to run the company successfully;
  - (b) relationship of remuneration to performance is clear and meets appropriate performance benchmarks; and
  - (c) remuneration to directors, key managerial personnel and senior management involves a balance between fixed and incentive pay reflecting short and long-term performance objectives appropriate to the working of the company and its goals.

Provided that such policy shall be disclosed in the Board's report.

- (5) The Board of Directors of a company which consists of more than one thousand shareholders, debenture-holders, deposit-holders and any other security holders at any time during a financial year shall constitute a Stakeholders Relationship Committee consisting of a chairperson who shall be a non-executive director and such other members as may be decided by the Board.
- (6) The Stakeholders Relationship Committee shall consider and resolve the grievances of security holders of the company.
- (7) The chairperson of each of the committees constituted under this section or, in his absence, any other member of the committee authorised by him in this behalf shall attend the general meetings of the company.
- (8) In case of any contravention of the provisions of section 177 and this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees, or with both.

Provided that non-consideration of resolution of any grievance by the Stakeholders Relationship Committee in good faith shall not constitute a contravention of this section.

**Explanation.—**The expression "senior management" means personnel of the company who are members of its core management team excluding Board of Directors comprising all members of management one level below the executive directors, including the functional heads.

#### **7.6.11 Establishment of Vigil Mechanism**

- (1) Every listed company and the companies belonging to the following class or classes shall establish a vigil mechanism for their directors and employees to report their genuine concerns or grievances—
  - (a) the Companies which accept deposits from the public;
  - (b) the Companies which have borrowed money from banks and public financial institutions in excess of fifty crore rupees.
- (2) The companies which are required to constitute an audit committee shall oversee the vigil mechanism through the committee and if any of the members of the committee have a conflict



of interest in a given case, they should recuse themselves and the others on the committee would deal with the matter on hand.

- (3) In case of other companies, the Board of directors shall nominate a director to play the role of audit committee for the purpose of vigil mechanism to whom other directors and employees may report their concerns.
- (4) The vigil mechanism shall provide for adequate safeguards against victimisation of employees and directors who avail of the vigil mechanism and also provide for direct access to the Chairperson of the Audit Committee or the director nominated to play the role of Audit Committee, as the case may be, in exceptional cases.
- (5) In case of repeated frivolous complaints being filed by a director or an employee, the audit committee or the director nominated to play the role of audit committee may take suitable action against the concerned director or employee including reprimand.

#### **7.6.12 Powers of Board [Section 179]**

- (1) The Board of Directors of a company shall be entitled to exercise all such powers, and to do all such acts and things, as the company is authorised to exercise and do.

Provided that in exercising such power or doing such act or thing, the Board shall be subject to the provisions contained in that behalf in this Act, or in the memorandum or articles, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting.

Provided further that the Board shall not exercise any power or do any act or thing which is directed or required, whether under this Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting.

- (2) No regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.
- (3) The Board of Directors of a company shall exercise the following powers on behalf of the company by means of resolutions passed at meetings of the Board, namely:—
  - (a) to make calls on shareholders in respect of money unpaid on their shares;
  - (b) to authorise buy-back of securities under section 68;
  - (c) to issue securities, including debentures, whether in or outside India;
  - (d) to borrow monies;
  - (e) to invest the funds of the company;
  - (f) to grant loans or give guarantee or provide security in respect of loans;
  - (g) to approve financial statement and the Board's report;
  - (h) to diversify the business of the company;
  - (i) to approve amalgamation, merger or reconstruction;
  - (j) to take over a company or acquire a controlling or substantial stake in another company;
  - (k) any other matter which may be prescribed.

Provided that the Board may, 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 or in the case of a branch office of the company, the principal officer of the branch office, the powers specified in clauses (d) to (f) on such conditions as it may specify.

Provided further that the acceptance by a banking company in the ordinary course of its business of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise, or the placing of monies on deposit by a banking company with another banking company on such conditions as the Board may prescribe, shall not be deemed to be a borrowing of monies or, as the case may be, a making of loans by a banking company within the meaning of this section.

**Explanation I.**—Nothing in clause (d) shall apply to borrowings by a banking company from other banking companies or from the Reserve Bank of India, the State Bank of India or any other banks established by or under any Act.

**Explanation II.**—In respect of dealings between a company and its bankers, the exercise by the company of the power specified in clause (d) shall mean the arrangement made by the company with its bankers for the borrowing of money by way of overdraft or cash credit or otherwise and not the actual day-to-day operation on overdraft, cash credit or other accounts by means of which the arrangement so made is actually availed of.

- (4) Nothing in this section shall be deemed to affect the right of the company in general meeting to impose restrictions and conditions on the exercise by the Board of any of the powers specified in this section.

#### 7.6.13 Other Powers of Board

In addition to the powers specified under sub-section (3) of section 179 of the Act, the following powers shall also be exercised by the Board of Directors only by means of resolutions passed at meetings of the Board.-

- (1) to make political contributions;
- (2) to appoint or remove key managerial personnel (KMP);
- (3) to take note of appointment(s) or removal(s) of one level below the Key Management Personnel;
- (4) to appoint internal auditors and secretarial auditor;
- (5) to take note of the disclosure of director's interest and shareholding;
- (6) to buy, sell investments held by the company (other than trade investments), constituting five percent or more of the paid up share capital and free reserves of the investee company;
- (7) to invite or accept or renew public deposits and related matters;
- (8) to review or change the terms and conditions of public deposit;
- (9) to approve quarterly, half yearly and annual financial statements or financial results as the case may be.

#### 7.6.14 Restrictions on powers of Board [Section 180]

- (1) The Board of Directors of a company shall exercise the following powers only with the consent of the company by a special resolution, namely:—
- (a) to sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.

**Explanation.**—For the purposes of this clause,—

- (i) “undertaking” shall mean an undertaking in which the investment of the company exceeds twenty per cent. of its net worth as per the audited balance sheet of the preceding financial year or an undertaking which generates twenty per cent. of the total income of the company during the previous financial year;
- (ii) the expression “substantially the whole of the undertaking” in any financial year shall mean twenty per cent. or more of the value of the undertaking as per the audited balance sheet of the preceding financial year;



- (b) to invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation;
- (c) to borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company's bankers in the ordinary course of business.

Provided that the acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, shall not be deemed to be a borrowing of monies by the banking company within the meaning of this clause.

**Explanation.—** For the purposes of this clause, the expression “temporary loans” means loans repayable on demand or within six months from the date of the loan such as short-term, cash credit arrangements, the discounting of bills and the issue of other short-term loans of a seasonal character, but does not include loans raised for the purpose of financial expenditure of a capital nature;

- (d) to remit, or give time for the repayment of, any debt due from a director.
- (2) Every special resolution passed by the company in general meeting in relation to the exercise of the powers referred to in clause (c) of sub-section (1) shall specify the total amount up to which monies may be borrowed by the Board of Directors.
  - (3) Nothing contained in clause (a) of sub-section (1) shall affect—
    - (a) the title of a buyer or other person who buys or takes on lease any property, investment or undertaking as is referred to in that clause, in good faith; or
    - (b) the sale or lease of any property of the company where the ordinary business of the company consists of, or comprises, such selling or leasing.
  - (4) Any special resolution passed by the company consenting to the transaction as is referred to in clause (a) of sub-section (1) may stipulate such conditions as may be specified in such resolution, including conditions regarding the use, disposal or investment of the sale proceeds which may result from the transactions.

Provided that this sub-section shall not be deemed to authorise the company to effect any reduction in its capital except in accordance with the provisions contained in this Act.

- (5) No debt incurred by the company in excess of the limit imposed by clause (c) of sub-section (1) shall be valid or effectual, unless the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed by that clause had been exceeded.

### **General Circular No. 15/2013**

#### **Clarification on the Notification Dated 12.9.2013 -**

In respect of requirements of special resolution under Section 180 of the “said Act” as against ordinary resolution required by the Companies Act 1956, if notice for any such general meeting was issued prior to 12.9.2013, then such resolution may be in accordance with the requirement of the Companies Act 1956.

### **General Circular no. 04/2014**

It is hereby clarified that the resolution passed under section 293 of the Companies Act, 1956 prior to 12.09.2013 with reference to borrowings (subject to the limits prescribed) and / or creation of security on assets of the company will be regarded as sufficient compliance of the requirements of section 180 of the Companies Act, 2013 for a period of one year from the date of notification of section 180 of the Act i.e. one year from 12.9.2013.

### 7.6.15 Company to Contribute to bona fide and Charitable Funds, Etc. [Section 181]

The Board of Directors of a company may contribute to bona fide charitable and other funds.

Provided that prior permission of the company in general meeting shall be required for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent. of its average net profits for the three immediately preceding financial years.

### 7.6.16 Prohibitions and Restrictions regarding Political Contributions [Section 182]

- (1) Notwithstanding anything contained in any other provision of this Act, a company, other than a Government company and a company which has been in existence for less than three financial years, may contribute any amount directly or indirectly to any political party.

Provided that the amount referred to in sub-section (1) or, as the case may be, the aggregate of the amount which may be so contributed by the company in any financial year shall not exceed seven and a half per cent. of its average net profits during the three immediately preceding financial years.

Provided further that no such contribution shall be made by a company unless a resolution authorising the making of such contribution is passed at a meeting of the Board of Directors and such resolution shall, subject to the other provisions of this section, be deemed to be justification in law for the making and the acceptance of the contribution authorised by it.

- (2) Without prejudice to the generality of the provisions of sub-section (1),—
  - (a) a donation or subscription or payment caused to be given by a company on its behalf or on its account to a person who, to its knowledge, is carrying on any activity which, at the time at which such donation or subscription or payment was given or made, can reasonably be regarded as likely to affect public support for a political party shall also be deemed to be contribution of the amount of such donation, subscription or payment to such person for a political purpose;
  - (b) the amount of expenditure incurred, directly or indirectly, by a company on an advertisement in any publication, being a publication in the nature of a souvenir, brochure, tract, pamphlet or the like, shall also be deemed,—
    - (i) where such publication is by or on behalf of a political party, to be a contribution of such amount to such political party, and
    - (ii) where such publication is not by or on behalf of, but for the advantage of a political party, to be a contribution for a political purpose.
- (3) Every company shall disclose in its profit and loss account any amount or amounts contributed by it to any political party during the financial year to which that account relates, giving particulars of the total amount contributed and the name of the party to which such amount has been contributed.
- (4) If a company makes any contribution in contravention of the provisions of this section, the company shall be punishable with fine which may extend to five times the amount so contributed and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months and with fine which may extend to five times the amount so contributed.

**Explanation.—**For the purposes of this section, “political party” means a political party registered under section 29A of the Representation of the People Act, 1951.

**Circular No. 19/2013**

It is hereby clarified as under;

- (i) Companies contributing any amount or amounts to an 'Electoral Trust Company' for contributing to a political party or parties are not required to make disclosures required under section 182(3) of Companies Act 2013. It will suffice if the Accounts of the company disclose the amount released to an Electoral Trust Company.
- (ii) Companies contributing any amount or amounts directly to a political party or parties will be required to make the disclosures laid down in section 192(3) of the Companies Act, 2013.
- (iii) Electoral Trust companies will be required to disclose all amounts received by them from other companies/sources in their Books of Accounts and also disclose the amount or amounts contributed by them to a political party or parties as required by section 182(3) of Companies Act, 2013.

**7.6.17 Power of Board and Other Persons to make Contributions to National Defence Fund, Etc. [Section 183]**

- (1) The Board of Directors of any company or any person or authority exercising the powers of the Board of Directors of a company, or of the company in general meeting, may, notwithstanding anything contained in sections 180, 181 and section 182 or any other provision of this Act or in the memorandum, articles or any other instrument relating to the company, contribute such amount as it thinks fit to the National Defence Fund or any other Fund approved by the Central Government for the purpose of national defence.
- (2) Every company shall disclose in its profits and loss account the total amount or amounts contributed by it to the Fund referred to in sub-section (1) during the financial year to which the amount relates.

**7.6.18 Disclosure of Interest by Director [Section 184]**

- (1) Every director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the disclosures already made, then at the first Board meeting held after such change, disclose his concern or interest in any company or companies or bodies corporate, firms, or other association of individuals which shall include the shareholding, in such manner as may be prescribed.
- (2) Every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into—

(a) with a body corporate in which such director or such director in association with any other director, holds more than two per cent. shareholding of that body corporate, or is a promoter, manager, Chief Executive Officer of that body corporate; or

(b) with a firm or other entity in which, such director is a partner, owner or member, as the case may be,

shall disclose the nature of his concern or interest at the meeting of the Board in which the contract or arrangement is discussed and shall not participate in such meeting.

Provided that where any director who is not so concerned or interested at the time of entering into such contract or arrangement, he shall, if he becomes concerned or interested after the contract or arrangement is entered into, disclose his concern or interest forthwith when he becomes concerned or interested or at the first meeting of the Board held after he becomes so concerned or interested.

- (3) A contract or arrangement entered into by the company without disclosure under sub-section (2) or with participation by a director who is concerned or interested in any way, directly or indirectly, in the contract or arrangement, shall be voidable at the option of the company.

- (4) If a director of the company contravenes the provisions of sub-section (1) or subsection (2), such director shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to one lakh rupees, or with both.
- (5) Nothing in this section—
  - (a) shall be taken to prejudice the operation of any rule of law restricting a director of a company from having any concern or interest in any contract or arrangement with the company;
  - (b) shall apply to any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds or hold not more than two per cent. of the paid-up share capital in the other company.

#### 7.6.19 Loan to Directors, Etc. [Section 185]

- (1) Save as otherwise provided in this Act, no company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person.

Provided that nothing contained in this sub-section shall apply to—

- (a) the giving of any loan to a managing or whole-time director—
  - (i) as a part of the conditions of service extended by the company to all its employees; or
  - (ii) pursuant to any scheme approved by the members by a special resolution; or
- (b) a company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans an interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India.

**Explanation.—** For the purposes of this section, the expression “to any other person in whom director is interested” means—

- (a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
  - (b) any firm in which any such director or relative is a partner;
  - (c) any private company of which any such director is a director or member;
  - (d) anybody corporate at a general meeting of which not less than twenty-five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or
  - (e) anybody corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.
- (c) any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company; or
  - (d) any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company.

Provided that the loans made under clauses (c) and (d) are utilized by the subsidiary company for its principal business activities.

- (2) If any loan is advanced or a guarantee or security is given or provided in contravention of the provisions of sub-section (1), the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, and the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may



extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

#### **7.6.20 Loan and Investment by Company [Section 186]**

- (1) Without prejudice to the provisions contained in this Act, a company shall unless otherwise prescribed, make investment through not more than two layers of investment companies.

Provided that the provisions of this sub-section shall not affect,—

- (i) a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;
- (ii) a subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

- (2) No company shall directly or indirectly —

- (a) give any loan to any person or other body corporate;
- (b) give any guarantee or provide security in connection with a loan to any other body corporate or person; and
- (c) acquire by way of subscription, purchase or otherwise, the securities of any other body corporate,

exceeding sixty per cent. of its paid-up share capital, free reserves and securities premium account or one hundred per cent. of its free reserves and securities premium account, whichever is more.

- (3) Where the giving of any loan or guarantee or providing any security or the acquisition under sub-section (2) exceeds the limits specified in that sub-section, prior approval by means of a special resolution passed at a general meeting shall be necessary.
- (4) The company shall disclose to the members in the financial statement the full particulars of the loans given, investment made or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilised by the recipient of the loan or guarantee or security.
- (5) No investment shall be made or loan or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution concerned where any term loan is subsisting, is obtained.

Provided that prior approval of a public financial institution shall not be required where the aggregate of the loans and investments so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate, along with the investments, loans, guarantee or security proposed to be made or given does not exceed the limit as specified in sub-section (2), and there is no default in repayment of loan installments or payment of interest thereon as per the terms and conditions of such loan to the public financial institution.

- (6) No company, which is registered under section 12 of the Securities and Exchange Board of India Act, 1992 and covered under such class or classes of companies as may be prescribed, shall take inter-corporate loan or deposits exceeding the prescribed limit and such company shall furnish in its financial statement the details of the loan or deposits.
- (7) No loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.
- (8) No company which is in default in the repayment of any deposits accepted before or after the commencement of this Act or in payment of interest thereon, shall give any loan or give any guarantee or provide any security or make an acquisition till such default is subsisting.

- (9) Every company giving loan or giving a guarantee or providing security or making an acquisition under this section shall keep a register which shall contain such particulars and shall be maintained in such manner as may be prescribed.
- (10) The register referred to in sub-section (9) shall be kept at the registered office of the company and—
- (a) shall be open to inspection at such office; and
  - (b) extracts may be taken therefrom by any member, and copies thereof may be furnished to any member of the company on payment of such fees as may be prescribed.
- (11) Nothing contained in this section, except sub-section (1), shall apply—
- (a) to a loan made, guarantee given or security provided by a banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities;
  - (b) to any acquisition—
    - (i) made by a non-banking financial company registered under Chapter IIIB of the Reserve Bank of India Act, 1934 and whose principal business is acquisition of securities.  
Provided that exemption to non-banking financial company shall be in respect of its investment and lending activities;
    - (ii) made by a company whose principal business is the acquisition of securities;
    - (iii) of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.
    - (iv) made by a banking company or an insurance company or a housing finance company, making acquisition of securities in the ordinary course of its business.
- (12) The Central Government may make rules for the purposes of this section.
- (13) If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

**Explanation.**—For the purposes of this section,—

- (a) the expression “investment company” means a company whose principal business is the acquisition of shares, debentures or other securities;
- (b) the expression “infrastructure facilities” means the facilities specified in Schedule VI.

**General Circular No. 15/2014**

**Clarification Regarding Maintaining Register in new Format [Sub-section (9) of Section 186]**

It is hereby clarified that register maintained by companies pursuant to sub-section (5) of Section 372A of Companies Act, 1956 may continue as per requirements under these provisions and the new format prescribed vide Form MBP2 shall be used for particulars entered in such registers on and from 1.4.2014.

**7.6.21 Investments of Company to be held in its Own Name [Section 187]**

- (1) All investments made or held by a company in any property, security or other asset shall be made and held by it in its own name.

Provided that the company may hold any shares in its subsidiary company in the name of any nominee or nominees of the company, if it is necessary to do so, to ensure that the number of members of the subsidiary company is not reduced below the statutory limit.



- (2) Nothing in this section shall be deemed to prevent a company—
- (a) from depositing with a bank, being the bankers of the company, any shares or securities for the collection of any dividend or interest payable thereon; or
  - (b) from depositing with, or transferring to, or holding in the name of, the State Bank of India or a scheduled bank, being the bankers of the company, shares or securities, in order to facilitate the transfer thereof.  
Provided that if within a period of six months from the date on which the shares or securities are transferred by the company to, or are first held by the company in the name of, the State Bank of India or a scheduled bank as aforesaid, no transfer of such shares or securities takes place, the company shall, as soon as practicable after the expiry of that period, have the shares or securities re-transferred to it from the State Bank of India or the scheduled bank or, as the case may be, again hold the shares or securities in its own name; or
  - (c) from depositing with, or transferring to, any person any shares or securities, by way of security for the repayment of any loan advanced to the company or the performance of any obligation undertaken by it;
  - (d) from holding investments in the name of a depository when such investments are in the form of securities held by the company as a beneficial owner.
- (3) Where in pursuance of clause (d) of sub-section (2), any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall maintain a register which shall contain such particulars as may be prescribed and such register shall be open to inspection by any member or debenture-holder of the company without any charge during business hours subject to such reasonable restrictions as the company may by its articles or in general meeting impose.
- (4) If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees, or with both.

#### **7.6.22 Related Party Transactions [Section 188]**

- (1) Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to—
- (a) sale, purchase or supply of any goods or materials;
  - (b) selling or otherwise disposing of, or buying, property of any kind;
  - (c) leasing of property of any kind;
  - (d) availing or rendering of any services;
  - (e) appointment of any agent for purchase or sale of goods, materials, services or property;
  - (f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
  - (g) underwriting the subscription of any securities or derivatives thereof, of the company.

Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a resolution.

Provided further that no member of the company shall vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party.

Provided also that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis.

Provided also that the requirement of passing the resolution under first proviso shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

**Explanation.—** In this sub-section,—

- (a) the expression "office or place of profit" means any office or place—
    - (i) where such office or place is held by a director, if the director holding it receives from the company anything by way of remuneration over and above the remuneration to which he is entitled as director, by way of salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;
    - (ii) where such office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it receives from the company anything by way of remuneration, salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;
  - (b) the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.
- (2) Every contract or arrangement entered into under sub-section (1) shall be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement.
  - (3) Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a resolution in the general meeting under sub-section (1) and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board and if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it.
  - (4) Without prejudice to anything contained in sub-section (3), it shall be open to the company to proceed against a director or any other employee who had entered into such contract or arrangement in contravention of the provisions of this section for recovery of any loss sustained by it as a result of such contract or arrangement.
  - (5) Any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of the provisions of this section shall,—
    - (i) in case of listed company, be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both; and
    - (ii) in case of any other company, be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.



### **General Circular No. 30/2014**

#### **Clarification on Matters Relating to Related Party**

##### **1. Scope of Second Proviso to Section 188(1):**

Second proviso to sub-section (1) of section 188 requires that no member of the company shall vote on a special resolution to approve the contract or arrangement (referred to in the first proviso), if such a member is a related party. It is clarified that 'related party' referred to in the second proviso has to be construed with reference only to the contract or arrangement for which the said special resolution is being passed. Thus, the term 'related party' in the above context refers only to such related party as may be a related party in the context of the contract or arrangement for which the said special resolution is being passed.

##### **2. Applicability of Section 188 to Corporate Restructuring, Amalgamations etc.:**

It is clarified that transactions arising out of Compromises, Arrangements and Amalgamations dealt with under specific provisions of the Companies Act, 1956/Companies Act, 2013, will not attract the requirements of section 188 of the Companies Act, 2013.

##### **3. Requirement of Fresh Approvals for Past Contracts Under Section 188:**

Contracts entered into by companies, after making necessary compliances under Section 297 of the Companies Act, 1956, which already came into effect before the commencement of Section 188 of the Companies Act, 2013, will not require fresh approval under the said section 188 till the expiry of the original term of such contracts. Thus, if any modification in such contract is made on or after 1<sup>st</sup> April, 2014, the requirements under section 188 will have to be complied with.

#### **7.6.23 Register of Contracts or Arrangements in which Directors are Interested [Section 189]**

- (1) Every company shall keep one or more registers giving separately the particulars of all contracts or arrangements to which sub-section (2) of section 184 or section 188 applies, in such manner and containing such particulars as may be prescribed and after entering the particulars, such register or registers shall be placed before the next meeting of the Board and signed by all the directors present at the meeting.
- (2) Every director or key managerial personnel shall, within a period of thirty days of his appointment, or relinquishment of his office, as the case may be, disclose to the company the particulars specified in sub-section (1) of section 184 relating to his concern or interest in the other associations which are required to be included in the register under that sub-section or such other information relating to himself as may be prescribed.
- (3) The register referred to in sub-section (1) shall be kept at the registered office of the company and it shall be open for inspection at such office during business hours and extracts may be taken therefrom, and copies thereof as may be required by any member of the company shall be furnished by the company to such extent, in such manner, and on payment of such fees as may be prescribed.
- (4) The register to be kept under this section shall also be produced at the commencement of every annual general meeting of the company and shall remain open and accessible during the continuance of the meeting to any person having the right to attend the meeting.
- (5) Nothing contained in sub-section (1) shall apply to any contract or arrangement—
  - (a) for the sale, purchase or supply of any goods, materials or services if the value of such goods and materials or the cost of such services does not exceed five lakh rupees in the aggregate in any year; or
  - (b) by a banking company for the collection of bills in the ordinary course of its business.

- (6) Every director who fails to comply with the provisions of this section and the rules made thereunder shall be liable to a penalty of twenty-five thousand rupees.

#### **7.6.24 Contract of Employment with Managing or Whole-Time Directors [Section 190]**

- (1) Every company shall keep at its registered office,—
  - (a) where a contract of service with a managing or whole-time director is in writing, a copy of the contract; or
  - (b) where such a contract is not in writing, a written memorandum setting out its terms.
- (2) The copies of the contract or the memorandum kept under sub-section (1) shall be open to inspection by any member of the company without payment of fee.
- (3) If any default is made in complying with the provisions of sub-section (1) or sub-section (2), the company shall be liable to a penalty of twenty-five thousand rupees and every officer of the company who is in default shall be liable to a penalty of five thousand rupees for each default.
- (4) The provisions of this section shall not apply to a private company.

#### **7.6.25 Payment to Director for Loss of Office, etc., in Connection with Transfer of Undertaking, Property or Shares [Section 191]**

- (1) No director of a company shall, in connection with—
  - (a) the transfer of the whole or any part of any undertaking or property of the company; or
  - (b) the transfer to any person of all or any of the shares in a company being a transfer resulting from—
    - (i) an offer made to the general body of shareholders;
    - (ii) an offer made by or on behalf of some other body corporate with a view to a company becoming a subsidiary company of such body corporate or a subsidiary company of its holding company;
    - (iii) an offer made by or on behalf of an individual with a view to his obtaining the right to exercise, or control the exercise of, not less than one-third of the total voting power at any general meeting of the company; or
    - (iv) any other offer which is conditional on acceptance to a given extent, receive any payment by way of compensation for loss of office or as consideration for retirement from office, or in connection with such loss or retirement from such company or from the transferee of such undertaking or property, or from the transferees of shares or from any other person, not being such company, unless particulars as may be prescribed with respect to the payment proposed to be made by such transferee or person, including the amount thereof, have been disclosed to the members of the company and the proposal has been approved by the company in general meeting.
- (2) Nothing in sub-section (1) shall affect any payment made by a company to a managing director or whole-time director or manager of the company by way of compensation for loss of office or as consideration for retirement from office or in connection with such loss or retirement subject to limits or priorities, as may be prescribed.
- (3) If the payment under sub-section (1) or sub-section (2) is not approved for want of quorum either in a meeting or an adjourned meeting, the proposal shall not be deemed to have been approved.
- (4) Where a director of a company receives payment of any amount in contravention of sub-section (1) or the proposed payment is made before it is approved in the meeting, the amount so received by the director shall be deemed to have been received by him in trust for the company.



- (5) If a director of the company contravenes the provisions of this section, such director shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.
- (6) Nothing in this section shall be taken to prejudice the operation of any law requiring disclosure to be made with respect to any payment received under this section or such other like payments made to a director.

#### **7.6.26 Restriction on Non-Cash Transactions involving Directors [Section 192]**

- (1) No company shall enter into an arrangement by which—
  - (a) a director of the company or its holding, subsidiary or associate company or a person connected with him acquires or is to acquire assets for consideration other than cash, from the company; or
  - (b) the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected, unless prior approval for such arrangement is accorded by a resolution of the company in general meeting and if the director or connected person is a director of its holding company, approval under this sub-section shall also be required to be obtained by passing a resolution in general meeting of the holding company.
- (2) The notice for approval of the resolution by the company or holding company in general meeting under sub-section (1) shall include the particulars of the arrangement along with the value of the assets involved in such arrangement duly calculated by a registered valuer.
- (3) Any arrangement entered into by a company or its holding company in contravention of the provisions of this section shall be voidable at the instance of the company unless—
  - (a) the restitution of any money or other consideration which is the subject-matter of the arrangement is no longer possible and the company has been indemnified by any other person for any loss or damage caused to it; or
  - (b) any rights are acquired bona fide for value and without notice of the contravention of the provisions of this section by any other person.

#### **7.6.27 Contract by One Person Company. [Section 193]**

- (1) Where One Person Company limited by shares or by guarantee enters into a contract with the sole member of the company who is also the director of the company, the company shall, unless the contract is in writing, ensure that the terms of the contract or offer are contained in a memorandum or are recorded in the minutes of the first meeting of the Board of Directors of the company held next after entering into contract.

Provided that nothing in this sub-section shall apply to contracts entered into by the company in the ordinary course of its business.

- (2) The company shall inform the Registrar about every contract entered into by the company and recorded in the minutes of the meeting of its Board of Directors under sub-section (1) within a period of fifteen days of the date of approval by the Board of Directors.

#### **7.6.28 Prohibition on Forward Dealings in Securities of Company by Director or key Managerial Personnel [Section 194]**

- (1) No director of a company or any of its key managerial personnel shall buy in the company, or in its holding, subsidiary or associate company—
  - (a) a right to call for delivery or a right to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures; or

- (b) a right, as he may elect, to call for delivery or to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures.
- (2) If a director or any key managerial personnel of the company contravenes the provisions of sub-section (1), such director or key managerial personnel shall be punishable with imprisonment for a term which may extend to two years or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.
- (3) Where a director or other key managerial personnel acquires any securities in contravention of sub-section (1), he shall, subject to the provisions contained in sub-section (2), be liable to surrender the same to the company and the company shall not register the securities so acquired in his name in the register, and if they are in dematerialised form, it shall inform the depository not to record such acquisition and such securities, in both the cases, shall continue to remain in the names of the transferors.

**Explanation.—** For the purposes of this section, “relevant shares” and “relevant debentures” mean shares and debentures of the company in which the concerned person is a whole-time director or other key managerial personnel or shares and debentures of its holding and subsidiary companies.

#### **7.6.29 Prohibition on Insider Trading of Securities [Section 195]**

- (1) No person including any director or key managerial personnel of a company shall enter into insider trading.

Provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or employment or under any law.

**Explanation.—** For the purposes of this section,—

- (a) “insider trading” means—
  - (i) an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer of the company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or
  - (ii) an act of counselling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person;
- (b) “price-sensitive information” means any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.
- (2) If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.



## 7.7 APPOINTMENT AND REMUNERATION OF MANAGERIAL PERSONNEL

### 7.7.1 Appointment of Managing Director, Whole-time Director or Manager [Section 196]

- (1) No company shall appoint or employ at the same time a managing director and a manager.
- (2) No company shall appoint or re-appoint any person as its managing director, whole-time director or manager for a term exceeding five years at a time.

Provided that no re-appointment shall be made earlier than one year before the expiry of his term.

- (3) No company shall appoint or continue the employment of any person as managing director, whole-time director or manager who —

- (a) is below the age of twenty-one years or has attained the age of seventy years.

Provided that appointment of a person who has attained the age of seventy years may be made by passing a special resolution in which case the explanatory statement annexed to the notice for such motion shall indicate the justification for appointing such person;

- (b) is an undischarged insolvent or has at any time been adjudged as an insolvent;
- (c) has at any time suspended payment to his creditors or makes, or has at any time made, a composition with them; or
- (d) has at any time been convicted by a court of an offence and sentenced for a period of more than six months.

- (4) Subject to the provisions of section 197 and Schedule V, a managing director, whole-time director or manager shall be appointed and the terms and conditions of such appointment and remuneration payable be approved by the Board of Directors at a meeting which shall be subject to approval by a resolution at the next general meeting of the company and by the Central Government in case such appointment is at variance to the conditions specified in that Schedule.

Provided that a notice convening Board or general meeting for considering such appointment shall include the terms and conditions of such appointment, remuneration payable and such other matters including interest, of a director or directors in such appointments, if any.

Provided further that a return in the prescribed form shall be filed within sixty days of such appointment with the Registrar.

- (5) Subject to the provisions of this Act, where an appointment of a managing director, whole-time director or manager is not approved by the company at a general meeting, any act done by him before such approval shall not be deemed to be invalid.

### 7.7.2 Filing of Return of Appointment

A company shall file a return of appointment of a Managing Director, Whole Time Director or Manager, Chief Executive Officer (CEO), Company Secretary and Chief Financial Officer (CFO) within sixty days of the appointment, with the Registrar in Form No. **MR.1** along with such fee as may be specified for this purpose.

### 7.7.3 Overall Maximum Managerial Remuneration and Managerial Remuneration in case of Absence or Inadequacy of Profits [Section 197]

- (1) The total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed eleven per cent. of the net profits of that company for that financial year computed in the manner laid down in section 198 except that the remuneration of the directors shall not be deducted from the gross profits.

Provided that the company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding eleven per cent. of the net profits of the company, subject to the provisions of Schedule V.

Provided further that, except with the approval of the company in general meeting,—

- (i) the remuneration payable to any one managing director; or whole-time director or manager shall not exceed five per cent. of the net profits of the company and if there is more than one such director remuneration shall not exceed ten per cent. of the net profits to all such directors and manager taken together;
  - (ii) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed,—
    - (A) one per cent. of the net profits of the company, if there is a managing or whole-time director or manager;
    - (B) three per cent. of the net profits in any other case.
- (2) The percentages aforesaid shall be exclusive of any fees payable to directors under sub-section (5).
- (3) Notwithstanding anything contained in sub-sections (1) and (2), but subject to the provisions of Schedule V, if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole-time director or manager, by way of remuneration any sum exclusive of any fees payable to directors under sub-section (5) hereunder except in accordance with the provisions of Schedule V and if it is not able to comply with such provisions, with the previous approval of the Central Government.
- (4) The remuneration payable to the directors of a company, including any managing or whole-time director or manager, shall be determined, in accordance with and subject to the provisions of this section, either by the articles of the company, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting and 5 the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity.

Provided that any remuneration for services rendered by any such director in other capacity shall not be so included if—

- (a) the services rendered are of a professional nature; and
  - (b) in the opinion of the Nomination and Remuneration Committee, if the company is covered under sub-section (1) of section 178, or the Board of Directors in other cases, the director possesses the requisite qualification for the practice of the profession.
- (5) A director may receive remuneration by way of fee for attending meetings of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board.

Provided that the amount of such fees shall not exceed the amount as may be prescribed.

Provided further that different fees for different classes of companies and fees in respect of independent director may be such as may be prescribed.

- (6) A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.
- (7) Notwithstanding anything contained in any other provision of this Act but subject to the provisions of this section, an independent director shall not be entitled to any stock option and may receive remuneration by way of fees provided under sub-section (5), reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.



- (8) The net profits for the purposes of this section shall be computed in the manner referred to in section 198.
- (9) If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without the prior sanction of the Central Government, where it is required, he shall refund such sums to the company and until such sum is refunded, hold it in trust for the company.
- (10) The company shall not waive the recovery of any sum refundable to it under sub-section (9) unless permitted by the Central Government.
- (11) In cases where Schedule V is applicable on grounds of no profits or inadequate profits, any provision relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof, whether the provision be contained in the company's memorandum or articles, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or its Board, shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule and if such conditions are not being complied, the approval of the Central Government had been obtained.
- (12) Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed.
- (13) Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel.  
Provided that if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration.
- (14) Subject to the provisions of this section, any director who is in receipt of any commission from the company and who is a managing or whole-time director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report.
- (15) If any person contravenes the provisions of this section, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

#### **7.7.4 Sitting Fees**

A company may pay a sitting fee to a director for attending meetings of the Board or committees thereof, such sum as may be decided by the Board of directors thereof which shall not exceed one lakh rupees per meeting of the Board or committee thereof.

Provided that for Independent Directors and Women Directors, the sitting fee shall not be less than the sitting fee payable to other directors.

#### **7.7.5 Disclosure in Board's Report**

- (1) Every listed company shall disclose in the Board's report-
  - (i) the ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year;
  - (ii) the percentage increase in remuneration of each director, Chief Financial Officer, Chief Executive Officer, Company Secretary or Manager, if any, in the financial year;
  - (iii) the percentage increase in the median remuneration of employees in the financial year;

- (iv) the number of permanent employees on the rolls of company;
- (v) the explanation on the relationship between average increase in remuneration and company performance; (vi) comparison of the remuneration of the Key Managerial Personnel against the performance of the company; (vii) variations in the market capitalisation of the company, price earnings ratio as at the closing date of the current financial year and previous financial year and percentage increase over decrease in the market quotations of the shares of the company in comparison to the rate at which the company came out with the last public offer in case of listed companies, and in case of unlisted companies, the variations in the net worth of the company as at the close of the current financial year and previous financial year;
- (viii) average percentile increase already made in the salaries of employees other than the managerial personnel in the last financial year and its comparison with the percentile increase in the managerial remuneration and justification thereof and point out if there are any exceptional circumstances for increase in the managerial remuneration;
- (ix) comparison of the each remuneration of the Key Managerial Personnel against the performance of the company;
- (x) the key parameters for any variable component of remuneration availed by the directors;
- (xi) the ratio of the remuneration of the highest paid director to that of the employees who are not directors but receive remuneration in excess of the highest paid director during the year; and
- (xii) affirmation that the remuneration is as per the remuneration policy of the company.

**Explanation.-** For the purposes of this rule.-

- (i) the expression "median" means the numerical value separating the higher half of a population from the lower half and the median of a finite list of numbers may be found by arranging all the observations from lowest value to highest value and picking the middle one;
  - (ii) if there is an even number of observations, the median shall be the average of the two middle values.
- (2) The board's report shall include a statement showing the name of every employee of the company, who-
- (i) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than sixty lakh rupees;
  - (ii) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than five lakh rupees per month;
  - (iii) if employed throughout the financial year or part thereof, was in receipt of remuneration in that year which, in the aggregate, or as the case may be, at a rate which, in the aggregate, is in excess of that drawn by the managing director or whole-time director or manager and holds by himself or along with his spouse and dependent children, not less than two percent of the equity shares of the company.
- (3) The statement referred to in sub-rule (2) shall also indicate -
- (i) designation of the employee;
  - (ii) remuneration received;
  - (iii) nature of employment, whether contractual or otherwise;
  - (iv) qualifications and experience of the employee;



- (v) date of commencement of employment;
- (vi) the age of such employee;
- (vii) the last employment held by such employee before joining the company;
- (viii) the percentage of equity shares held by the employee in the company within the meaning of clause (iii) of sub-rule (2) above; and
- (ix) whether any such employee is a relative of any director or manager of the company and if so, name of such director or manager.

**Provided** that the particulars of employees posted and working in a country outside India, not being directors or their relatives, drawing more than sixty lakh rupees per financial year or five lakh rupees per month, as the case may be, as may be decided by the Board, shall not be circulated to the members in the Board's report, but such particulars shall be filed with the Registrar of Companies while filing the financial statement and Board Reports.

**Provided Further** that such particulars shall be made available to any shareholder on a specific request made by him in writing before the date of such Annual General Meeting wherein financial statements for the relevant financial year are proposed to be adopted by shareholders and such particulars shall be made available by the company within three days from the date of receipt of such request from shareholders.

**Provided Also** that in case of request received even after the date of completion of Annual General Meeting, such particulars shall be made available to the shareholders within seven days from the date of receipt of such request.

#### **7.7.6 Calculation of Profits [Section 198]**

- (1) In computing the net profits of a company in any financial year for the purpose of section 197,—
  - (a) credit shall be given for the sums specified in sub-section (2), and credit shall not be given for those specified in sub-section (3); and
  - (b) the sums specified in sub-section (4) shall be deducted, and those specified in sub-section (5) shall not be deducted.
- (2) In making the computation aforesaid, credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.
- (3) In making the computation aforesaid, credit shall not be given for the following sums, namely:—
  - (a) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company;
  - (b) profits on sales by the company of forfeited shares;
  - (c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;
  - (d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets.  
Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value;
  - (e) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

- (4) In making the computation aforesaid, the following sums shall be deducted, namely:—
- (a) all the usual working charges;
  - (b) directors' remuneration;
  - (c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;
  - (d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;
  - (e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;
  - (f) interest on debentures issued by the company;
  - (g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;
  - (h) interest on unsecured loans and advances;
  - (i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;
  - (j) outgoings inclusive of contributions made under section 181;
  - (k) depreciation to the extent specified in section 123;
  - (l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;
  - (m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;
  - (n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m);
  - (o) debts considered bad and written off or adjusted during the year of account.
- (5) In making the computation aforesaid, the following sums shall not be deducted, namely:—
- (a) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4);
  - (b) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4);
  - (c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value;
  - (d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

#### **7.7.7 Recovery of Remuneration in Certain Cases [Section 199]**

Without prejudice to any liability incurred under the provisions of this Act or any other law for the time being in force, where a company is required to re-state its financial statements due to fraud or



non-compliance with any requirement under this Act and the rules made thereunder, the company shall recover from any past or present managing director or whole-time director or manager or Chief Executive Officer (by whatever name called) who, during the period for which the financial statements are required to be re-stated, received the remuneration (including stock option) in excess of what would have been payable to him as per restatement of financial statements.

### **7.7.8 Central Government or Company to Fix Limit with Regard to Remuneration [Section 200]**

Notwithstanding anything contained in this Chapter, the Central Government or a company may, while according its approval under section 196, to any appointment or to any remuneration under section 197 in respect of cases where the company has inadequate or no profits, fix the remuneration within the limits specified in this Act, at such amount or percentage of profits of the company, as it may deem fit and while fixing the remuneration, the Central Government or the company shall have regard to—

- (a) the financial position of the company;
- (b) the remuneration or commission drawn by the individual concerned in any other capacity;
- (c) the remuneration or commission drawn by him from any other company;
- (d) professional qualifications and experience of the individual concerned;
- (e) such other matters as may be prescribed.

### **7.7.9 Applications to the Central Government**

The Central Government or the company shall have regard to the following matters, namely:-

- (1) the Financial and operating performance of the company during the three preceding financial years.
- (2) the relationship between remuneration and performance.
- (3) the principle of proportionality of remuneration within the company, ideally by a rating methodology which compares the remuneration of directors to that of other directors on the board who receives remuneration and employees or executives of the company.
- (4) whether remuneration policy for directors differs from remuneration policy for other employees and if so, an explanation for the difference.
- (5) the securities held by the director, including options and details of the shares pledged as at the end of the preceding financial year.

### **7.7.10 Fees**

- (1) Every application made to the Central Government under the provisions of Chapter XIII shall be made in Form No. **MR. 2** and shall be accompanied by fee as may be specified for the purpose.
- (2) The companies other than listed companies and subsidiary of a listed company may without Central Government approval pay remuneration to its managerial personnel, in the event of no profit or inadequate profit beyond ceiling specified in Section II, Part II of Schedule V, subject to complying with the following conditions namely:-
  - (i) payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under sub-section (1) of section 178 also by the Nomination and Remuneration Committee, if any, and while doing so record in writing the clear reason and justification for payment of remuneration beyond the said limit;
  - (ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon preference shares and dividend on preference shares for a continuous period of thirty days in the preceding financial year before the date of payment to such managerial personnel;

- (iii) the approval of shareholders by way of a special resolution at a general meeting of the company for payment of remuneration for a period not exceeding three years;
  - (iv) a statement along-with a notice calling the general meeting referred to clause (iii) of sub-rule (2) above, shall contain the information as per sub clause (iv) of second proviso to clause (B) of section II of part-II of Schedule V of the Act including reasons and justification for payment of remuneration beyond the said limit;
  - (v) the company has filed Balance Sheet and Annual Return which are due to be filed with the Registrar of Companies.
- (3) Every such application seeking approval shall be made to the Central Government within a period of ninety days from the date of such appointment.

#### **7.7.11 Forms of and Procedure in Relation to, Certain Applications [Section 201]**

- (1) Every application made to the Central Government under this Chapter shall be in such form as may be prescribed.
- (2) (a) Before any application is made by a company to the Central Government under any of the sections aforesaid, there shall be issued by or on behalf of the company a general notice to the members thereof, indicating the nature of the application proposed to be made.
- (b) Such notice shall be published at least once in a newspaper in the principal language of the district in which the registered office of the company is situate and circulating in that district, and at least once in English in an English newspaper circulating in that district.
- (c) The copies of the notices, together with a certificate by the company as to the due publication thereof, shall be attached to the application.

#### **7.7.12 Compensation for Loss of Office of Managing or Whole-Time Director or Manager [Section 202]**

- (1) A company may make payment to a managing or whole-time director or manager, but not to any other director, by way of compensation for loss of office, or as consideration for retirement from office or in connection with such loss or retirement.
- (2) No payment shall be made under sub-section (1) in the following cases, namely:—
- (a) where the director resigns from his office as a result of the reconstruction of the company, or of its amalgamation with any other body corporate or bodies corporate, and is appointed as the managing or whole-time director, manager or other officer of the reconstructed company or of the body corporate resulting from the amalgamation;
  - (b) where the director resigns from his office otherwise than on the reconstruction of the company or its amalgamation as aforesaid;
  - (c) where the office of the director is vacated under sub-section (1) of section 167;
  - (d) where the company is being wound up, whether by an order of the Tribunal or voluntarily, provided the winding up was due to the negligence or default of the director;
  - (e) where the director has been guilty of fraud or breach of trust in relation to, or of gross negligence in or gross mismanagement of, the conduct of the affairs of the company or any subsidiary company or holding company thereof; and
  - (f) where the director has instigated, or has taken part directly or indirectly in bringing about, the termination of his office.
- (3) Any payment made to a managing or whole-time director or manager in pursuance of sub-section (1) shall not exceed the remuneration which he would have earned if he had been in office for the remainder of his term or for three years, whichever is shorter, calculated on the basis of the average remuneration actually earned by him during a period of three years immediately



preceding the date on which he ceased to hold office, or where he held the office for a lesser period than three years, during such period.

Provided that no such payment shall be made to the director in the event of the commencement of the winding up of the company, whether before or at any time within twelve months after, the date on which he ceased to hold office, if the assets of the company on the winding up, after deducting the expenses thereof, are not sufficient to repay to the shareholders the share capital, including the premiums, if any, contributed by them.

- (4) Nothing in this section shall be deemed to prohibit the payment to a managing or whole-time director, or manager, of any remuneration for services rendered by him to the company in any other capacity.

#### **7.7.13 Appointment of Key Managerial Personnel [Section 203]**

- (1) Every company belonging to such class or classes of companies as may be prescribed shall have the following whole-time key managerial personnel,—
  - (i) managing director, or Chief Executive Officer or manager and in their absence, personnel. a whole-time director;
  - (ii) Company secretary; and
  - (iii) Chief Financial Officer .

Provided that an individual shall not be appointed or reappointed as the chairperson of the company, in pursuance of the articles of the company, as well as the managing director or Chief Executive Officer of the company at the same time after the date of commencement of this Act unless,—

- (a) the articles of such a company provide otherwise; or
- (b) the company does not carry multiple businesses.

Provided further that nothing contained in the first proviso shall apply to such class of companies engaged in multiple businesses and which has appointed one or more Chief Executive Officers for each such business as may be notified by the Central Government.

- (2) Every whole-time key managerial personnel of a company shall be appointed by means of a resolution of the Board containing the terms and conditions of the appointment including the remuneration.
- (3) A whole-time key managerial personnel shall not hold office in more than one company except in its subsidiary company at the same time.

Provided that nothing contained in this sub-section shall disentitle a key managerial personnel from being a director of any company with the permission of the Board.

Provided further that whole-time key managerial personnel holding office in more than one company at the same time on the date of commencement of this Act, shall, within a period of six months from such commencement, choose one company, in which he wishes to continue to hold the office of key managerial personnel.

Provided also that a company may appoint or employ a person as its managing director, if he is the managing director or manager of one, and of not more than one, other company and such appointment or employment is made or approved by a resolution passed at a meeting of the Board with the consent of all the directors present at the meeting and of which meeting, and of the resolution to be moved thereat, specific notice has been given to all the directors then in India.

- (4) If the office of any whole-time key managerial personnel is vacated, the resulting vacancy shall be filled-up by the Board at a meeting of the Board within a period of six months from the date of such vacancy.
- (5) If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every director and key managerial personnel of the company who is in default shall be punishable with fine which may extend to fifty thousand rupees and where the contravention is a continuing one, with a further fine which may extend to one thousand rupees for every day after the first during which the contravention continues.

As per the Notification F. N. 1/5/2013-CL-V dated 25<sup>th</sup> July, 2014, in exercise of the powers conferred by the second proviso to sub-section (1) of section 203 of the Companies Act, 2013, the Central Government hereby notifies that public companies having paid-up share capital of rupees one hundred crore or more and annual turnover of rupees one thousand crore or more which are engaged in multiple businesses and have appointed Chief Executive Officer for each such business shall be the class of companies for the purposes of the second proviso to sub-section (1) of section 203 of the said Act.

**Explanation.** - For the purposes of this notification, the paid-up share capital and the annual turnover shall be decided on the basis of the latest audited balance sheet.

#### **7.7.14 Appointment of Company Secretaries in Companies not Covered Under Rule 8 [Rule 8A]**

A company other than a company covered under rule 8 which has a paid up share capital of five crore rupees or more shall have a whole-time company secretary.

#### **7.7.15 Secretarial Audit for Bigger Companies [Section 204]**

- (1) Every listed company and a company belonging to other class of companies as may be prescribed shall annex with its Board's report made in terms of sub-section (3) of section 134, a secretarial audit report, given by a company secretary in practice, in such form as may be prescribed.
- (2) It shall be the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company.
- (3) The Board of Directors, in their report made in terms of sub-section (3) of section 134, shall explain in full any qualification or observation or other remarks made by the company secretary in practice in his report under sub-section (1).
- (4) If a company or any officer of the company or the company secretary in practice, contravenes the provisions of this section, the company, every officer of the company or the company secretary in practice, who is in default, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

#### **7.7.16 Secretarial Audit Report**

- (1) For the purposes of sub-section (1) of section 204, the other class of companies shall be as under-
  - (a) every public company having a paid-up share capital of fifty crore rupees or more; or
  - (b) every public company having a turnover of two hundred fifty crore rupees or more.
- (2) The format of the Secretarial Audit Report shall be in Form No.MR.3.

#### **7.7.17 Functions of Company Secretary [Section 205]**

- (1) The functions of the company secretary shall include,—
  - (a) to report to the Board about compliance with the provisions of this Act, the rules made thereunder and other laws applicable to the company;



- (b) to ensure that the company complies with the applicable secretarial standards;
- (c) to discharge such other duties as may be prescribed.

**Explanation.**—For the purpose of this section, the expression “secretarial standards” means secretarial standards issued by the Institute of Company Secretaries of India constituted under section 3 of the Company Secretaries Act, 1980 and approved by the Central Government.

- (2) The provisions contained in section 204 and section 205 shall not affect the duties and functions of the Board of Directors, chairperson of the company, managing director or whole-time director under this Act, or any other law for the time being in force.

### 7.7.18 Duties of Company Secretary

The duties of Company Secretary shall also discharge, the following duties, namely:-

- (1) to provide to the directors of the company, collectively and individually, such guidance as they may require, with regard to their duties, responsibilities and powers;
- (2) to facilitate the convening of meetings and attend Board, committee and general meetings and maintain the minutes of these meetings;
- (3) to obtain approvals from the Board, general meeting, the government and such other authorities as required under the provisions of the Act;
- (4) to represent before various regulators, and other authorities under the Act in connection with discharge of various duties under the Act;
- (5) to assist the Board in the conduct of the affairs of the company;
- (6) to assist and advise the Board in ensuring good corporate governance and in complying with the corporate governance requirements and best practices; and
- (7) to discharge such other duties as have been specified under the Act or rules; and
- (8) such other duties as may be assigned by the Board from time to time.

## 7.8 COMPANIES INCORPORATED OUTSIDE INDIA

### 7.8.1 Application of Act to Foreign Companies [Section 379]

Where not less than fifty per cent. of the paid-up share capital, whether equity or preference or partly equity and partly preference, of a foreign company is held by one or more citizens of India or by one or more companies or bodies corporate incorporated in India, or by one or more citizens of India and one or more companies or bodies corporate incorporated in India, whether singly or in the aggregate, such company shall comply with the provisions of this Chapter and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India.

### 7.8.2 Documents, etc., to be delivered to Registrar by Foreign Companies [Section 380]

- (1) Every foreign company shall, within thirty days of the establishment of its place of business in India, deliver to the Registrar for registration—
  - (a) a certified copy of the charter, statutes or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company and, if the instrument is not in the English language, a certified translation thereof in the English language;
  - (b) the full address of the registered or principal office of the company;
  - (c) a list of the directors and secretary of the company containing such particulars as may be prescribed;

- (d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company;
  - (e) the full address of the office of the company in India which is deemed to be its principal place of business in India;
  - (f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;
  - (g) declaration that none of the directors of the company or the authorized representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and
  - (h) any other information as may be prescribed.
- (2) Every foreign company existing at the commencement of this Act shall, if it has not delivered to the Registrar before such commencement, the documents and particulars specified in sub-section (1) of section 592 of the Companies Act, 1956, continue to be subject to the obligation to deliver those documents and particulars in accordance with that Act.
- (3) Where any alteration is made or occurs in the documents delivered to the Registrar under this section, the foreign company shall, within thirty days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form.

### **7.8.3 Particulars relating to Directors and Secretary to be Furnished to the Registrar by Foreign Companies**

- (1) Every foreign company shall, within thirty days of establishment of its place of business in India, in addition to the particulars specified in sub-section (1) of section 380 of the Act, also deliver to the Registrar for registration, a list of directors and Secretary of such company.
- (2) The list of directors and secretary or equivalent (by whatever name called) of the foreign company shall contain the following particulars, for each of the persons included in such list, namely: -
- (a) personal name and surname in full;
  - (b) any former name or names and surname or surnames in full;
  - (c) father's name or mother's name and spouse's name;
  - (d) date of birth;
  - (e) residential address;
  - (f) nationality;
  - (g) if the present nationality is not the nationality of origin, his nationality of origin;
  - (h) passport Number, date of issue and country of issue; (if a person holds more than one passport then details of all passports to be given)
  - (i) income-tax permanent account number (PAN), if applicable;
  - (j) occupation, if any ;
  - (k) whether directorship in any other Indian company, (Director Identification Number (DIN), Name and Corporate Identity Number (CIN) of the company in case of holding directorship);
  - (l) other directorship or directorships held by him;
  - (m) Membership Number (for Secretary only); and
  - (n) e-mail ID.
- (3) A foreign company shall, within a period of thirty days of the establishment of its place of business in India, file with the registrar Form FC-1 with such fee as provided in Companies (Registration



Offices and Fees) Rules, 2014 and with the documents required to be delivered for registration by a foreign company in accordance with the provisions of sub-section (1) of section 380 and the application shall also be supported with an attested copy of approval from the Reserve Bank of India under Foreign Exchange Management Act or Regulations, and also from other regulators, if any, approval is required by such foreign company to establish a place of business in India or a declaration from the authorised representative of such foreign company that no such approval is required.

- (4) Where any alteration is made or occurs in the document delivered to the Registrar for registration under sub-section (1) of section 380, the foreign company shall file with the Registrar, a return in Form FC-2 along with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014 containing the particulars of the alteration, within a period of thirty days from the date on which the alteration was made or occurred.

#### **7.8.4 Accounts of Foreign Company [Section 381]**

- (1) Every foreign company shall, in every calendar year,—

- (a) make out a balance sheet and profit and loss account in such form, containing such particulars and including or having annexed or attached thereto such documents as may be prescribed; and
- (b) deliver a copy of those documents to the Registrar.

Provided that the Central Government may, by notification, direct that, in the case of any foreign company or class of foreign companies, the requirements of clause (a) shall not apply, or shall apply subject to such exceptions and modifications as may be specified in that notification.

- (2) If any such document as is mentioned in sub-section (1) is not in the English language, there shall be annexed to it a certified translation thereof in the English language.
- (3) Every foreign company shall send to the Registrar along with the documents required to be delivered to him under sub-section (1), a copy of a list in the prescribed form of all places of business established by the company in India as at the date with reference to which the balance sheet referred to in sub-section (1) is made out.

#### **7.8.5 Financial Statement of Foreign Company**

- (1) Every foreign company shall prepare financial statement of its Indian business operations in accordance with Schedule III or as near thereto as may be possible for each financial year including—

- (i) documents required to be annexed thereto in accordance with the provisions of Chapter IX of the Act i.e. Accounts of Companies ;
- (ii) documents relating to copies of latest consolidated financial statements of the parent foreign company, as submitted by it to the prescribed authority in the country of its incorporation under the provisions of the law for the time being in force in that country;

Provided that where such documents are not in English language, there shall be annexed to it a certified translation thereof in the English language.

Provided further that where the Central Government has exempted or specified different documents for any foreign company or a class of foreign companies, then documents as specified shall be submitted;

- (iii) Such other documents as may be required to be annexed or attached in accordance with sub-rule (2).

(2) Every foreign company shall, along with the financial statement required to be filed with the Registrar, attach thereto the following documents;

namely: —

(a) Statement of related party transaction, which shall include—

- (i) name of the person in India which shall be deemed to be the related party within the meaning of clause (76) of section 2 of the Act of the foreign company or of any subsidiary or holding company of such foreign company or of any firm in which such foreign company or its subsidiary or holding company is a partner;
- (ii) nature of such relationship;
- (iii) description and nature of transaction;
- (iv) amount of such transaction during the year with opening, closing, highest and lowest balance during the year and provisions made (if any) in respect of such transactions;
- (v) reason of such transaction;
- (vi) material effect of such transaction on both the parties;
- (vii) amount written off or written back in respect of dues from or to the related parties;
- (viii) a declaration that such transactions were carried out at arms length basis; and
- (ix) any other details of the transaction necessary to understand the financial impact;

(b) Statement of repatriation of profits which shall include—

- (i) amount of profits repatriated during the year;
- (ii) recipients of the repatriation;
- (iii) form of repatriation;
- (iv) dates of repatriation;
- (v) details if repatriation made to a jurisdiction other than the residence of the beneficiary;
- (vi) mode of repatriation; and
- (vii) approval of the Reserve Bank of India or any other authority, if any.

(c) Statement of transfer of funds (including dividends if any) which shall, in relation of any fund transfer between place of business of foreign company in India and any other related party of the foreign company outside India including its holding, subsidiary and associate company, include—

- (i) date of such transfer;
- (ii) amount of fund transferred or received;
- (iii) mode of receipt or transfer of fund;
- (iv) purpose of such receipt or transfer; and
- (v) approval of Reserve Bank of India or any other authority, if any

(3) The documents referred to in this rule shall be delivered to the Registrar within a period of six months of the close of the financial year of the foreign company to which the documents relate.

Provided that the Registrar may, for any special reason, and on application made in writing by the foreign company concerned, extend the said period by a period not exceeding three months.



### **7.8.6 Audit of Accounts of foreign company**

- (1) Every foreign company shall get its accounts, pertaining to the Indian business operations prepared in accordance with the requirements of clause (a) of sub-section (1) of section 381 and rule 4, audited by a practicing Chartered Accountant in India or a firm or limited liability partnership of practicing chartered accountants.

#### **Explanation.—**

For the purposes of this sub-rule, the expressions “Chartered Accountant”, “Firm” and limited liability partnership shall have the meanings respectively assigned to them under the Act and Limited Liability Partnership Act, 2008 (6 of 2009) respectively.

- (2) The provisions of Chapter X i.e. Audit and Auditors and rules made there under, as far as applicable, shall apply, mutatis mutandis, to the foreign company.

### **7.8.7 Display of Name, etc., of Foreign Company [Section 382]**

Every foreign company shall—

- (a) conspicuously exhibit on the outside of every office or place where it carries on business in India, the name of the company and the country in which it is incorporated, in letters easily legible in English characters, and also in the characters of the language or one of the languages in general use in the locality in which the office or place is situate;
- (b) cause the name of the company and of the country in which the company is incorporated, to be stated in legible English characters in all business letters, billheads and letter paper, and in all notices, and other official publications of the company; and
- (c) if the liability of the members of the company is limited, cause notice of that fact—
  - (i) to be stated in every such prospectus issued and in all business letters, bill-heads, letter paper, notices, advertisements and other official publications of the company, in legible English characters; and
  - (ii) to be conspicuously exhibited on the outside of every office or place where it carries on business in India, in legible English characters and also in legible characters of the language or one of the languages in general use in the locality in which the office or place is situate.

### **7.8.8 List of Places of Business of Foreign Company**

Every foreign company shall file with the Registrar, along with the financial statement, in Form FC.3 with such fee as provided under Companies (Registration Offices and Fees) Rules, 2014 a list of all the places of business established by the foreign company in India as on the date of balance sheet.

### **7.8.9 Service on Foreign Company [Section 383]**

Any process, notice, or other document required to be served on a foreign company shall be deemed to be sufficiently served, if addressed to any person whose name and address have been delivered to the Registrar under section 380 and left at, or sent by post to, the address which has been so delivered to the Registrar or by electronic mode.

### **7.8.10 Debentures, Annual Return, Registration of Charges, Books of Account and their Inspection [Section 384]**

- (1) The provisions of section 71 shall apply mutatis mutandis to a foreign company.
- (2) The provisions of section 92 shall, subject to such exceptions, modifications and adaptations as may be made therein by rules made under this Act, apply to a foreign company as they apply to a company incorporated in India.

- (3) The provisions of section 128 shall apply to a foreign company to the extent of requiring it to keep at its principal place of business in India, the books of account referred to in that section, with respect to monies received and spent, sales and purchases made, and assets and liabilities, in the course of or in relation to its business in India.
- (4) The provisions of Chapter VI shall apply mutatis mutandis to charges on properties which are created or acquired by any foreign company.
- (5) The provisions of Chapter XIV shall apply mutatis mutandis to the Indian business of a foreign company as they apply to a company incorporated in India.

#### **7.8.11 Fee for Registration of Documents [Section 385]**

There shall be paid to the Registrar for registering any document required by the provisions of this Chapter to be registered by him, such fee, as may be prescribed.

#### **7.8.12 Office where Documents to be Delivered and Fee for Registration of Documents**

- (1) Any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi, and references to the Registrar in Chapter XXII of the Act i.e. Companies Incorporated Outside India and these rules shall be construed accordingly.
- (2) The fee to be paid to the Registrar for registering any document relating to a foreign company shall be such as provided in the Companies (Registration Offices and Fees) Rules, 2014.
- (3) If any foreign company ceases to have a place of business in India, it shall forthwith give notice of the fact to the Registrar, and as from the date on which notice is so given, the obligation of the company to deliver any document to the Registrar shall cease, provided it has no other place of business in India.

#### **7.8.13 Certification**

A copy of any charter, statutes, memorandum and articles, or other instrument constituting or defining the constitution of a Foreign company shall be duly certified to be a true copy in the manner given below -

- (1) If the company is incorporated in a country outside the Commonwealth-
  - (a) the copy aforesaid shall be certified as a true copy by-
    - (i) an official of the Government to whose custody the original is situated; or
    - (ii) a Notary (Public) of such Country; or
    - (iii) an officer of the company.
  - (b) The signature or seal of the official referred to in sub-clause (i) of clause (a) or the certificate of the Notary (Public) referred to in sub-clause (ii) of clause (a) shall be authenticated by a diplomatic or consular officer empowered in this behalf under section 3 of the Diplomatic and Consular Officers (Oaths and Fees) Act, 1948 (XL of 1948), or where there is no such officer, by any of the officials mentioned in section 6 of the Commissioners of Oath Act, 1889 (52 and 53 Vic. C. 10), or in any relevant Act for the said purpose.
  - (c) The certificate of the officer of the company referred to in sub-clause (iii) of clause (a) shall be signed before a person having authority to administer an oath as provided under section 3 of the Diplomatic and Consular Officers (Oath and Fees) Act, 1948, or as the case may be, by section 3 of the Commissioners of Oath Act, 1889 and the status of the person administering the oath in the latter case being authenticated by any official specified in section 6 of the Commissioners of Oaths Act, 1889 or in any relevant Act for the said purpose.



- (2) If the company is incorporated in any part of the Commonwealth, the copy of the document shall be certified as a true copy by-
  - (a) an official of the Government to whose custody the original of the document is committed; or
  - (b) a Notary (Public) in that part of the Commonwealth; or
  - (c) an officer of the company, on oath before a person having authority to administer an oath in that part of the Commonwealth.
- (3) Any altered document delivered to the Registrar should also be duly certified in the manner mentioned above.
  - (a) If the Company is incorporated in a country falling outside the Commonwealth, but a party to the Hague Apostille Convention, 1961 the copy of the documents shall be certified as a true copy by an official of the Government to whose custody the original is committed and be duly apostilled in accordance with Hague Convention;
  - (b) a list of the directors and the secretary of the Company, if any, the name and address of persons resident in India, authorized to accept notice on behalf of the Company shall be duly notarized and be apostilled in the Country of their origin in accordance with Hague Convention;
  - (c) the signatures and address on the Memorandum of Association and proof of identity, where required, of foreign nationals seeking to register a company in India shall be notarized before the notary of the country of their origin and be duly apostilled in accordance with the said Hague Convention.

#### **7.8.14 Authentication of Translated Documents**

- (1) All the documents required to be filed with the Registrar by the foreign companies shall be in English language and where any such document is not in English language, there shall be attached a translation thereof in English language duly certified to be correct in the manner given in these rules.
- (2) Where any such translation is made outside India, it shall be authenticated by the signature and the seal, if any, of-
  - (a) the official having custody of the original; or
  - (b) a Notary (Public) of the country (or part of the country) where the company is incorporated.

**Provided** that where the company is incorporated in a country outside the Commonwealth, the signature or seal of the person so certifying shall be authenticated by a diplomatic or consular officer empowered in this behalf under section 3 of the Diplomatic and Consular Officers (Oaths and Fees) Act, 1948, or, where there is no such officer, by any of the officials mentioned in section 6, of the Commissioners of Oaths Act, 1889, or in any relevant Act for the said purpose.
- (3) Where such translation is made within India, it shall be authenticated by-
  - (a) an advocate, attorney or pleader entitled to appear before any High Court; or
  - (b) an affidavit, of a competent person having, in the opinion of the Registrar, an adequate knowledge of the language of the original and of English.

#### **7.8.15 Interpretation [Section 386]**

For the purposes of the foregoing provisions of this Chapter,—

- (a) the expression “certified” means certified in the prescribed manner to be a true copy or a correct translation;

- (b) the expression "director", in relation to a foreign company, includes any person in accordance with whose directions or instructions the Board of Directors of the company is accustomed to act; and
- (c) the expression "place of business" includes a share transfer or registration office.

#### **7.8.16 Dating of Prospectus and Particulars to be Contained Therein [Section 387]**

(1) No person shall issue, circulate or distribute in India any prospectus offering to subscribe for securities of a company incorporated or to be incorporated outside India, whether the company has or has not established, or when formed will or will not establish, a place of business in India, unless the prospectus is dated and signed, and—

(a) contains particulars with respect to the following matters, namely:—

- (i) the instrument constituting or defining the constitution of the company;
- (ii) the enactments or provisions by or under which the incorporation of the company was effected;
- (iii) address in India where the said instrument, enactments or provisions, or copies thereof, and if the same are not in the English language, a certified translation thereof in the English language can be inspected;
- (iv) the date on which and the country in which the company would be or was incorporated; and
- (v) whether the company has established a place of business in India and, if so, the address of its principal office in India; and

(b) states the matters specified under section 26.

Provided that sub-clauses (i), (ii) and (iii) of clause (a) of this sub-section shall not apply in the case of a prospectus issued more than two years after the date at which the company is entitled to commence business.

- (2) Any condition requiring or binding an applicant for securities to waive compliance with any requirement imposed by virtue of sub-section (1), or purporting to impute him with notice of any contract, documents or matter not specifically referred to in the prospectus, shall be void.
- (3) No person shall issue to any person in India a form of application for securities of such a company or intended company as is mentioned in sub-section (1), unless the form is issued with a prospectus which complies with the provisions of this Chapter and such issue does not contravene the provisions of section 388.

Provided that this sub-section shall not apply if it is shown that the form of application was issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to securities.

(4) This section —

- (a) shall not apply to the issue to existing members or debenture holders of a company of a prospectus or form of application relating to securities of the company, whether an applicant for securities will or will not have the right to renounce in favour of other persons; and
- (b) except in so far as it requires a prospectus to be dated, to the issue of a prospectus relating to securities which are or are to be in all respects uniform with securities previously issued and for the time being dealt in or quoted on a recognised stock exchange,

but, subject as aforesaid, this section shall apply to a prospectus or form of application whether issued on or with reference to the formation of a company or subsequently.



- (5) Nothing in this section shall limit or diminish any liability which any person may incur under any law for the time being in force in India or under this Act apart from this section.

#### **7.8.17 Documents to be Annexed to Prospectus**

The following documents shall be annexed to the prospectus, namely: -

- (a) any consent to the issue of the prospectus required from any person as an expert;
- (b) a copy of contracts for appointment of managing director or manager and in case of a contract not reduced into writing, a memorandum giving full particulars thereof;
- (c) a copy of any other material contracts, not entered in the ordinary course of business, but entered within preceding two years;
- (d) a copy of underwriting agreement; and
- (e) a copy of power of attorney, if prospectus is signed through duly authorized agent of directors.

#### **7.8.18 Provision as to Expert's Consent and Allotment [Section 388]**

- (1) No person shall issue, circulate or distribute in India any prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, whether the company has or has not been established, or when formed will or will not establish, a place of business in India,—
- (a) if, where the prospectus includes a statement purporting to be made by an expert, he has not given, or has before delivery of the prospectus for registration withdrawn, his written consent to the issue of the prospectus with the statement included in the form and context in which it is included, or there does not appear in the prospectus a statement that he has given and has not withdrawn his consent as aforesaid; or
  - (b) if the prospectus does not have the effect, where an application is made in pursuance thereof, of rendering all persons concerned bound by all the provisions of sections 33 and 40, so far as applicable.
- (2) For the purposes of this section, a statement shall be deemed to be included in a prospectus, if it is contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith.

#### **7.8.19 Registration of Prospectus [Section 389]**

No person shall issue, circulate or distribute in India any prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, whether the company has or has not established, or when formed will or will not establish, a place of business in India, unless before the issue, circulation or distribution of the prospectus in India, a copy thereof certified by the chairperson of the company and two other directors of the company as having been approved by resolution of the managing body has been delivered for registration to the Registrar and the prospectus states on the face of it that a copy has been so delivered, and there is endorsed on or attached to the copy, any consent to the issue of the prospectus required by section 388 and such documents as may be prescribed.

#### **7.8.20 Offer of Indian Depository Receipts [Section 390]**

Notwithstanding anything contained in any other law for the time being in force, the Central Government may make rules applicable for—

- (a) the offer of Indian Depository Receipts;
- (b) the requirement of disclosures in prospectus or letter of offer issued in connection with Indian Depository Receipts;

- (c) the manner in which the Indian Depository Receipts shall be dealt with in a depository mode and by custodian and underwriters; and
- (d) the manner of sale, transfer or transmission of Indian Depository Receipts, by a company incorporated or to be incorporated outside India, whether the company has or has not established, or will or will not establish, any place of business in India.

#### 7.8.21 Issue of Indian Depository Receipts (IDRs)

- (1) For the purposes of section 390, no company incorporated or to be incorporated outside India, whether the company has or has not established, or may or may not establish, any place of business in India (hereinafter in this rule called 'issuing company') shall make an issue of Indian Depository Receipts (IDRs) unless such company complies with the conditions mentioned under this rule, in addition to the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 and any directions issued by the Reserve Bank of India.

**Explanation.** - For the purposes of this rule, the term "Indian Depository Receipt" (hereinafter referred to as 'IDR') means any instrument in the form of a depository receipt created by a Domestic Depository in India and authorized by a company incorporated outside India making an issue of such depository receipts.

- (2) The issuing company shall not issue IDRs unless-
  - (a) its pre-issue paid-up capital and free reserves are at least US\$ 50 million and it has a minimum average market capitalization (during the last three years) in its parent country of at least US\$ 100 million;
  - (b) it has been continuously trading on a stock exchange in its parent or home country (the country of incorporation of such company) for at least three immediately preceding years;
  - (c) it has a track record of distributable profits in terms of section 123 of the Act, for at least three out of immediately preceding five years;
  - (d) It fulfills such other eligibility criteria as may be laid down by the Securities and Exchange Board of India from time to time in this behalf.
- (3) The issuing company shall follow the following procedure for making an issue of IDRs:
  - (a) the issuing company shall, where required, obtain the necessary approvals or exemptions from the appropriate authorities from the country of its incorporation under the relevant laws relating to issue of capital and IDRs.
  - (b) issuing company shall obtain prior written approval from the Securities and Exchange Board of India on an application made in this behalf for issue of IDRs along with the issue size.
  - (c) an application under clause (b) shall be made to the Securities and Exchange Board of India (along with draft prospectus) at least ninety days prior to the opening date of the IDRs issue, in such form, along with such fee and furnishing such information as may be specified by the Securities and Exchange Board of India from time to time.

Provided that the issuing company shall also file with the Securities and Exchange Board of India, through a Merchant Banker, a due diligence report along with the application under clause (b) in the form specified by the Securities and Exchange Board of India.

- (d) the Securities and Exchange Board of India may, within a period of thirty days of receipt of an application under clause (c), call for such further information, and explanations, as it may deem necessary, for disposal of such application and shall dispose the application within a period of thirty days of receipt of further information or explanation.

Provided that if within a period of sixty days from the date of submission of application or draft prospectus, the Securities and Exchange Board of India specifies any changes to be made in



the draft prospectus, the prospectus shall not be filed with the Securities and Exchange Board of India or Registrar of Companies unless such changes have been incorporated therein.

- (e) the issuing company shall on approval being granted by the Securities and Exchange Board of India to an application under clause (b), pay to the Securities and Exchange Board of India an issue fee as may be prescribed from time to time by the Securities and Exchange Board of India.
- (f) the issuing company shall file a prospectus, certified by two authorized signatories of the issuing company, one of whom shall be a whole-time director and other the Chief Financial Officer<sup>^</sup> stating the particulars of the resolution of the Board by which it was approved with the Securities and Exchange Board of India and Registrar of Companies, New Delhi before such issue.

Provided that at the time of filing of said prospectus with the Registrar of Companies, New Delhi, a copy of approval granted by the Securities and Exchange Board of India and the statement of fees paid by the Issuing Company to the Securities and Exchange Board of India shall also be attached.

- (g) the prospectus to be filed with the Securities and Exchange Board of India and the Registrar of Companies, New Delhi shall contain the particulars as prescribed in sub-rule (8) and shall be signed by all the whole-time directors of the issuing company, and the Chief Financial Officer.
- (h) the issuing company shall appoint an overseas custodian bank, a Domestic Depository and a Merchant Banker for the purpose of issue of IDRs
- (i) the issuing company may appoint underwriters registered with the Securities and Exchange Board of India to underwrite the issue of IDRs
- (j) the issuing company shall deliver the underlying equity shares or cause them to be delivered to an Overseas Custodian Bank and the said bank shall authorize the domestic depository to issue IDRs
- (k) the issuing company shall obtain in-principle listing permission from one or more stock exchanges having nationwide trading terminals in India.

Explanation- For the purposes of this rule,-

- (i) "Domestic Depository" means custodian of securities registered with the Securities and Exchange Board of India and authorized by the issuing company to issue IDRs
- (ii) "Merchant Banker" means a Merchant Banker as defined in sub-regulation (cb) of regulation 2 of the Securities and Exchange Board (Merchant Bankers) Regulations, 1992.
- (iii) "Overseas Custodian Bank" means a banking company which is established in a country outside India and which acts as custodian for the equity shares of Issuing Company, against which IDRs are proposed to be issued by having a custodial arrangement or agreement with the Domestic Depository or by establishing a place of business in India.

- (4) The Merchant Banker to the issue of IDRs shall deliver for registration the following documents or information to the Securities and Exchange Board of India and Registrar of Companies at New Delhi, namely: -
  - (a) instrument constituting or defining the constitution of the issuing company;
  - (b) the enactments or provisions having the force of law by or under which the incorporation of the Issuing company was effected, a copy of such provisions attested by an officer of the company be annexed;
  - (c) if the issuing company has established place of business in India, address of its principal office in India;

- (d) if the issuing company does not establish a principal place of business in India, an address in India where the said instrument, enactments or provision or copies thereof are available for public inspection, and if these are not in English, a translation thereof certified by a key managerial personnel of the Issuing company shall be kept for public inspection;
  - (e) a certified copy of the certificate of incorporation of the issuing company in the country in which it is incorporated;
  - (f) the copies of the agreements entered into between the issuing company, the overseas custodian bank, the Domestic Depository, which shall inter alia specify the rights to be passed on to the IDR holders;
  - (g) if any document or any portion thereof required to be filed with the Securities and Exchange Board of India or the Registrar of Companies is not in English language, a translation of that document or portion thereof in English, certified by a key managerial personnel of the company to be correct and attested by an authorized officer of the Embassy or Consulate of that country in India, shall be attached to each copy of the document.
- (5) (a) No application form for the securities of the issuing company shall be issued unless the form is accompanied by a memorandum containing the salient features of prospectus in the specified form.
- (b) An application form can be issued without the memorandum as specified in clause (a), if it is issued in connection with an invitation to enter into an underwriting agreement with respect to the ID₹
- (c) The prospectus for subscription of IDRs of the Issuing company which includes a statement purporting to be made by an expert shall not be circulated, issued or distributed in India or abroad unless a statement that the expert has given his written consent to the issue thereof and has not withdrawn such consent before the delivery of a copy of the prospectus to the Securities and Exchange Board of India and the Registrar of Companies, New Delhi, appears on the prospectus.
- (d) The provisions of the Act shall apply for all liabilities for mis-statements in prospectus or punishment for fraudulently inducing persons to invest money in IDRs.
- (e) The person(s) responsible for issue of the prospectus shall not incur any liability by reason of any noncompliance with or contravention of any provision of this rule, if-
- (i) as regards any matter not disclosed, he proves that he had no knowledge thereof; or
  - (ii) the contravention arose in respect of such matters which in the opinion of the Central Government or the Securities and Exchange Board of India were not material.
- (6) (a) A holder of IDRs may transfer the IDRs, may ask the Domestic Depository to redeem them or any person may seek reissuance of IDRs by conversion of underlying equity shares, subject to the provisions of the Foreign Exchange Management Act, 1999, the Securities and Exchange Board of India Act, 1992, or the rules, regulations or guidelines issued under these Acts, or any other law for the time being in force;
- (b) In case of redemption, Domestic Depository shall request the Overseas Custodian Bank to get the corresponding underlying equity shares released in favour of the holder of IDRs for being sold directly on behalf of holder of IDRs, or being transferred in the books of Issuing company in the name of holder of IDRs and a copy of such request shall be sent to the issuing company for information. (c) A holder of IDRs may, at any time, nominate a person to whom his IDRs shall vest in the event of his death and Form FC-5 may be used for this purpose.



- (7) (a) The repatriation of the proceeds of issue of IDRs shall be subject to laws for the time being in force relating to export of foreign exchange.
- (b) The number of underlying equity shares offered in a financial year through IDR offerings shall not exceed twenty five per cent of the post issue number of equity shares of the company.
- (c) Notwithstanding the denomination of securities of an Issuing company, the IDRs issued by it shall be denominated in Indian Rupees.
- (d) The IDRs issued under this Rule shall be listed on the recognized Stock Exchange(s) in India as specified in clause (k) of sub-rule (3) and such IDRs may be purchased, possessed and freely transferred by a person resident in India as defined in section 2(v) of the Foreign Exchange Management Act, 1999, subject to the provisions of the said Act.

Provided that the IDRs issued by an Issuing company may be purchased, possessed and transferred by a person other than a person resident in India if such Issuing company obtains specific approval from Reserve Bank of India in this regard or complies with any policy or guidelines that may be issued by Reserve Bank of India on the subject matter;

- (e) Every issuing company shall comply with such continuous disclosure requirements as may be specified by the Securities and Exchange Board of India in this regard.
- (f) On the receipt of dividend or other corporate action on the IDRs as specified in the agreements between the Issuing company and the Domestic Depository, the Domestic Depository shall distribute them to the IDR holders in proportion to their holdings of IDRs.

- (8) The prospectus or letter of offer shall, inter alia, contain the following particulars, namely: -

**(a) General Information-**

- (i) Name and address of the registered office of the company;
- (ii) name and address of the Domestic Depository, the Overseas Custodian Bank with the address of its office in India, the Merchant Banker, the underwriter to the issue and any other intermediary which may be appointed in connection with the issue of IDRs;
- (iii) names and addresses of Stock Exchanges where applications are made or proposed to be made for listing of the IDRs;
- (iv) the provisions relating to punishment for fictitious applications;
- (v) statement or declaration for refund of excess subscription;
- (vi) declaration about issue of allotment letters or certificates or IDRs within the stipulated period;
- (vii) date of opening of issue;
- (viii) date of closing of issue;
- (ix) date of earliest closing of the issue;
- (x) declaration by the Merchant Banker with regard to adequacy of resources of underwriters to discharge their respective obligations, in case of being required to do so;
- (xi) a statement by the Issuing company that all moneys received out of issue of IDRs shall be transferred to a separate domestic bank account, name and address of the bank and the nature and number of the account to which the amount shall be credited;
- (xii) the details of proposed utilisation of the proceeds of the IDR issue.

- (b) Capital Structure of the Company-** The authorized, issued, subscribed and paid-up capital of the issuing company;

**(c) Terms of the Issue-**

- (i) rights of the IDR holders against the underlying securities;
- (ii) details of availability of prospectus and forms, i.e., date, time, place etc;
- (iii) amount and mode of payment seeking issue of IDRs; and
- (iv) any special tax benefits for the Issuing company and holders of IDRs in India.

**(d) Particulars of Issue-**

- (i) the objects of the issue;
- (ii) the cost of the Project, if any; and
- (iii) the means of financing the projects, if any including contribution by promoters.

**(e) Company, Management and Project-**

- (i) the main objects, history and present business of the company;
- (ii) the Promoters or parent group or owner group and their background.  
Provided that in case there are no identifiable promoters, the names, addresses and other particulars as may be specified by the Securities and Exchange Board of India of all the persons who hold five percent, or more equity share capital of the company shall be disclosed;
- (iii) the subsidiaries of the company, if any;
- (iv) the particulars of the Management or Board (i.e. Name and complete address(es) of Directors, Manager, Managing Director or other principal officers of the company);
- (v) the location of the project, if any;
- (vi) the details of plant and machinery, infrastructure facilities, technology etc., where applicable;
- (vii) the schedule of implementation of project and progress made so far, if applicable;
- (viii) nature of product(s), consumer(s), industrial users;
- (ix) the particulars of legal, financial and other defaults, if any;
- (x) the risk factors to the issue as perceived; and
- (xi) consent of the Merchant Bankers, Overseas Custodian Bank, the Domestic Depository and all other intermediaries associated with the issue of IDRs.
- (xii) the information, as may be specified by the Securities and Exchange Board of India, in respect of listing, trading record or history of the Issuing company on all the stock exchanges, whether situated in its parent country or elsewhere.

**(f) Report-**

- (i) Where the law of a country, in which the Issuing company is incorporated, requires annual statutory audit of the accounts of the Issuing company, a report by the statutory auditor of the Issuing company, in such form as may be specified by the Securities and Exchange Board of India on -
  - (A) the audited financial statements of the Issuing company in respect of three financial years immediately preceding the date of prospectus;
  - (B) the interim audited financial statements in respect of the period ending on a date which is less than 180 days prior to the date of opening of the issue, if the gap

between the ending date of the latest audited financial statements disclosed under clause (A) and the date of the opening of the issue is more than 180 days.

Provided that if the gap between such date of latest audited financial statements and the date of opening of issue is 180 days or less, the requirement under item (B) shall be deemed to be complied with, if a statement, as may be specified by the Securities and Exchange Board of India, in respect of material changes in the financial position of Issuing company for such gap is disclosed in the Prospectus.

Provided further that in case of an Issuing company which is a foreign bank incorporated outside India and which is regulated by a member of the Bank for International Settlements or a member of the International Organization of Securities Commissions which is a signatory to a Multilateral Memorandum of Understanding, the requirement under this paragraph, in respect of period beginning with last date of period for which the latest audited financial statements are made and the date of opening of the issue shall be satisfied, if the relevant financial statements are based on limited review report of such statutory auditor;

- (ii) Where the law of the country, in which the Issuing company is incorporated, does not require annual statutory audit of the accounts of the Issuing company, a report, in such form as may be specified by the Securities And Exchange Board of India, certified by a Chartered Accountant in practice within the terms and meaning of the Chartered Accountants Act, 1949 on -

(A) the financial statements of the Issuing company, in particular on the profits and losses for each of the three financial years immediately preceding the date of prospectus and upon the assets and liabilities of the Issuing company; and

(B) the interim financial statements in respect of the period ending on a date which is less than one hundred and eighty days prior to the date of opening of the issue have to be included in report, if the gap between the ending date of the latest financial statements disclosed under item (A) and the date of the opening of the issue is more than one hundred and eighty days.

Provided that if the gap between such date of latest audited financial statements and the date of opening of issue is one hundred and eighty days or less, the requirement under item (B) shall be deemed to be complied with if a statement, as may be specified by the Securities And Exchange Board of India, in respect of changes in the financial position of Issuing company for such gap is disclosed in the Prospectus.

- (iii) the gap between date of opening of issue and date of reports specified under sub-clauses (i) and (ii) shall not exceed one hundred and twenty days;

- (iv) If the proceeds of the IDR issue are used for investing in other body(ies) corporate, then following details of such body(ies) corporate shall be given-

(A) the Name and address(es) of the bodies corporate;

(B) the reports stated in sub-clauses (i) and (ii), as the case may be, in respect of such body (ies) corporate also."

**(g) Other Information –**

(i) the Minimum subscription for the issue;

(ii) the fees and expenses payable to the intermediaries involved in the issue of IDRs;

(iii) the declaration with regard to compliance with the Foreign Exchange Management Act, 1999.

**(h) Inspection of Documents-**

The Place at which inspection of the offer documents, the financial statements and auditor's report thereof shall be allowed during the normal business hours; and

- (i) Any other information as specified by the Securities and Exchange Board of India or the Income-tax Authorities or the Reserve Bank of India or other regulatory authorities from time to time.

**7.8.22 Application of Sections 34 to 36 and Chapter XX [Section 391]**

- (1) The provisions of sections 34 to 36 (both inclusive) shall apply to—
  - (i) the issue of a prospectus by a company incorporated outside India under section 389 as they apply to prospectus issued by an Indian company;
  - (ii) the issue of Indian Depository Receipts by a foreign company.
- (2) The provisions of Chapter XX shall apply mutatis mutandis for closure of the place of business of a foreign company in India as if it were a company incorporated in India.

**7.8.23 Punishment for Contravention [Section 392]**

Without prejudice to the provisions of section 391, if a foreign company contravenes the provisions of this Chapter, the foreign company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and in the case of a continuing offence, with an additional fine which may extend to fifty thousand rupees for every day after the first during which the contravention continues and every officer of the foreign company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both.

**7.8.24 Action for Improper use or Description as Foreign Company**

If any person or persons trade or carry on business in any manner under any name or title or description as a foreign company registered under the Act or the rules made there under, that person or each of those persons shall, unless duly registered as foreign company under the Act and rules made there under, shall be liable for investigation under section 210 of the Act and action consequent upon that investigation shall be taken against that person.

**7.8.25 Company's Failure to Comply with Provisions of this Chapter not to affect Validity of Contracts, etc. [Section 393]**

Any failure by a company to comply with the provisions of this Chapter shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof, but the company shall not be entitled to bring any suit, claim any set-off, make any counter-claim or institute any legal proceeding in respect of any such contract, dealing or transaction, until the company has complied with the provisions of this Act applicable to it.

# Study Note - 8

## THE RIGHT TO INFORMATION ACT, 2005



### This Study Note includes

- 8.1 Concepts and Definitions
- 8.2 Right to Information and Obligations of Public Authorities
- 8.3 The Central Information Commission (CIC)
- 8.4 The State Information Commission (SIC)
- 8.5 Powers and Functions of Information Commissions, Appeal and Penalties
- 8.6 Act not to Apply to Certain Organization
- 8.7 Appropriate Government to Prepare Programmes

### 8. THE RIGHT TO INFORMATION ACT, 2005 - INTRODUCTION

Right to Information Act 2005 is an important Act enacted by the Parliament to secure to the citizen of India the fundamental right of freedom of speech and expression enshrined in Article 19(1) of the Constitution of India. It is the outcome of mass movement spearheaded by Majdor Kisan Shakti Sangthan (MKSS) in 1994, demand of Civil Society organizations, Supreme Court's intervention, United Nations Declaration 1948, National Campaign for Peoples Right to Information 1990, etc. Though Article 19(1)(a) of the Constitution of India enshrine right to speech and expression as a fundamental right but right to information was not treated as a fundamental right as the same was not specifically mentioned in the Articles. Information sought by citizens from Government Departments or other Statutory Bodies were being denied on the pretext of Official Secrecy or confidentiality. Supreme Court in various cases like Bennett Coleman Vs Union of India, State of UP vs. Raj Narain etc held that right to speech and expression also includes right to information. But section 5 of Official Secret Act, 1923, Section 123-126 of the Indian Evidence Act, 1872 and Rule 11 of Central Civil Service (Conduct) Rule 1964 etc were great obstruction in providing information to the citizens. In People's Union for Civil Liberties vs. Union of India, the right to information was held a human right necessary for making the Government transparent and accountable. In 1996 Press Council of India drafted a bill called National Institute of Rural Development. 'Freedom of Information Act 1997'. Later on in 1997 a Working Group headed by Shri Arun Shorie drafted 'Freedom of Information Bill 1997'. In 2000 Freedom of Information Bill 2000 was tabled before the Parliament but the Parliament referred it to select committee for review. Again in 2002 Freedom of Information Act 2002 was enacted but never came into force. Subsequently in 2004 a new Right to Information Bill 2004 was tabled in Parliament which received consent of the President on 15<sup>th</sup> June 2005 and came into force with effect from 13th October 2005.

This Act intends to set out the practical regime of right to information for the citizens of India, to secure access to information available under the control of public authorities, to promote transparency and accountability on the working of every Public Authority. Disclosure of State information in British India was governed from 1889 by the Official Secret Act 1923. This law secures information related to security of the State, sovereignty of the country and friendly relations with foreign states, and contains provisions which prohibit disclosure of non-classified information. Similarly rule 11 of Central Civil Service (Conduct) rules and the Indian Evidence Act impose further restrictions on government officials' powers to disclose information to the public. Now RTI Act 2005 take care of these and relaxes these restrictions but at the same time maintain confidentiality of some information. Under this Act, citizens of India have access to information under the control of public authorities with the objective of promoting transparency and accountability in these organizations. The Act, under Section 4, requires certain proactive disclosure of information. It also, in terms of Sections 8 and 9, provides for certain categories of information to be exempt from disclosure. Certain types of information can still be denied under this Act also. As per section 8, some information

relating to security, sovereignty and integrity of India, information expressly forbidden to be published by any court of law or tribunal, information the disclosure of which cause breach of Privilege of Parliament or the State Legislature, confidential commercial information, trade secrets or intellectual property, information received from foreign Government etc are exempt from disclosure under this Act.

Before enactment of this Act in 2005, there were RTI Acts in various states like Tamil Nadu (1997) Goa (1997), Rajasthan (2000), Karnataka (2000), Delhi (2001), Maharashtra (2002), Assam (2002), Madhya Pradesh (2003), and Jammu & Kashmir (2004). This Act is applicable to whole of India except the state of Jammu and Kashmir which has its own Right to Information Act of 2009, the successor to the repealed J&K Right to Information Act, 2004 and its 2008 amendment. At the International level also, more than 70 countries were already having similar laws relating to providing information to their citizens. This Act spreads in 6 Chapters and contains 31 sections and two schedules.

This Act is applicable to all constitutional authorities, including the executive, legislature and judiciary; any institution or body established or constituted by an act of the Parliament or a state legislature. It is also defined in the Act that bodies or authorities established or constituted by order or notification of appropriate government including bodies “owned, controlled or substantially financed” by Government, or Non-Government organizations “substantially financed, directly or indirectly by funds” provided by the Government are also covered in it.

Sec. 3 of the Act provides that all citizens shall have the Right to Information subject to the provisions of the Act and “Information” means any material in any form including records, documents, memos, e-mails, opinions, advices, press releases, circulars, orders, logbooks, contracts, reports, papers, samples, models, data material held in any electronic form and information relating to any private body which can be accessed by a public authority under any other law for the time being in force.

The Act provides a simple and inexpensive method of seeking information from Public Authorities. The Act also provides, in terms of Section 5, for appointment of Public Information Officers and Assistant Public Information Officers to address the requests for information. For this purpose, all authorities covered must appoint their Public Information Officer (PIO). Any person may submit a request in plain paper to the PIO for information in writing with a fee of ₹10 which can be paid in cash, Postal order, Demand draft etc. It is the PIO's obligation to provide information to citizens of India who request information under the Act. If the request pertains to another public authority (in whole or part) it is the PIO's responsibility to transfer/forward the concerned portions of the request to a PIO of the other authority within 5 days. In addition, every public authority is required to designate Assistant Public Information Officers (APIOs) to receive RTI requests and appeals for forwarding to the PIOs of their Public Authority. The Act specifies time limits for replying to the request. If the request has been made to the PIO, the reply is to be given within 30 days of receipt. If the request has been made to an APIO, the reply is to be given within 35 days of receipt. However, if life or liberty of any person is involved, the PIO is expected to reply within 48 hours. Denial of Information asked under this Act, penalty can be imposed by the Information Commission on Public Information Officer or an officer asked to assist the Public Information Officer. For unreasonable delay a fine of 250 per day subject to a maximum of ₹ 25,000 can be imposed. Similarly, for illegitimate refusal to accept the application, mala fide denial, knowingly providing false information, destruction of information etc fine upto ₹ 25,000 can be imposed. The important concepts and sections of the Act are discussed as under.

## 8.1 CONCEPTS AND DEFINITIONS (SEC 2)

- (a) “Appropriate Government” means in relation to a public authority which is established, constituted, owned, controlled or substantially financed by funds provided directly or indirectly—
- (i) By the Central Government or the Union territory administration, the Central Government;
  - (ii) by the State Government, the State Government;

## > 8.2 | LAWS, ETHICS AND GOVERNANCE



- (b) "Central Information Commission" means the Central Information Commission constituted under sub-section (1) of section 12;
- (c) "Central Public Information Officer" means the Central Public Information Officer designated under sub-section (1) and includes a Central Assistant Public Information Officer designated as such under sub-section (2) of section 5;
- (d) "Chief Information Commissioner" and "Information Commissioner" mean the Chief Information Commissioner and Information Commissioner appointed under sub-section (3) of section 12;
- (e) "Competent authority" means—
- (i) the Speaker in the case of the House of the People or the Legislative Assembly of a State or a Union territory having such Assembly and the Chairman in the case of the Council of States or Legislative Council of a State;
  - (ii) The Chief Justice of India in the case of the Supreme Court;
  - (iii) The Chief Justice of the High Court in the case of a High Court;
  - (iv) The President or the Governor, as the case may be, in the case of other authorities established or constituted by or under the Constitution;
  - (v) the administrator appointed under article 239 of the Constitution;
- (f) "information" means any material in any form, including records, documents, memos, e-mails, opinions, advices, press releases, circulars, orders, logbooks, contracts, reports, papers, samples, models, data material held in any electronic form and information relating to any private body which can be accessed by a public authority under any other law for the time being in force;
- (g) "prescribed" means prescribed by rules made under this Act by the appropriate Government or the competent authority, as the case may be;
- (h) "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;
- (i) "record" includes—
- (a) any document, manuscript and file;
  - (b) any microfilm, microfiche and facsimile copy of a document;
  - (c) any reproduction of image or images embodied in such microfilm (whether enlarged or not); and
  - (d) any other material produced by a computer or any other device;
- Explanation –** The expression "authority or body or institution of self-government established or constituted" by any law made by Parliament shall not include any association or body of individuals registered or recognized as political party under the Representation of the People Act, 1951.
- (j) "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;
- (k) "State Information Commission" means the State Information Commission constituted under sub-section (1) of section 15;
- (l) "State Chief Information Commissioner" and "State Information Commissioner" mean the State Chief Information Commissioner and the State Information Commissioner appointed under sub-section (3) of section 15;
- (m) "State Public Information Officer" means the State Public Information Officer designated under sub-section (1) and includes a State Assistant Public Information Officer designated as such under sub-section (2) of section 5;
- (n) "third party" means a person other than the citizen making a request for information and includes a public authority.

## 8.2 RIGHT TO INFORMATION AND OBLIGATIONS OF PUBLIC AUTHORITIES

3. Subject to the provisions of this Act, all citizens shall have the right to information.
4. (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,—
    - (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) all 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 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.

5. (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 added in computing the period for response specified under sub-section (1) of section 7.

- (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.

6. (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:

Provided that the transfer of an application pursuant to this sub-section shall be made as soon as possible but in no case later than five days from the date of receipt of the application.

7. (1) Subject to the proviso to sub-section (2) of section 5 or the proviso to sub-section (3) of section 6, the Central Public Information Officer or State Public Information Officer, as the case may be, on receipt of a request under section 6 shall, as expeditiously as possible, and in any case within thirty days of the receipt of the request, either provide the information on payment of such fee as may be prescribed or reject the request for any of the reasons specified in sections 8 and 9:

Provided that where the information sought for concerns the life or liberty of a person, the same shall be provided within forty-eight hours of the receipt of the request.

- (2) If the Central Public Information Officer or State Public Information Officer, as the case may be, fails to give decision on the request for information within the period specified under sub-section (1), the Central Public Information Officer or State Public Information Officer, as the case may be, shall be deemed to have refused the request.
- (3) Where a decision is taken to provide the information on payment of any further fee representing the cost of providing the information, the Central Public Information Officer or State Public



Information Officer, as the case may be, shall send intimation to the person making the request, giving—

- (a) the details of further fees representing the cost of providing the information as determined by him, together with the calculations made to arrive at the amount in accordance with fee prescribed under sub-section (1), requesting him to deposit that fees, and the period intervening between the dispatch of the said intimation and payment of fees shall be excluded for the purpose of calculating the period of thirty days referred to in that sub-section;
  - (b) information concerning his or her right with respect to review the decision as to the amount of fees charged or the form of access provided, including the particulars of the appellate authority, time limit, process and any other forms.
- (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).
- (7) 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.
- (8) 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.
- (9) 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 would be detrimental to the safety or preservation of the record in question.
- 8. (1)** Notwithstanding anything contained in this Act, there shall be no obligation to give any citizen,—
- (a) information, disclosure of which would prejudicially affect the sovereignty and integrity of India, the security, strategic, scientific or economic interests of the State, relation with foreign State or lead to incitement of an offence;
  - (b) information which has been expressly forbidden to be published by any court of law or tribunal or the disclosure of which may constitute contempt of court;
  - (c) information, the disclosure of which would cause a breach of privilege of Parliament or the State Legislature;

- (d) information including commercial confidence, trade secrets or intellectual property, the disclosure of which would harm the competitive position of a third party, unless the competent authority is satisfied that larger public interest warrants the disclosure of such information;
- (e) information available to a person in his fiduciary relationship, unless the competent authority is satisfied that the larger public interest warrants the disclosure of such information;
- (f) information received in confidence from foreign Government;
- (g) information, the disclosure of which would endanger the life or physical safety of any person or identify the source of information or assistance given in confidence for law enforcement or security purposes;
- (h) information which would impede the process of investigation or apprehension or prosecution of offenders; (i) cabinet papers including records of deliberations of the Council of Ministers, Secretaries and other officers:

Provided that the decisions of Council of Ministers, the reasons thereof, and the material on the basis of which the decisions were taken shall be made public after the decision has been taken, and the matter is complete, or over:

Provided further that those matters which come under the exemptions specified in this section shall not be disclosed;

- (j) information which relates to personal information the disclosure of which has no relationship to any public activity or interest, or which would cause unwarranted invasion of the privacy of the individual unless the Central Public Information Officer or the State Public Information Officer or the appellate authority, as the case may be, is satisfied that the larger public interest justifies the disclosure of such information:

Provided that the information which cannot be denied to the Parliament or a State Legislature shall not be denied to any person.

- (2) Notwithstanding anything in the Official Secrets Act, 1923 nor any of the exemptions permissible in accordance with sub-section (1), a public authority may allow access to information, if public interest in disclosure outweighs the harm to the protected interests.
- (3) Subject to the provisions of clauses (a), (c) and (i) of sub-section (1), any information relating to any occurrence, event or matter which has taken place, occurred or happened twenty years before the date on which any request is made under section 6 shall be provided to any person making a request under that section:

Provided that where any question arises as to the date from which the said period of twenty years has to be computed, the decision of the Central Government shall be final, subject to the usual appeals provided for in this Act.

- 9. Without prejudice to the provisions of section 8, a Central Public Information Officer or a State Public Information Officer, as the case may be, may reject a request for information where such a request for providing access would involve an infringement of copyright subsisting in a person other than the State.

### **Severability**

- 10. (1) Where a request for access to information is rejected on the ground that it is in relation to information which is exempt from disclosure, then, notwithstanding anything contained in this Act, access may be provided to that part of the record which does not contain any information which is exempt from disclosure under this Act and which can reasonably be severed from any part that contains exempt information.



- (2) Where access is granted to a part of the record under sub-section (1), the Central Public Information Officer or State Public Information Officer, as the case may be, shall give a notice to the applicant, informing—
- (a) that only part of the record requested, after severance of the record containing information which is exempt from disclosure, is being provided;
  - (b) the reasons for the decision, including any findings on any material question of fact, referring to the material on which those findings were based;
  - (c) the name and designation of the person giving the decision;
  - (d) the details of the fees calculated by him or her and the amount of fee which the applicant is required to deposit; and
  - (e) his or her rights with respect to review of the decision regarding non-disclosure of part of the information, the amount of fee charged or the form of access provided, including the particulars of the 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, time limit, process and any other form of access.

### **Third Party Information**

11. (1) Where a Central Public Information Officer or a State Public Information Officer, as the case may be, intends to disclose any information or record, or part thereof on a request made under this Act, which relates to or has been supplied by a third party and has been treated as confidential by that third party, the Central Public Information Officer or State Public Information Officer, as the case may be, shall, within five days from the receipt of the request, give a written notice to such third party of the request and of the fact that the Central Public Information Officer or State Public Information Officer, as the case may be, intends to disclose the information or record, or part thereof, and invite the third party to make a submission in writing or orally, regarding whether the information should be disclosed, and such submission of the third party shall be kept in view while taking a decision about disclosure of information:

Provided that except in the case of trade or commercial secrets protected by law, disclosure may be allowed if the public interest in disclosure outweighs in importance any possible harm or injury to the interests of such third party.

- (2) Where a notice is served by the Central Public Information Officer or State Public Information Officer, as the case may be, under sub-section (1) to a third party in respect of any information or record or part thereof, the third party shall, within ten days from the date of receipt of such notice, be given the opportunity to make representation against the proposed disclosure.
- (3) Notwithstanding anything contained in section 7, the Central Public Information Officer or State Public Information Officer, as the case may be, shall, within forty days after receipt of the request under section 6, if the third party has been given an opportunity to make representation under sub-section (2), make a decision as to whether or not to disclose the information or record or part thereof and give in writing the notice of his decision to the third party.
- (4) A notice given under sub-section (3) shall include a statement that the third party to whom the notice is given is entitled to prefer an appeal under section 19 against the decision.

## **8.3 THE CENTRAL INFORMATION COMMISSION (CIC)**

12. (1) The Central Government shall, by notification in the Official Gazette, constitute a body to be known as the Central Information Commission to exercise the powers conferred on, and to perform the functions assigned to, it under this Act.

- (2) The Central Information Commission shall consist of—
  - (a) the Chief Information Commissioner; and
  - (b) such number of Central Information Commissioners, not exceeding ten, as may be deemed necessary.
- (3) The Chief Information Commissioner and Information Commissioners shall be appointed by the President on the recommendation of a committee consisting of—
  - (i) the Prime Minister, who shall be the Chairperson of the committee;
  - (ii) the Leader of Opposition in the Lok Sabha; and
  - (iii) a Union Cabinet Minister to be nominated by the Prime Minister.

**Explanation:** For the purposes of removal of doubts, it is hereby declared that where the Leader of Opposition in the House of the People has not been recognised as such, the Leader of the single largest group in opposition of the Government in the House of the People shall be deemed to be the Leader of Opposition.

- (4) The general superintendence, direction and management of the affairs of the Central Information Commission shall vest in the Chief Information Commissioner who shall be assisted by the Information Commissioners and may exercise all such powers and do all such acts and things which may be exercised or done by the Central Information Commission autonomously without being subjected to directions by any other authority under this Act.
- (5) The Chief Information Commissioner and Information Commissioners shall be persons of eminence in public life with wide knowledge and experience in law, science and technology, social service, management, journalism, mass media or administration and governance.
- (6) The Chief Information Commissioner or an Information Commissioner shall not be a Member of Parliament or Member of the Legislature of any State or Union territory, as the case may be, or hold any other office of profit or connected with any political party or carrying on any business or pursuing any profession.
- (7) The headquarters of the Central Information Commission shall be at Delhi and the Central Information Commission may, with the previous approval of the Central Government, establish offices at other places in India.

- 13.** (1) The Chief Information Commissioner shall hold office for a term of five years from the date on which he enters upon his office and shall not be eligible for reappointment:

Provided that no Chief Information Commissioner shall hold office as such after he has attained the age of sixty-five years.

- (2) Every Information Commissioner shall hold office for a term of five years from the date on which he enters upon his office or till he attains the age of sixty-five years, whichever is earlier, and shall not be eligible for reappointment as such Information Commissioner:

Provided that every Information Commissioner shall, on vacating his office under this sub-section be eligible for appointment as the Chief Information Commissioner in the manner specified in sub-section (3) of section 12:

Provided further that where the Information Commissioner is appointed as the Chief Information Commissioner, his term of office shall not be more than five years in aggregate as the Information Commissioner and the Chief Information Commissioner.

- (3) The Chief Information Commissioner or an Information Commissioner shall before he enters upon his office make and subscribe before the President or some other person appointed by him in that behalf, an oath or affirmation according to the form set out for the purpose in the First Schedule.



- (4) The Chief Information Commissioner or an Information Commissioner may, at any time, by writing under his hand addressed to the President, resign from his office:

Provided that the Chief Information Commissioner or an Information Commissioner may be removed in the manner specified under section 14.

- (5) The salaries and allowances payable to and other terms and conditions of service of—
- (a) the Chief Information Commissioner shall be the same as that of the Chief Election Commissioner; (b) an Information Commissioner shall be the same as that of an Election Commissioner:

Provided that if the Chief Information Commissioner or an Information Commissioner, at the time of his appointment is, in receipt of a pension, other than a disability or wound pension, in respect of any previous service under the Government of India or under the Government of a State, his salary in respect of the service as the Chief Information Commissioner or an Information Commissioner shall be reduced by the amount of that pension including any portion of pension which was commuted and pension equivalent of other forms of retirement benefits excluding pension equivalent of retirement gratuity:

Provided further that if the Chief Information Commissioner or an Information Commissioner if, at the time of his appointment is, in receipt of retirement benefits in respect of any previous service rendered in a Corporation established by or under any Central Act or State Act or a Government company owned or controlled by the Central Government or the State Government, his salary in respect of the service as the Chief Information Commissioner or an Information Commissioner shall be reduced by the amount of pension equivalent to the retirement benefits:

Provided also that the salaries, allowances and other conditions of service of the Chief Information Commissioner and the Information Commissioners shall not be varied to their disadvantage after their appointment.

- (6) The Central Government shall provide the Chief Information Commissioner and the Information Commissioners with such officers and employees as may be necessary for the efficient performance of their functions under this Act, and the salaries and allowances payable to and the terms and conditions of service of the officers and other employees appointed for the purpose of this Act shall be such as may be prescribed.

- 14.** (1) Subject to the provisions of sub-section (3), the Chief Information Commissioner or any Information Commissioner shall be removed from his office only by order of the President on the ground of proved misbehaviour or incapacity after the Supreme Court, on a reference made to it by the President, has, on inquiry, reported that the Chief Information Commissioner or any Information Commissioner, as the case may be, ought on such ground be removed.
- (2) The President may suspend from office, and if deem necessary prohibit also from attending the office during inquiry, the Chief Information Commissioner or Information Commissioner in respect of whom a reference has been made to the Supreme Court under sub-section (1) until the President has passed orders on receipt of the report of the Supreme Court on such reference.
- (3) Notwithstanding anything contained in sub-section (1), the President may by order remove from office the Chief Information Commissioner or any Information Commissioner if the Chief Information Commissioner or a Information Commissioner, as the case may be,—
- (a) is adjudged an insolvent; or
- (b) has been convicted of an offence which, in the opinion of the President, involves moral turpitude; or
- (c) engages during his term of office in any paid employment outside the duties of his office; or

- (d) is, in the opinion of the President, unfit to continue in office by reason of infirmity of mind or body; or
  - (e) has acquired such financial or other interest as is likely to affect prejudicially his functions as the Chief Information Commissioner or a Information Commissioner.
- (4) If the Chief Information Commissioner or a Information Commissioner in any way, concerned or interested in any contract or agreement made by or on behalf of the Government of India or participates in any way in the profit thereof or in any benefit or emolument arising therefrom otherwise than as a member and in common with the other members of an incorporated company, he shall, for the purposes of sub-section (1), be deemed to be guilty of misbehaviour.

#### 8.4 THE STATE INFORMATION COMMISSION (SIC)

##### Constitution of State Information Commission

15. (1) Every State Government shall, by notification in the Official Gazette, constitute a body to be known as the ..... (name of the State) Information Commission to exercise the powers conferred on, and to perform the functions assigned to, it under this Act.
- (2) The State Information Commission shall consist of—
- (a) the State Chief Information Commissioner, and
  - (b) such number of State Information Commissioners, not exceeding ten, as may be deemed necessary.
- (3) The State Chief Information Commissioner and the State Information Commissioners shall be appointed by the Governor on the recommendation of a committee consisting of—
- (i) the Chief Minister, who shall be the Chairperson of the committee;
  - (ii) the Leader of Opposition in the Legislative Assembly; and
  - (iii) a Cabinet Minister to be nominated by the Chief Minister
- Explanation.**—For the purposes of removal of doubts, it is hereby declared that where the Leader of Opposition in the Legislative Assembly has not been recognised as such, the Leader of the single largest group in opposition of the Government in the Legislative Assembly shall be deemed to be the Leader of Opposition.
- (4) The general superintendence, direction and management of the affairs of the State Information Commission shall vest in the State Chief Information Commissioner who shall be assisted by the State Information Commissioners and may exercise all such powers and do all such acts and things which may be exercised or done by the State Information Commission autonomously without being subjected to directions by any other authority under this Act.
- (5) The State Chief Information Commissioner and the State Information Commissioners shall be persons of eminence in public life with wide knowledge and experience in law, science and technology, social service, management, journalism, mass media or administration and governance.
- (6) The State Chief Information Commissioner or a State Information Commissioner shall not be a Member of Parliament or Member of the Legislature of any State or Union territory, as the case may be, or hold any other office of profit or connected with any political party or carrying on any business or pursuing any profession.
- (7) The headquarters of the State Information Commission shall be at such place in the State as the State Government may, by notification in the Official Gazette, specify and the State Information Commission may, with the previous approval of the State Government, establish offices at other places in the State.



## Term of Office and Conditions of Service

16. (1) The State Chief Information Commissioner shall hold office for a term of five years from the date on which he enters upon his office and shall not be eligible for reappointment:

Provided that no State Chief Information Commissioner shall hold office as such after he has attained the age of sixty-five years.

- (2) Every State Information Commissioner shall hold office for a term of five years from the date on which he enters upon his office or till he attains the age of sixty-five years, whichever is earlier, and shall not be eligible for reappointment as such State Information Commissioner:

Provided that every State Information Commissioner shall, on vacating his office under this sub-section, be eligible for appointment as the State Chief Information Commissioner in the manner specified in sub-section (3) of section 15:

Provided further that where the State Information Commissioner is appointed as the State Chief Information Commissioner, his term of office shall not be more than five years in aggregate as the State Information Commissioner and the State Chief Information Commissioner.

- (3) The State Chief Information Commissioner or a State Information Commissioner, shall before he enters upon his office make and subscribe before the Governor or some other person appointed by him in that behalf, an oath or affirmation according to the form set out for the purpose in the First Schedule.

- (4) The State Chief Information Commissioner or a State Information Commissioner may, at any time, by writing under his hand addressed to the Governor, resign from his office:

Provided that the State Chief Information Commissioner or a State Information Commissioner may be removed in the manner specified under section 17.

- (5) The salaries and allowances payable to and other terms and conditions of service of—

- (a) the State Chief Information Commissioner shall be the same as that of an Election Commissioner; (b) the State Information Commissioner shall be the same as that of the Chief Secretary to the State Government:

Provided that if the State Chief Information Commissioner or a State Information Commissioner, at the time of his appointment is, in receipt of a pension, other than a disability or wound pension, in respect of any previous service under the Government of India or under the Government of a State, his salary in respect of the service as the State Chief Information Commissioner or a State Information Commissioner shall be reduced by the amount of that pension including any portion of pension which was commuted and pension equivalent of other forms of retirement benefits excluding pension equivalent of retirement gratuity:

Provided further that where the State Chief Information Commissioner or a State Information Commissioner if, at the time of his appointment is, in receipt of retirement benefits in respect of any previous service rendered in a Corporation established by or under any Central Act or State Act or a Government company owned or controlled by the Central Government or the State Government, his salary in respect of the service as the State Chief Information Commissioner or the State Information Commissioner shall be reduced by the amount of pension equivalent to the retirement benefits:

Provided also that the salaries, allowances and other conditions of service of the State Chief Information Commissioner and the State Information Commissioners shall not be varied to their disadvantage after their appointment.

- (6) The State Government shall provide the State Chief Information Commissioner and the State Information Commissioners with such officers and employees as may be necessary for the efficient performance of their functions under this Act, and the salaries and allowances payable to and the terms and conditions of service of the officers and other employees appointed for the purpose of this Act shall be such as may be prescribed.

17. (1) Subject to the provisions of sub-section (3), the State Chief Information Commissioner or a State Information Commissioner shall be removed from his office only by order of the Governor on the ground of proved misbehaviour or incapacity after the Supreme Court, on a reference made to it by the Governor, has on inquiry, reported that the State Chief Information Commissioner or a State Information Commissioner, as the case may be, ought on such ground be removed.
- (2) The Governor may suspend from office, and if deem necessary prohibit also from attending the office during inquiry, the State Chief Information Commissioner or a State Information Commissioner in respect of whom a reference has been made to the Supreme Court under sub-section (1) until the Governor has passed orders on receipt of the report of the Supreme Court on such reference.
- (3) Notwithstanding anything contained in sub-section (1), the Governor may by order remove from office the State Chief Information Commissioner or a State Information Commissioner if a State Chief Information Commissioner or a State Information Commissioner, as the case may be,—
  - (a) is adjudged an insolvent; or
  - (b) has been convicted of an offence which, in the opinion of the Governor, involves moral turpitude; or
  - (c) engages during his term of office in any paid employment outside the duties of his office; or
  - (d) is, in the opinion of the Governor, unfit to continue in office by reason of infirmity of mind or body; or
  - (e) has acquired such financial or other interest as is likely to affect prejudicially his functions as the State Chief Information Commissioner or a State Information Commissioner.
- (4) If the State Chief Information Commissioner or a State Information Commissioner in any way, concerned or interested in any contract or agreement made by or on behalf of the Government of the State or participates in any way in the profit thereof or in any benefit or emoluments arising therefrom otherwise than as a member and in common with the other members of an incorporated company, he shall, for the purposes of sub-section (1), be deemed to be guilty of misbehaviour.

## 8.5 POWERS AND FUNCTIONS OF THE INFORMATION COMMISSIONS, APPEAL AND PENALTIES

18. (1) Subject to the provisions of this Act, it shall be the duty of the Central Information Commission or State Information Commission, as the case may be, to receive and inquire into a complaint from any person,—
  - (a) who has been unable to submit a request to a Central Public Information Officer or State Public Information Officer, as the case may be, either by reason that no such officer has been appointed under this Act, or because the Central Assistant Public Information Officer or State Assistant Public Information Officer, as the case may be, has refused to accept his or her application for information or appeal under this Act for forwarding the same to the Central Public Information Officer or State Public Information Officer or senior officer specified in sub-section (1) of section 19 or the Central Information Commission or the State Information Commission, as the case may be;
  - (b) who has been refused access to any information requested under this Act;
  - (c) who has not been given a response to a request for information or access to information within the time limit specified under this Act;
  - (d) who has been required to pay an amount of fee which he or she considers unreasonable;
  - (e) who believes that he or she has been given incomplete, misleading or false information under this Act, and



- (f) in respect of any other matter relating to requesting or obtaining access to records under this Act. (2) Where the Central Information Commission or State Information Commission, as the case may be, is satisfied that there are reasonable grounds to inquire into the matter, it may initiate an inquiry in respect thereof.
- (3) The Central Information Commission or State Information Commission, as the case may be, shall, while inquiring into any matter under this section, have the same powers as are vested in a civil court while trying a suit under the Code of Civil Procedure, 1908, in respect of the following matters, namely:—
- (a) summoning and enforcing the attendance of persons and compel them to give oral or written evidence on oath and to produce the documents or things;
  - (b) requiring the discovery and inspection of documents;
  - (c) receiving evidence on affidavit;
  - (d) requisitioning any public record or copies thereof from any court or office;
  - (e) issuing summons for examination of witnesses or documents; and
  - (f) any other matter which may be prescribed.
- (4) Notwithstanding anything inconsistent contained in any other Act of Parliament or State Legislature, as the case may be, the Central Information Commission or the State Information Commission, as the case may be, may, during the inquiry of any complaint under this Act, examine any record to which this Act applies which is under the control of the public authority, and no such record may be withheld from it on any grounds.

### 8.5.1 Appeal

19. (1) Any person who, does not receive a decision within the time specified in sub-section (1) or clause (a) of sub-section (3) of section 7, or is aggrieved by a decision of the Central Public Information Officer or State Public Information Officer, as the case may be, may within thirty days from the expiry of such period or from the receipt of such a decision prefer an appeal to such officer who is senior in rank to the Central Public Information Officer or State Public Information Officer as the case may be, in each public authority:
- Provided that such officer may admit the appeal after the expiry of the period of thirty days if he or she is satisfied that the appellant was prevented by sufficient cause from filing the appeal in time.
- (2) Where an appeal is preferred against an order made by a Central Public Information Officer or a State Public Information Officer, as the case may be, under section 11 to disclose third party information, the appeal by the concerned third party shall be made within thirty days from the date of the order.
- (3) A second appeal against the decision under sub-section (1) shall lie within ninety days from the date on which the decision should have been made or was actually received, with the Central Information Commission or the State Information Commission:
- Provided that the Central Information Commission or the State Information Commission, as the case may be, may admit the appeal after the expiry of the period of ninety days if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal in time.
- (4) If the decision of the Central Public Information Officer or State Public Information Officer, as the case may be, against which an appeal is preferred relates to information of a third party, the Central Information Commission or State Information Commission, as the case may be, shall give a reasonable opportunity of being heard to that third party.

- (5) In any appeal proceedings, the onus to prove that a denial of a request was justified shall be on the Central Public Information Officer or State Public Information Officer, as the case may be, who denied the request.
- (6) An appeal under sub-section (1) or sub-section (2) shall be disposed of within thirty days of the receipt of the appeal or within such extended period not exceeding a total of forty-five days from the date of filing thereof, as the case may be, for reasons to be recorded in writing.
- (7) The decision of the Central Information Commission or State Information Commission, as the case may be, shall be binding.
- (8) In its decision, the Central Information Commission or State Information Commission, as the case may be, has the power to—
  - (a) require the public authority to take any such steps as may be necessary to secure compliance with the provisions of this Act, including—
    - (i) by providing access to information, if so requested, in a particular form;
    - (ii) by appointing a Central Public Information Officer or State Public Information Officer, as the case may be;
    - (iii) by publishing certain information or categories of information;
    - (iv) by making necessary changes to its practices in relation to the maintenance, management and destruction of records;
    - (v) by enhancing the provision of training on the right to information for its officials;
    - (vi) by providing it with an annual report in compliance with clause (b) of sub-section (1) of section 4; (b) require the public authority to compensate the complainant for any loss or other detriment suffered;
  - (c) impose any of the penalties provided under this Act;
  - (d) reject the application.
- (9) The Central Information Commission or State Information Commission, as the case may be, shall give notice of its decision, including any right of appeal, to the complainant and the public authority.
- (10) The Central Information Commission or State Information Commission, as the case may be, shall decide the appeal in accordance with such procedure as may be prescribed.

### **8.5.2 Penalties**

- 20.** (1) Where the Central Information Commission or the State Information Commission, as the case may be, at the time of deciding any complaint or appeal is of the opinion that the Central Public Information Officer or the State Public Information Officer, as the case may be, has, without any reasonable cause, refused to receive an application for information or has not furnished information within the time specified under sub-section (1) of section 7 or malafidely denied the request for information or knowingly given incorrect, incomplete or misleading information or destroyed information which was the subject of the request or obstructed in any manner in furnishing the information, it shall impose a penalty of two hundred and fifty rupees each day till application is received or information is furnished, so however, the total amount of such penalty shall not exceed twenty-five thousand rupees:

Provided that the Central Public Information Officer or the State Public Information Officer, as the case may be, shall be given a reasonable opportunity of being heard before any penalty is imposed on him:

Provided further that the burden of proving that he acted reasonably and diligently shall be



on the Central Public Information Officer or the State Public Information Officer, as the case may be.

- (2) Where the Central Information Commission or the State Information Commission, as the case may be, at the time of deciding any complaint or appeal is of the opinion that the Central Public Information Officer or the State Public Information Officer, as the case may be, has, without any reasonable cause and persistently, failed to receive an application for information or has not furnished information within the time specified under sub-section (1) of section 7 or malafidely denied the request for information or knowingly given incorrect, incomplete or misleading information or destroyed information which was the subject of the request or obstructed in any manner in furnishing the information, it shall recommend for disciplinary action against the Central Public Information Officer or the State Public Information Officer, as the case may be, under the service rules applicable to him.

#### **Protection of Action Taken in Good Faith**

21. No suit, prosecution or other legal proceeding shall lie against any person for anything which is in good faith done or intended to be done under this Act or any rule made thereunder.

#### **Act to Have Overriding Effect**

22. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in the Official Secrets Act, 1923, and any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act.

#### **Bar of Jurisdiction of Courts**

23. No court shall entertain any suit, application or other proceeding in respect of any order made under this Act and no such order shall be called in question otherwise than by way of an appeal under this Act.

### **8.6 ACT NOT TO APPLY TO CERTAIN ORGANIZATIONS**

24. (1) Nothing contained in this Act shall apply to the intelligence and security organisations specified in the Second Schedule, being organisations established by the Central Government or any information furnished by such organisations to that Government:

Provided that the information pertaining to the allegations of corruption and human rights violations shall not be excluded under this sub-section:

Provided further that in the case of information sought for is in respect of allegations of violation of human rights, the information shall only be provided after the approval of the Central Information Commission, and notwithstanding anything contained in section 7, such information shall be provided within forty-five days from the date of the receipt of request.

- (2) The Central Government may, by notification in the Official Gazette, amend the Schedule by including therein any other intelligence or security organisation established by that Government or omitting therefrom any organisation already specified therein and on the publication of such notification, such organisation shall be deemed to be included in or, as the case may be, omitted from the Schedule.
- (3) Every notification issued under sub-section (2) shall be laid before each House of Parliament.
- (4) Nothing contained in this Act shall apply to such intelligence and security organisation being organisations established by the State Government, as that Government may, from time to time, by notification in the Official Gazette, specify:

Provided that the information pertaining to the allegations of corruption and human rights violations shall not be excluded under this sub-section:

Provided further that in the case of information sought for is in respect of allegations of violation of human rights, the information shall only be provided after the approval of the State Information Commission and, notwithstanding anything contained in section 7, such information shall be provided within forty-five days from the date of the receipt of request.

- (5) Every notification issued under sub-section (4) shall be laid before the State Legislature.
- 25.** (1) The Central Information Commission or State Information Commission, as the case may be, shall, as soon as practicable after the end of each year, prepare a report on the implementation of the provisions of this Act during that year and forward a copy thereof to the appropriate Government.
- (2) Each Ministry or Department shall, in relation to the public authorities within their jurisdiction, collect and provide such information to the Central Information Commission or State Information Commission, as the case may be, as is required to prepare the report under this section and comply with the requirements concerning the furnishing of that information and keeping of records for the purposes of this section.
- (3) Each report shall state in respect of the year to which the report relates,—
- (a) the number of requests made to each public authority;
  - (b) the number of decisions where applicants were not entitled to access to the documents pursuant to the requests, the provisions of this Act under which these decisions were made and the number of times such provisions were invoked;
  - (c) the number of appeals referred to the Central Information Commission or State Information Commission, as the case may be, for review, the nature of the appeals and the outcome of the appeals;
  - (d) particulars of any disciplinary action taken against any officer in respect of the administration of this Act;
  - (e) the amount of charges collected by each public authority under this Act;
  - (f) any facts which indicate an effort by the public authorities to administer and implement the spirit and intention of this Act;
  - (g) recommendations for reform, including recommendations in respect of the particular public authorities, for the development, improvement, modernisation, reform or amendment to this Act or other legislation or common law or any other matter relevant for operationalising the right to access information.
- (4) The Central Government or the State Government, as the case may be, may, as soon as practicable after the end of each year, cause a copy of the report of the Central Information Commission or the State Information Commission, as the case may be, referred to in sub-section (1) to be laid before each House of Parliament or, as the case may be, before each House of the State Legislature, where there are two Houses, and where there is one House of the State Legislature before that House.
- (5) If it appears to the Central Information Commission or State Information Commission, as the case may be, that the practice of a public authority in relation to the exercise of its functions under this Act does not conform with the provisions or spirit of this Act, it may give to the authority a recommendation specifying the steps which ought in its opinion to be taken for promoting such conformity.



## 8.7 APPROPRIATE GOVERNMENT TO PREPARE PROGRAMMES

26. (1) The appropriate Government may, to the extent of availability of financial and other resources,—
- (a) develop and organise educational programmes to advance the understanding of the public, in particular of disadvantaged communities as to how to exercise the rights contemplated under this Act;
  - (b) encourage public authorities to participate in the development and organisation of programmes referred to in clause (a) and to undertake such programmes themselves;
  - (c) promote timely and effective dissemination of accurate information by public authorities about their activities; and
  - (d) train Central Public Information Officers or State Public Information Officers, as the case may be, of public authorities and produce relevant training materials for use by the public authorities themselves.
- (2) The appropriate Government shall, within eighteen months from the commencement of this Act, compile in its official language a guide containing such information, in an easily comprehensible form and manner, as may reasonably be required by a person who wishes to exercise any right specified in this Act.
- (3) The appropriate Government shall, if necessary, update and publish the guidelines referred to in sub-section (2) at regular intervals which shall, in particular and without prejudice to the generality of sub-section (2), include—
- (a) the objects of this Act;
  - (b) the postal and street address, the phone and fax number and, if available, electronic mail address of the Central Public Information Officer or State Public Information Officer, as the case may be, of every public authority appointed under sub-section (1) of section 5;
  - (c) the manner and the form in which request for access to an information shall be made to a Central Public Information Officer or State Public Information Officer, as the case may be;
  - (d) the assistance available from and the duties of the Central Public Information Officer or State Public Information Officer, as the case may be, of a public authority under this Act;
  - (e) the assistance available from the Central Information Commission or State Information Commission, as the case may be;
  - (f) all remedies in law available regarding an act or failure to act in respect of a right or duty conferred or imposed by this Act including the manner of filing an appeal to the Commission;
  - (g) the provisions providing for the voluntary disclosure of categories of records in accordance with section 4;
  - (h) the notices regarding fees to be paid in relation to requests for access to an information; and
  - (i) any additional regulations or circulars made or issued in relation to obtaining access to an information in accordance with this Act.
- (4) The appropriate Government must, if necessary, update and publish the guidelines at regular intervals.

- 27.** (1) The appropriate Government may, by notification in the Official Gazette, make rules to carry out the provisions of this Act.
- (2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:-
- (a) the cost of the medium or print cost price of the materials to be disseminated under sub-section (4) of section 4;
  - (b) the fee payable under sub-section (1) of section 6;
  - (c) the fee payable under sub-sections (1) and (5) of section 7;
  - (d) the salaries and allowances payable to and the terms and conditions of service of the officers and other employees under sub-section (6) of section 13 and sub-section (6) of section 16;
  - (e) the procedure to be adopted by the Central Information Commission or State Information Commission, as the case may be, in deciding the appeals under Information Commission, as the case may be, in deciding the appeals under sub-section (10) of section 19; and
  - (f) any other matter which is required to be, or may be, prescribed.
- 28.** (1) The competent authority may, by notification in the Official Gazette, make rules to carry out the provisions of this Act.
- (2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:
- (i) the cost of the medium of print cost price of the material to be disseminated under sub-section (4) of section 4;
  - (ii) the fee payable under sub-section (1) of section 6;
  - (iii) the fee payable under sub-section (1) of section 7; and
  - (iv) any other matter which is required to be, or may be, prescribed
- 29.** (1) Every rule made by the Central Government under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case, may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.
- (2) Every rule made under this Act by a State Government shall be laid, as soon as may be after it is notified, before the State Legislature.
- 30.** (1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as appear to it to be necessary or expenditure for removal of the difficulty:
- Provided that no such order shall be made after the expiry of a period of two years from the date of the commencement of this Act.
- (2) Every order made under this section shall, as soon as may be after it is made, be laid before each House of Parliament.
- 31.** The Freedom of Information Act, 2002 is hereby repealed.



32. Notwithstanding anything contained in any judgement, decree or order of any court or commission, the provisions of this Act, as amended by the Right to Information (Amendment) Act, 2013, shall have effect and shall be deemed always to have effect, in the case of any association or body of individuals registered or recognized as political party under the Representation of the People Act, 1951 or any other law for the time being in force and the rules made or notifications issued thereunder.

**Let Us Recapitulate:**

- Right to Information Act 2005 is an important Act enacted by the Parliament to secure to the citizen of India the fundamental right of freedom of speech and expression enshrined in Article 19(1) of the Constitution of India.
- The Act also provides, in terms of Section 5, for appointment of Public Information Officers and Assistant Public Information Officers to address requests for information.
- 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—
- the Central Public Information Officer or State Public Information Officer, as the case may be, of the concerned public authority;
- Where a request for access to information is rejected on the ground that it is in relation to information which is exempt from disclosure, then, notwithstanding anything contained in this Act, access may be provided to that part of the record which does not contain any information which is exempt from disclosure under this Act and which can reasonably be severed from any part that contains exempt information.
- The Central Government shall, by notification in the Official Gazette, constitute a body to be known as the Central Information Commission to exercise the powers conferred on, and to perform the functions assigned to, it under this Act.



# Study Note - 9

## GOVERNANCE



### This Study Note includes

- 9.1 Concept and Definition
- 9.2 Corporate Governance in the UK
- 9.3 Corporate Governance in Germany
- 9.4 Corporate Governance in Japan
- 9.6 Corporate Governance in India:
- 9.7 Corporate Governance in USA
- 9.8 Corporate Governance and Internal Auditors
- 9.9 Statutory Audits

### 9. GOVERNANCE - INTRODUCTION

'Corporate Governance' has become one of the most commonly used phrases in the current global business vocabulary. This raises the question, 'is corporate governance a vital component of successful business or is it simply another fad that will fade away over time? The notorious collapse of Enron in 2001, one of America's largest companies, has focused international attention on company failures and the role that strong corporate governance needs to play them. The UK has responded by producing the Higgs Report (2003) and the Smith Report (2003), whereas the US produced the Sarbanes – Oxley Act (2002). Nations around the world are instigating far-reaching programmes for Corporate governance reform, as evidenced by the proliferation of Corporate Governance codes and policy documents, voluntary or mandatory, both at the national and supra-national level. We believe that the present focus on corporate governance will be maintained into the future and that, over time, corporate governance issues grow in importance, rather than fade into insignificance. The phenomenal growth of interest in Corporate Governance has been accompanied by a growing body of academic research. As the discipline matures, far greater definition and clarity are being achieved concerning the nature of corporate governance. In this chapter we consider the broad-ranging nature of corporate governance and the many ways of defining the subject. We discuss Corporate Governance from a theoretical perspective.

### 9.1 CONCEPT AND DEFINITION

There is no single, accepted definition of Corporate Governance. There are substantial differences in definition according to which country we are considering. Arriving at 'a' definition of Corporate Governance is no easy task. Corporate Governance as a discipline in its own right is relatively new. We consider that the subject may be treated in a narrow or a broad manner, depending on the viewpoint of the policy maker, practitioner, researcher or theorist. It seems that existing definitions of Corporate Governance fall on to a spectrum, with 'narrow' views at one end and more inclusive, 'broad' views placed at the other. Once approach toward Corporate Governance adopts a narrow view, where Corporate Governance is restricted to the relationship between a company and its shareholders. This is the traditional finance paradigm, expressed in 'agency theory'. At the other end of the spectrum, corporate governance may be seen as a web of relationships, not only between a company and its owners (shareholders) but also between a company and a broad range of other 'stakeholders': employees, customers, suppliers, bondholders, to name but a few. such a view tends to be expressed in 'stakeholder theory'. This is a more inclusive and broad way of treating the subject of corporate governance and one which is gradually attracting greater attention.

Corporate governance is...

- The process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders (Parkinson, 1994). – Strongly agree
- The governance role is not concerned with the running of the business of the company per se, but with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations of accountability and regulation by interests beyond the corporate boundaries (Tricker, 1984). – Agree
- The governance of an enterprise is the sum of those activities that make up the internal regulation of the business in compliance with the obligations placed on the firm by legislation, ownership trusteeship of assets, their management and their deployment (Cannon, 1994). – Agree
- The relationship between shareholders and their companies and the way in which shareholders act to encourage best practice (e.g., by voting at AGMs and by regular meetings with companies' senior management). Increasingly, this includes shareholder 'activism' which involves a campaign by a shareholder or a group of shareholders to achieve change in companies (The Corporate Governance Handbook, 1996). – Some agreement
- The structures, process, cultures and systems that engender the successful operation of the Organization (Keasey and Wright, 1993). – Some agreement
- The system by which companies are directed and controlled (The Cadbury Report, 1992) – slight agreement

We consider some published definitions of corporate governance each of which adopt a different view of the subject and provide a consensus on the relative importance of these definitions. These definitions were not intended to discriminate completely between different views, but rather each was chosen to emphasize slightly different interpretations of the Corporate Governance function. The selection represents a range of definitions, starting from the narrowest which described the basic role of Corporate Governance (The Cadbury Report, 1992; see also, Cadbury, 2002) to a solely financial perspective involving only shareholders and company management (Parkinson, 1994) and extending to a broader definition that encompassed corporate accountability to a wide range of stakeholders and society at large (Tricker, 1984). We also included a definition that emphasized the importance of shareholder activism, as this allowed us to gauge institutional investors' views on their own role in Corporate Governance (The Corporate Governance Handbook, 1996). The selection also included definitions that were regulation-centered (Cannon, 1994) or focused on corporate success (Keasey and Wright, 1993). The definitions are ranked according to the institutional investors' views of their relative importance.

In general the definitions of Corporate Governance found in the literature tend to share certain characteristics, one of which is the notion of accountability. Narrow definitions are oriented around corporate accountability to shareholders. Some narrower, shareholder-oriented definitions of Corporate Governance focus specifically on the ability of a country's legal system to protect minority shareholder rights (e.g., La Porta et al., 1998). However, such definitions are mainly applicable to cross-country comparisons of Corporate Governance. We return to the legal influence on different systems of corporate governance around the world.

Broader definitions of Corporate Governance stress a broader level of accountability to shareholders and other stakeholders. We can see that Tricker's (1984) definition, encompassing accountability to a broader group of people than just the shareholders. This demonstrates an interest within the financial community in a broader, stakeholder-oriented approach to Corporate Governance. The broadest definitions consider that companies are accountable to the whole of society, future generations and the natural world. Relatively broad, definitions consider that companies are accountable to the whole of society, future generations and the natural world. We suggest that corporate governance is the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.

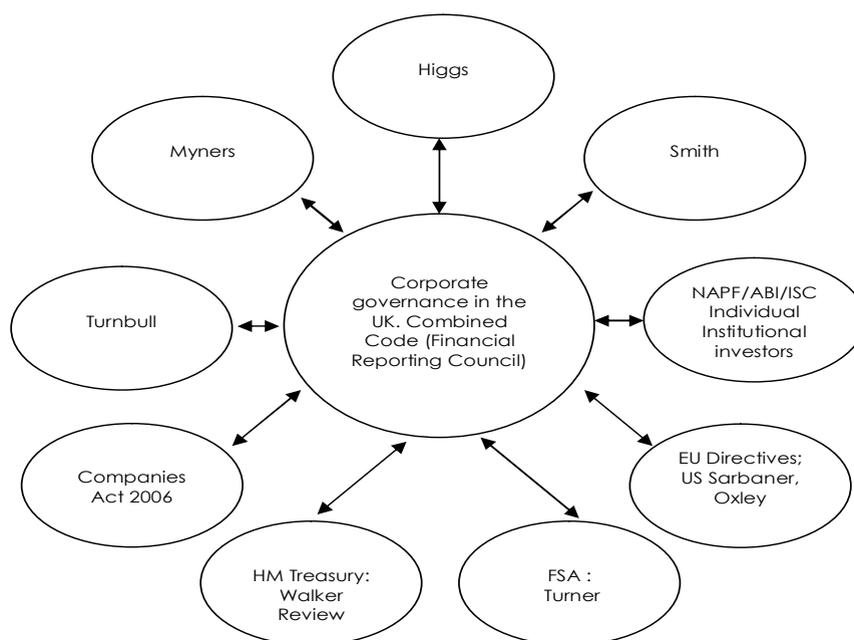
Theoretical frameworks that suggest companies should be accountable only to their shareholders are not necessarily inconsistent with theoretical frameworks that champion stakeholder accountability. The reason underlying this argument is that shareholders' interest can only be satisfied by taking account of stakeholder interests, as companies that are accountable to all of their stakeholders are over the long term more successful and more prosperous. Definition of Corporate Governance therefore rests on the perception that companies can maximize value creation over the long term, by discharging their accountability to all of their stakeholders and by optimizing their system of Corporate Governance.

Overall, this perception is growing among the professional community and academic research is beginning to provide empirical in support of this view of corporate governance, accountability and corporate profitability. However, this is the 'business case' for corporate governance and, more generally, for corporate social responsibility. Should companies improve corporate governance and discharge accountability to all of their stakeholders purely because it is ethical? We discuss these ethical issues in the subsection on stakeholder theory. In the real world, it is unlikely that businessmen and investors will be interested in acting ethically unless there are positive financial returns to be made from so doing, as there appears to be a strong business case underlying corporate governance reform and stakeholder accountability, then the corporate and financial communities are more likely to embrace these approaches.

## 9.2 CORPORATE GOVERNANCE IN THE UK

The UK has a well-developed market with a diverse shareholder base including institutional investors, financial institutions, and individuals. The UK illustrates well the problems that may be associated with the separation of the ownership and control of corporations and hence has many of the associated agency problems. These agency problems, including misuse of corporate assets by directors and a lack of effective control over, and accountability of, directors' actions, contributed to a number of financial scandals in the UK.

As in other countries, the development of corporate governance in the UK was initially the findings of a trilogy of codes: the Cadbury Report (1992), the Greenbury Report (1995), and the Hampel Report (1998).



**Figure:** Development of corporate governance in the UK

Figure illustrates the development of corporate governance in the UK. The centre oval represents the Combined Code published in 2008 by the Financial Reporting Council. Around the centre oval, we can see the various influences since 1998 (the original Combined Code, published in 1998, encompassed the Cadbury, Greenbury, and Hampel report recommendations). These influences can be split into four broad areas. First, there are reports that have looked at specific areas of Corporate Governance: the Turnbull Report on Internal Controls the Myners review of Institutional Investment, the Higgs Review of the role and effectiveness of non-executive directors, and the Smith Review of Audit Committees. Secondly, there has been the influence of institutional investors and their representative groups. Thirdly, influences affecting the regulatory framework within which corporate governance in the UK operates have included the UK company law review, the Walker Review for HM Treasury and the Financial Services Authority Review. Fourthly, there have been what might be termed 'external influences' such as the EU review of company law and the US Sarbanes-Oxley Act. Each of these is now discussed in turn.

### **9.2.1 Various Reports on Governance:**

#### **9.2.1.1 Cadbury Report (1992)**

Following various financial scandals and collapses (Coloroll and Polly Peck, to name but two) and a perceived general lack of confidence in the financial reporting of many UK companies, the Financial Reporting Council, the London Stock Exchange, and the accountancy profession established the Committee on the Financial Aspects of Corporate Governance in May 1991. After the Committee was set up, the scandals at BCCI and Maxwell happened, and as a result, the committee interpreted its remit more widely and looked beyond the financial aspects to Corporate Governance as a whole. The Committee was chaired by Sir Adrian Cadbury and, when the Committee reported in December 1992, the report became widely known as 'the Cadbury Report'.

The recommendations covered: the operation of the main board; the establishment, composition, and operation of key board committees; the importance of, and contribution that can be made by, non-executive directors; the reporting and control mechanisms of a business. The Cadbury Report recommended a code of Best Practice with which the boards of all listed companies registered in the UK should comply, and utilized a 'comply or explain' mechanism. This mechanism means that a company should comply with the code but, if it cannot comply with any particular aspect of it, then it should explain why it is unable to do so. This disclosure gives investors detailed information about any instances of non-compliance and enables them to decide whether the company's non-compliance is justified.

#### **9.2.1.2 Greenbury Report (1995)**

The Greenbury committee was set up in response to concern at both the size of directors' remuneration packages and their inconsistent and incomplete disclosure in companies' annual reports. It made, in 1995, comprehensive recommendations regarding disclosure of directors' remuneration packages. There has been much discussion about how much disclosure there should be of directors' remuneration and how useful detailed disclosures might be. Whilst the work of the Greenbury Committee focused on the directors of public limited companies, it hoped that both smaller listed companies and unlisted companies would find its recommendations useful.

Central to the Greenbury report recommendations were strengthening accountability and enhancing the performance of directors. These two aims were to be achieved by (i) the presence of a remuneration committee comprised of independent non-executive directors who would report fully to the shareholders each year about the company's executive remuneration policy, including full disclosure of the elements in the remuneration of individual directors; and (ii) the adoption of performance measures linking rewards to the performance of both the company and individual directors, so that the interests of directors and shareholders were more closely aligned.

Since that time (1995), disclosure of directors' remuneration has become quite prolific in UK company accounts.



### 9.2.1.3 Hampel Report (1998)

The Hampel Committee was set up in 1995 to review the implementation of the Cadbury and Greenbury Committee recommendations. The Hampel Committee reported in 1998. The Hampel Report said: 'We endorse the overwhelming majority of the findings of the two earlier committees'. There has been much discussion about the extent to which a company should consider the interests of various stakeholders, such as employees, customers, suppliers, providers of credit, the local community, etc., as well as the interests of its shareholders. The Hampel report stated that the directors as a board are responsible for *relations with* stakeholders; but they are accountable to the shareholders'. However, the report does also state that directors can meet their legal duties to shareholders, and can pursue the objective of long-term shareholder value successfully, only by developing and sustaining these stakeholder relationships'.

The Hampel Report, like its precursors, also emphasized the important role that institutional investors have to play in the companies in which they invest (investee companies). It is highly desirable that companies and institutional investors engage in dialogue and that institutional investors make considered use of their shares in other words, institutional investors should consider carefully the resolutions on which they have a right to vote and reach a decision based on careful thought, rather than engage in 'box ticking'.

### 9.2.1.4 Combined Code (1998)

The Combined Code drew together the recommendations of the Cadbury, Greenbury, and Hampel reports. It has two sections, one aimed at Companies and another aimed at Institutional Investors. The combined code operates on the 'comply or explain' basis mentioned above. In relation to the internal controls of the business, the combined code states that 'the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets' and that 'the directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational, and compliance controls and risk management'. The Turnbull Report issued in 1999 gave directors guidance on carrying out this review.

### 9.2.1.5 Turnbull (1999)

The Turnbull Committee, chaired by Nigel Turnbull, was established by the Institute of Chartered Accountants in England and Wales (ICAEW) to provide guidance on the implementation of the internal control requirements of the Combined Code. The Turnbull Report confirms that it is the responsibility of the board of directors to ensure that the company has a sound system of internal control, and that the controls are working as they should. The board should assess the effectiveness of internal controls and report on them in the annual report. Of course, a company is subject to new risks both from the outside environment and as a result of decisions that the board makes about corporate strategy and objectives. In the managing of risk, boards will need to take into account the existing internal control system in the company and also whether any changes are required to ensure that new risks are adequately and effectively managed.

### 9.2.1.6 Myners (2001, 2008)

The Myners report on Institutional investment, issued in 2001 by HM Treasury, concentrated more on the trusteeship aspects of institutional investors and the legal requirements for trustees, with the aim of raising the standards and promoting greater shareholder activism. For example, the Myners report expects that institutional investors should be more proactive, especially in the stance they take with underperforming companies. Some institutional investors have already shown more of a willingness to engage actively with companies to try to ensure that shareholder value is not lost by underperforming companies.

In 2007, the NAPF published the results of its review of the extent to which Pension Fund trustees were complying with the principles. The report stated 'the recommendations set out in this report provide a

framework for developing further the Principles so that they remain relevant for the world in which pension fund trustees operate today'. Subsequently HM Treasury published *Updating the Myners Principles: A Response to Consultation* in 2008. There are six principles identified: effective decision-making; clear objectives; risk and liabilities; performance assessment; responsible ownership; transparency; and reporting. The report emphasized greater industry ownership of the principles and places the onus on trustees to report on their own practices.

### **9.2.1.7 Higgs (2003)**

The Higgs Review, chaired by Derek Higgs, reported in January 2003 on the role and effectiveness of non-executive directors. Higgs offered support for the Combined Code whilst making some additional recommendations. These recommendations included : stating the number of meetings of the board and its main committees in the annual report, together with the attendance records of individual directors; that a chief executive director should not also become chairman of the same company; non-executive directors should meet as a group at least once a year without executive directors being present, and the annual report should indicate whether such meetings have occurred; chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles; the board should inform shareholders as to why they believe a certain individual should be appointed to a non-executive directorship and how they may meet the requirements of the role; there should be a comprehensive induction programme for new non-executive directors, and resources should be available for ongoing development of directors; the performance of the board, its committees and its individual members, should be evaluated at least once a year, the annual report should state whether these reviews are being held and how they are conducted; a full time executive director should not hold more than one non-executive directorship or become chairman of a major company; no one non-executive director should sit on all three principal board committees (audit, remuneration, nomination). There was substantial opposition to some of the recommendations but they nonetheless helped to inform the Combined Code. Good practice suggestions from the Higgs Report were published in 2006.

Following a recommendation in chapter 10 of the Higgs Review, a group led by Professor Laura Tyson, looked at how companies might utilize broader pools of talent with varied skills and experience, and different perspectives to enhance board effectiveness. The Tyson report was published in 2003.

### **9.2.1.8 Smith (2003)**

the Smith Review of Audit Committees, a group appointed by the Financial reporting council, reported in January 2003. The review made clear the important role of the audit committee: 'While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control' . The review defined the audit committee's role in terms of a high-level overview-it needs to satisfy itself that there is an appropriate system of controls in place but it does not undertake the monitoring itself .

### **9.2.1.9 Combined Code (2003)**

The revised Combined Code, published in July 2003, incorporated the substance of the Higgs and Smith reviews. However, rather than stating that no one non-executive director should sit on all three board committees, the Combined Code stated that 'undue reliance' should not be placed on particular individuals. The Combined Code also clarified the roles of the Chairman and the Senior Independent director (sid), emphasizing the Chairman's role in providing leadership to the non-executive directors and in communicating shareholders' views to the board; it also provided for a 'formal and rigorous annual evaluation' of the board's, the committees', and the individual directors' performance. At least half the board in larger listed companies was to be independent non-executive directors.

### **9.2.1.10 Revised Turnbull Guidance (2005)**

In 2005, revised guidance on the Turnbull Report (1999) was published. There were few substantive



changes but boards were encouraged to review their application of the guidance on a continuing basis and to look on the internal control statement as an opportunity to communicate to their shareholders how they manage risk and internal control. They should notify shareholders, in the annual report, of how any 'significant failings or weaknesses' in the effectiveness of the internal control system have been dealt with.

#### **9.2.1.11 Combined Code (2006)**

An updated version of the Combined Code was issued in June 2006. There were three main changes made:

- (i) to allow the company chairman to serve on (but not to chair) the remuneration committee where he is considered independent on appointment as chairman;
- (ii) to provide a 'vote withheld' option on proxy appointment forms to enable a shareholder to indicate that they wish to withhold their vote;
- (iii) to recommend that companies publish on their website the details of proxies lodged at general meetings where votes were taken on a show of hands.

#### **9.2.1.12 Combined Code (2008)**

The findings of the Financial Reporting Council (FRC) *Review of the Impact of the Combined Code* were published in December 2007. The overall findings indicated that the Combined Code (2006) had general support and that the FRC would concentrate on improving the practical application of the Combined Code.

In June 2008, the FRC published a new edition of the Combined Code which introduced two changes. These changes were (i) to remove the restriction on an individual chairing more than one FTSE 100 company; and (ii) for listed companies outside the FTSE 350, to allow the company chairman to sit on the audit committee where he or she was considered independent on appointment.

The FRC stated on their website that The revised Code took effect at the same time as new FSA Rules implementing EU requirements relating to corporate governance statements and audit committees. The revised code and new rules will apply to accounting periods beginning on or after 29 June 2008. In practice this means most companies will begin to apply them in 2009, and will report against them for the first time in 2010.

#### **9.2.1.13 Revised Smith Guidance (2008)**

A new edition of the guidance was issued in October 2008. The main changes to the guidance as detailed on the FRC website are:

Audit committees are encouraged to consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning; companies are encouraged to include in the audit committee's report information on the appointment, reappointment or removal of the auditor, including supporting information on tendering frequency, the tenure of the incumbent auditor and any contractual obligations that acted to restrict the committee's choice of auditor; a small number of detailed changes have been made to the section dealing with the independence of the auditor, to bring the guidance in line with the Auditing Practices Board's Ethical Standards [2004, revised 2008] for auditors, which have been issued since the guidance was first published in 2003; and an appendix has been added containing guidance on the factors to be considered if a group is contemplating employing firms from more than one network to undertake the audit.

#### **9.2.2 Institutional Investors and their Representative Groups**

Large institutional investors, mainly insurance companies and pension funds, usually belong to one of two representative bodies that act as a professional group 'voice' for their views: the Association of British Insurers (ABI) and the national association of Pension Funds (NAPF). Both the ABI and the

NAPF have best practice Corporate Governance guidelines that encompass the recommendations of the Combined Code. They monitor the corporate governance activities of companies and provide advice to members.

Some large institutional investors are very active in their own right in terms of their corporate governance activities. Hermes is a case in point, and it has published the hermes Principles, which detail how it perceives its relationship with the companies in which it invests (investee companies), what its expectations are of investee companies, and what investee companies can expect from hermes.

### **9.2.3 Companies Act 2006**

In the UK, the corporate law has been in need of a thorough review for some years and the Modern Company Law Review culminated in July 2002 in the publication of outline proposals for extensive modernization of company law, including various aspects of corporate governance. These proposals included: statutory codification of directors' common law duties; enhanced company reporting and audit requirements, including a requirement that economically significant companies produce an annual operating and financial review; disclosure on corporate websites of information relating to the annual report and accounts, and disclosure relating to voting.

The government published the Company Law Reform Bill in November 2005, and the Companies Act 2006 was enacted in late 2006. The Act updates previous Companies' Acts legislation, but does not completely replace them, and it contains some significant new provisions which impacts on various constituents including directors, shareholders, auditors and company secretaries. The act draws on the findings of the Company Law Review proposals'.

The main features are as follows:

- directors' duties are codified;
- companies can make greater use of electronic communications for communicating with shareholders;
- directors can file service addresses on public record rather than their private home addresses;
- shareholders will be able to agree limitations on directors' liability;
- there will be simpler model Articles of Association for private companies, to reflect the way in which small companies operate;
- private companies will not be required to have a company secretary;
- private companies will not need to hold an annual general meeting unless they agree to do so;
- the requirement for an operating and Financial review (OFR) has not been reinstated, rather companies are encouraged to produce a high quality Business Review;
- nominee shareholders can elect to receive information in hard copy form or electronically if they wish to do so;
- shareholders will receive more timely information;
- enhanced proxy rights will make it easier for shareholders to appoint theirs to attend and vote at general meetings;
- shareholders of quoted companies may have a shareholder proposal (resolution);
- circulated at the company's expense if received by the financial year end;
- whilst there has been significant encouragement over a number of years to encourage institutional investors to disclose how they use their votes, the act provides a power which could be used to require institutional investors to disclose how they have voted.



Overall there seems to be an increasing burden for quoted companies whilst on the other hand the burden seems to have been reduced for private companies. In terms of the rights of shareholders these are enhanced in a number of ways including greater use of electronic communications, more information, enhanced proxy rights, and provision regarding the circulation of shareholder proposals at the company's expense. Equally there is a corresponding emphasis on shareholders' responsibilities with encouragement for institutional shareholders to be more active and to disclose how they have voted.

#### **9.2.4 Financial Services Authority**

In September 2002, the Financial Services Authority (FSA) launched a review of the listing regime with the main aim being to assess the existing rules and identify which should be retained, and which changed. The areas covered by the review were: Corporate Governance; continuing obligations (encompassing corporate communication, and shareholders' rights and obligations); financial information; the sponsor regime.

The FSA Review took place against the background of potentially significant changes in both the EU and UK regulatory environments, and although some changes were made, there was much continuity in the proposals introduced in 2005.

Following the global banking crisis, Lord Adair Turner, Chairman of the FSA, was asked by the Chancellor of the Exchequer to carry out a review and make recommendations for reforming UK and international approaches to the way banks are regulated. The Turner Review was published in the Spring 2009. Issues highlighted include remuneration policies designed to avoid incentives for undue risk taking; whether changes in governance structure are needed to increase the independence of risk management functions; and consideration of the skill and time commitment-required for non-executive directors of large complex banks to effectively perform their role.

#### **9.2.5 Financial Reporting Council**

The Financial Reporting Council (FRC) has six operating bodies: the Accounting Standards Board (ASB), the Auditing Practices Board (APB), the Board for Actuarial Standards (BAS), the Professional oversight Board, the Financial Reporting Review Panel (FRRP), and the Accountancy and Actuarial Discipline Board (AADB).

The importance placed on corporate governance is evidenced by the fact that, in March 2004, the FRC set up a new committee to lead its work on corporate governance.

Overall, the FRC is responsible for promoting high standards of corporate governance. It aims to do so by:

- maintaining an effective Combined Code on Corporate Governance and promoting its widespread application;
- ensuring that related guidance, such as that on internal control, is current and relevant;
- influencing EU and Global Corporate Governance developments;
- helping to promote boardroom professionalism and diversity;
- encouraging constructive interaction between company boards and institutional shareholders.

The FRC has carried out several consultative reviews of the Combined Code which led to the amended Combined Code in 2006, and subsequently in 2008 (discussed earlier). The latest review took place in 2009. The frequency of the reviews are both an indicator of the FRC's responsibility for corporate governance of UK companies which involves leading public debate in the area and its response to the global financial crisis which has, in turn, affected confidence in aspects of corporate governance.

The FRC website mentions the independent review of the governance of banks and other financial institutions carried out by Sir David Walker. The Walker Review published its draft recommendations

in July 2009, some of the recommendations could be taken forward through amendments to the Combined Code. The FRC is considering the extent to which the Walker Review recommendations may be applicable for some or all listed companies in other sectors.

### 9.2.6 'External' Influences

The report of the EU High Level Group of Company Law Experts had implications for company law across Europe including the UK, and is further discussed below in the context of an international development. The impact of recent legislation in the USA, the Sarbanes Oxley Act, has also made its influence felt in the UK, and is also discussed in detail below.

## 9.3 CORPORATE GOVERNANCE IN GERMANY

Charkham (1994) stated that 'if there were a spectrum with "confrontation" at one end and "co-operation" at the other, we would confidently place German attitudes and behaviour far closer to the "co-operation" end than, say, those of the British or Americans'. This is an important statement in the context of understanding the philosophy of the German approach to business and to companies, whereby the shareholders are but one of a wider set of stakeholder interest with the employees and customers being given more emphasis. Charkham (1994) finds this approach evidenced in the industrial relations of German companies: 'Good industrial relations . . . would not be prominent in works on corporate governance systems in most countries, or at best would be regarded as peripheral. In Germany, however, good industrial relations are much nearer centre stage.' This is evidenced in the Works Constitution Act 1972, which sets out the rights of the works council and, broadly speaking, deals with all matters pertaining to the employees' conditions of employment. Works councils are part of the co-operative process between workers and employers, the idea being that **co-determination** (the right to be kept informed about the company's activities and to participate in decisions that may affect the workers) means that there is a basis for more trust and co-operation between workforce and employers. The Co-determination Act 1976 defines the proportion of employee and shareholder representatives on the supervisory board (*Aufsichtsrat*) and also stipulates that the management board has special responsibility for labour-related matters.

The business structure in Germany is detailed in Wymeersch (1998) where he identifies the most used business types in various continental European states. In Germany, as far as the larger business entities are concerned, the business types tend to be either public (*Aktiengesellschaft AG*) or private companies limited by shares (*Gesellschaft mit beschränkter Haftung, GmbH*). However, he identifies a hybrid that is also used in Germany- specifically, a hybrid of the *GmbH & Co. KG*, combining the advantages of the unincorporated *Kommanditgesellschaft* and the limited liability of *GmbH*.

In Germany, as in many continental European countries and the UK, there is a trend away from individual share ownership. The most influential shareholders are financial and non-financial companies, and there are significant cross-holdings, which mean that when analysing share ownership and control in Germany, one needs to look also at the links between companies. Banks, and especially a few large banks, play a central role in German corporate governance with representation on the supervisory boards of companies and links with other companies. Charkham (1994) identifies a number of reasons as to why banks are influential in Germany. First, there is direct ownership of company shares by banks; second, German shareholders generally lodge their shares with banks authorized to carry out their voting instructions (deposited share voting rights, or DSVR); third, banks tend to lend for the long term and hence develop a longer term relationship with the company (relationship lending); fourth, banks offer a wide range of services that the company may find it useful to draw upon. Given these factors, banks tend to build up a longer term, deeper relationship with companies, and their expertise is welcomed on the supervisory boards. hence the German corporate governance system could be termed an 'insider' system.

The German Corporate Governance system is based around a dual board system, and essentially, the



dual board system comprises a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*). The management board is responsible for managing the enterprise. Its members are jointly accountable for the management of the enterprise and the chairman of the management board co-ordinates the work of the management board. On the other hand, the supervisory board appoints, supervises, and advises the members of the management board and is directly involved in decisions of fundamental importance to the enterprise. The chairman of the supervisory board co-ordinates the work of the supervisory board. The members of the supervisory board are elected by the shareholders in general meetings. The co-determination principle provides for compulsory employees representation. So, for firms or companies which have more than five hundred or two thousand employees in Germany, employees are also represented in the supervisory board which then comprises one-third employee representative or one-half employee representative respectively. The representatives elected by the shareholders and representatives of the employees are equally obliged to act in the enterprise's best interests.

The idea of employee representation on boards is not always seen as a good thing because the employee representatives on the supervisory board may hold back decisions being made that are in the best interests of the company as a whole but not necessarily in the best interests of the employees as a group. An example, would be where a company wishes to rationalize its operations and close a factory but the practicalities of trying to get such a decision approved by employee representatives on the supervisory board, and the repercussions of such a decision on labour relations, prove too great for the strategy to be made a reality.

**Table** Key characteristics influencing German corporate governance

Feature	Key characteristic
Main business form	Public or private companies limited by shares
Predominant ownership structure	Financial and non-financial companies
Legal system	civil law
Board structure	dual
Important aspect	compulsory employee representation on supervisory board.

The committee on corporate governance in Germany was chaired by dr Gerhard Cromme and is usually referred to as the Cromme Report or Cromme Code. The code harmonizes a wide variety of laws and regulations and contains recommendations and also suggestions for complying with international best practice on Corporate Governance.

The Cromme Code was published in 2002 and is split into a number of sections, starting with a section on shareholders and the general meeting. The Cromme Code also reflects some of the latest developments in technology. The Cromme Code was amended in 2005. Whilst it remains substantially the same, there are some significant changes, which are shown in bold in the relevant sections (i)-(vi) below.

#### **(i) Shareholders and the general meeting**

At the general meeting, the management board submits the annual, and consolidated, financial statement, and the general meeting decides on the appropriation of net income and approves the decisions of the management board and the supervisory board. An important aspect of the general meeting is that it elects the shareholders representatives to the supervisory board and also, generally, the auditors.

Interestingly, the Cromme Code makes explicit provision that the management board shall not only provide the report and accounts and other documents required by law for the general meeting but should also publish them on the company's website together with the agenda. Similarly, the use of technology is encouraged as the general meeting should be capable of being followed on the internet or similar media.

The shareholders' right to vote is facilitated in a number of ways, including by the personal exercise of shareholders voting rights, and by the use of proxies.

**(ii) Co-operation between the management board and the supervisory board**

It is essential that the management board and the supervisory board co-operate closely for the benefit of the enterprise. The Cromme Code defines the management board's role as to co-ordinate the enterprise's strategic approach with the supervisory board and to discuss the implementation of strategy with the supervisory board at regular intervals. There are certain situations, such as those relating to the enterprise's planning, business development, risk situation, and risk management, when the management board should inform the supervisory board immediately of any issues.

The supervisory board is able to specify the management board's information and reporting duties in more detail. It is essential that there is open discussion between the management board and supervisory board as well as amongst the members within each of those two boards. The management board and the supervisory board report each year on the enterprise's corporate governance in the annual report and they should explain any deviations from the Cromme Code. The company shall keep previous declarations of conformity with the Code available for viewing on its website for five years.

**(iii) Management board**

The composition of the management board is determined by the supervisory board, and should be reported in the notes to the accounts. Any conflict of interest should be disclosed to the supervisory board. The Cromme Code states that 'the management board is responsible for independently managing the enterprise' with a view to acting in the enterprise's best interest, and endeavouring to increase the sustainable value of the enterprise. As mentioned earlier, the management board develops the enterprise's strategy and co-ordinates with the supervisory board on this issue.

The Cromme Report provides for the compensation to be comprised of a fixed salary and variable component. As in many other countries, the variable compensation element should be linked to the business performance as well as long-term incentives. Stock options are mentioned as one possible element of variable compensation components and these should be linked to certain performance criteria such as the achievement of predetermined share prices.

**(iv) Supervisory board**

It is important that the composition of the supervisory board reflects a suitable level of knowledge, ability, and experience to be able properly to carry out the tasks relevant to the business. There should be an adequate number of independent members.

'Independence' will mean no business or personal relations with the company or its management board which cause a conflict of interest. To help maintain its independence, not more than two former members of the management board should be members of the supervisory board. The former management board chairman or a management board member should not generally become supervisory board chairman or chairman of a supervisory board committee. Supervisory board members should not have directorships or similar positions or indeed have advisory roles with important competitors of the enterprise.

The supervisory board carries out a number of important functions as follows:

- (i) it provides independent advice and supervision regularly to the management board on the management of the business;
- (ii) the management board and the supervisory board should ensure that there is a long-term succession plan in place;
- (iii) the supervisory board may delegate some duties to other committees, which include compensation and audit committees;



- (iv) the chairman of the supervisory board, who should not be the chairman of the audit committee, co-ordinates work within the supervisory board and chairs its meetings and attends to the affairs of the supervisory board externally.

It is worth elaborating on the committees that may be formed with a remit for various delegated areas. These may include the audit committee (the chairman of the audit committee should not be a former member of the management board of the company); the chairman of the audit committee should have specialist knowledge and experience in the application of accounting principles and internal control processes, and a compensation committee to look at the compensation of the management board. This committee may also look at the appointment of members of the management board.

The Cromme Code also states that members of the management board of a listed company should not be on more than five supervisory boards in non-group listed companies. The compensation of members of the supervisory board is specified either by a resolution of the general meeting or in the articles of association. Members of the supervisory board may receive performance-related compensation as well as fixed compensation. The compensation of the supervisory board members should be disclosed in the Corporate Governance Report.

An interesting disclosure required by the Cromme Code is that if a supervisory board member takes part in less than half of the meetings of the supervisory board in a financial year, then this will be noted in the report of the supervisory board. Any conflicts of interest should be reported to the supervisory board and the supervisory board would then inform the general meeting of any conflicts of interest together with how these conflicts have been treated.

#### **(v) Transparency**

The code provides that the management board should disclose immediately any facts that might affect the enterprise's activities and which are not publicly known. The report emphasizes that all shareholders should be treated equally in respect of information disclosure and that the company may use appropriate media, such as the internet, to inform the shareholders and investors in an efficient and timely manner. There is disclosure required in terms of the shareholdings, including options and derivatives, that are held by individual management board and supervisory board members. These must be reported if they directly or indirectly exceed 1 per cent of the shares issued by the company. The code also states: 'If the entire holdings of all members of the management board and supervisory board exceed 1 per cent of the shares issued by the company, these shall be reported separately according to the management board and supervisory board.' These disclosures should all be included in the corporate Governance report.

#### **(vi) Reporting and audit of the annual financial statements**

The code states that the supervisory board or the audit committee should obtain a statement from the proposed auditor clarifying whether there are any 'professional, financial or other relationships' that might call the auditor's independence into question.

Interestingly, this statement should include the extent to which other services have been performed for the company in the past year, especially in the field of consultancy, or which are contracted for the following year. It is the supervisory board that concludes agreement on the auditors fee.

From the discussion above, it can be seen that the defining feature of Germany's corporate governance system is the significant role played by the supervisory board. In addition, the supervisory board has compulsory representation of workers via the co-determination rules. This can have an important impact on key strategic decisions, for example, if a German company decides that it needs to close one of its subsidiaries, then it may prefer to close down a subsidiary overseas, in a country such as the UK, which has a unitary board structure and hence no supervisory board with employee representation. Employees in the UK would therefore be in a weaker position than their German counterparts, and have less influence over any closure decision.

It is interesting to note that Charkham (2005), in reviewing corporate governance developments in Germany, is of the opinion that 'internal and external developments have put pressure on it, but its main provisions remain intact. The factors for change have been the diminishing role of the banks, the international governance codes and principles, and the international capital markets'.

In November 2005, Germany abolished the requirement for shares to be blocked in advance of a shareholder meeting. Blocking had meant that shares could not be traded for a period of time before a company's general meeting, if the holder of the shares wished to be able to vote on the resolutions tabled for the general meeting. therefore, it had effectively been a deterrent to voting because institutional investors often could not afford to be in a position whereby they were unable to trade their shares.

Recent legal changes now require companies to disclose pay details for executive directors, effective for annual reports for 2006 onwards. However, company management may propose that disclosure is limited and if the proposal is approved by 75 per cent of its shareholders, then the additional disclosure does not have to be given. An amended version of the German corporate Governance code was published in 2006 and recommended that various executive remuneration disclosures should be made in the corporate Governance report. Companies would be obliged to disclose if they were to deviate from these recommendations.

There were minor amendments to the German Corporate Governance Code in 2007 and 2008. In the forward to each of these codes, it is mentioned that the European company or Society Europaean (SE) gives German enterprises the opportunity to opt for the unitary board system in which case the form that co-determination would take would be a matter for agreement between the company management and the employees. Also there is now a recommendation in the section on the 'supervisory Board' that the supervisory board should form a nomination committee composed exclusively of shareholder representatives which should propose suitable candidates to the supervisory board for recommendation to the company's general meeting.

Goergen *et al.* (2008) review the governance role of large shareholders, creditors, the product market and the supervisory board, and also discuss the importance of mergers and acquisitions, the market in block trades, and the lack of a hostile takeover market. They find that, the German system is characterised by a market for partial corporate control, large shareholders and bank/creditor monitoring, a two-tier (management and supervisory) board with co-determination between shareholders and employees on the supervisory board, a disciplinary product-market, and Corporate Governance regulation largely based on EU directives but with deep roots in the German codes and legal doctrine. Another important feature of the German system is its Corporate Governance efficiency criterion which is focused on the maximisation of stakeholder value rather than shareholder value. However, the German corporate governance system has experienced many important changes over the last decade. First, the relationship between ownership or control concentration and profitability has changed over time. Second, the pay-for-performance relation is unfluenced by large shareholder control: in firms with controlling blockholders and when a universal bank is simultaneously an equity- and debtholder, the pay-for-performance relation is lower than in widely-held firms or blockholder-controlled firms. Third, since 1995 several major regulatory initiatives (including voluntary codes) have increased transparency and accountability.

Odenius (2008) reviews Germany's corporate governance system and the effectiveness of recent reforms. He states that since the early 1990s far-reaching reforms have complemented the traditional stakeholder system with important elements of the shareholder system. he raises the important question of whether these reforms have created sufficient flexibility for the market to optimize its corporate governance structure within well established social and legal norms. he concludes that there is scope for enhancing flexibility in three core areas, relating to: firstly internal control mechanisms, especially the flexibility of board structures; secondly self-dealing; and thirdly external control, particularly take-over activity.

## 9.4 CORPORATE GOVERNANCE IN JAPAN

Japan's economy developed very rapidly during the second half of the twentieth century. Particularly during the period 1985-89, there was a 'bubble economy', characterized by a sharp increase in share prices and the value of land; the early 1990s saw the bubble burst as share prices fell and land was devalued, as well as shareholders and landowners finding themselves losing vast fortunes, banks found that they had severe problems too. During the bubble period, the banks had lent large amounts of money against the value of land and, as the repayments and the banks were left with large non-performing loans. The effect of the fall in share prices and land values spread through the Japanese economy, which became quite stagnant, and the effects spread to other countries' economies, precipitating a regional recession.

The Japanese government wished to restore confidence in the Japanese economy and in the stock market, and to attract foreign direct investment to help regenerate growth in companies. Improved corporate governance was seen as a very necessary step in this process.

Japan's Corporate Governance System is often likened to that of Germany because banks can play an influential role in companies in both countries. However, there are fundamental differences between the systems, driven partly by culture and partly by the Japanese shareholding structure with the influence of the *keiretsu* (broadly, associations of companies). Charkham (1994) sums up three main concepts that affect Japanese attitudes towards Corporate Governance: obligation, family, and consensus. The first of these, obligation, is evidenced by the Japanese feeling of obligation to family, a company, or country; the second, family, is the strong feeling of being part of a 'family' whether this is a family person, or a company; finally, the third concept, consensus, means that there is an emphasis on agreement rather than antagonism. These three concepts deeply influence the Japanese approach to Corporate Governance.

The *keiretsu* sprang out of the *zaibatsu*. Okumura (2002) states: 'Before World War II, when *zaibatsu* (giant pre-war conglomerates) dominated the Japanese economy, individuals or families governed companies as major stockholders. By contrast, after the war, by virtue of corporate capitalism, companies in the form of corporations became large stockowners, and companies became major stockholders of each other's stock.' The companies forming the *keiretsu* may be in different industries, forming a cluster often with a bank at the centre. Charkham (1994) states that 'banks are said to have encouraged the formation and development of groups of this kind, as a source of mutual strength and reciprocal help'. Indeed, banks themselves have a special relationship with the companies they lend to, particularly if they are the lead or main bank for a given company. Banks often buy shares in their customer companies to firm up the relationship between company and bank. However, they are limited to as per cent holding in a given company but, in practice, the combination of the traditional bank relationship with its client and the shareholding mean that they can be influential, and often very helpful, if the company is in financial difficulties, viewing it as part of their obligation to the company to try to help it find a way out of its difficulties.

When compared to the German system, it should be noted that there is no automatic provision for employees to sit on the supervisory board. However, employees have traditionally come to expect that they will have lifelong employment with the same company - unfortunately, in times of economic downturn, this can no longer be guaranteed.

The Japan Corporate Governance Committee published its revised Corporate Governance Code in 2001. The code had six chapters, which contained a total of 14 principles. The code had an interesting introduction, part of which stated 'a good company maximizes the profits of its shareholders by efficiently creating value, and in the process contributes to the creation of a more prosperous society by enriching the lives of its employees and improving the welfare of its other stakeholders'.

Summary of key characteristics influencing Japanese Corporate Governance

### **Feature Key characteristic**

Main business form Public limited company

Predominant ownership structure *Keiretsu*; but institutional investor ownership is increasing

Legal system civil law

Board structure dual

Important aspect Influence of *keiretsu*

Hence the Code tried to take a balanced view of what a company is all about, and clearly the consideration of stakeholders is seen to be an important aspect. The foreword to the Code discussed and explained some of the basic tenets of Corporate Governance to help familiarize readers of the code with areas including the role and function of the board of directors, the supervisory body, independent directors, incentive-based compensation, disclosure, and investor relations.

#### **(i) Mission and role of the board of directors**

This first chapter contained five principles relating to: the position and purpose of the board of directors; the function and powers of the board of directors; the organization of the board of directors; outside directors and their independence; the role of the leader of the board of directors.

The board should be comprised of outside directors (someone who has never been a full-time director, executive, or employee of the company)- preferably a majority- and inside directors (executives or employees of the company). Independent directors are outside directors who can make their decisions independently. The board of directors' role is seen as one of management supervision including approving important strategic decisions, nominating candidates for director positions, appointment and removal of the CEO, and general oversight of accounting and auditing. the board of directors may also be required to approve certain decisions made by the CEO.

#### **(ii) Mission and role of the committees established within the board of directors**

The board is recommended to establish various committees including an audit committee, compensation committee, and nominating committee., Each committee established should comprise at least three directors, and an outside director appointed as chair of each committee. The majority of directors on the audit committee should be independent directors, whilst the majority of directors on the other two committees should be outside directors, of whom at least one should be an independent director.

The roles of the various committees are broadly defined and cover the usual areas that one would expect for each of these committees.

#### **(iii) Leadership responsibility of the CEO**

The CEO'S role is to formulate management strategies with the aim of maximizing corporate value in the long term. The CEO is supervised by the board of directors. the CEO may set up an executive management committee to assist him in conducting all aspects of the business. The CEO may not be a member of the committees listed above in (ii).

#### **(iv) Addressing Shareholder Derivative Litigation**

A litigation committee, comprised a majority of independent directors, may be established to determine whether litigation action should be made against directors or executives against whom the company/ shareholders may have a claim.

#### **(v) Securing fairness and transparency for executive management**

Two important areas were covered in this section of the Code: internal control and disclosure.



The CEO should ensure that there is an effective Corporate Governance System with adequate internal control. The audit committee should evaluate the CEO's policies on internal audit and control. The CEO should prepare an annual report about the internal audit and control, which should preferably be audited by a certified public accountant.

Disclosure should be made by the CEO of any information that may influence share prices; also information should be disclosed to the various stakeholder groups as appropriate.

#### **(vi) Reporting To The Shareholders And Communicating With Investors**

The shareholders' general meeting is seen as an opportunity for shareholders to listen to the reports of the directors and executives, and to obtain further information about the company through asking questions. Should the questions go unanswered in the general meeting, then the answer should be put on the company's website subsequent to the general meeting.

The company's executives are encouraged to meet analysts and others who can convey information to investors and shareholders about the company. Information should also be posted on the internet to try to ensure equality of access to information amongst the various investors.

The Commercial Code in Japan provides for the appointment of statutory auditors to monitor the various aspects of the company's activities. However, in 2002, there was an extensive revision of the commercial code essentially providing companies with the option of adopting a 'Us-style' corporate governance structure. The US-style structure would have a main board of directors to carry out the oversight function, and involve the establishment of audit, remuneration, and nomination committees, each with at least three members, a majority of whom should be non-executive. A board of corporate executive officers would also be appointed who would be in charge of the day to-day business operations. Under the US-style structure, the board of statutory auditors would be abolished. It can be seen that the Japanese Corporate Governance Committee's Code's recommendations dovetailed with the revised Commercial Code.

In 2004, the Tokyo Stock Exchange issued the *Principles of Corporate Governance for Listed Companies*. In the preface, the purpose of the Principles is described as being 'to provide a necessary common base for recognition, thereby enhancing corporate governance through the integration of voluntary activities by listed companies and demands by shareholders and investors'. The five principles are based around the OECD Principles of corporate Governance.

The first principle relates to exercising various rights of shareholders, including the right to participate and vote in general meetings, voting on such issues as the election and dismissal of directors and auditors, and fundamental corporate changes, the basic right to share various profits such as dividends, and the special right to make derivative lawsuits and injunction of activities in contravention of laws, regulations, and other rules. The voting environment should be developed and improved so that shareholders can exercise their votes appropriately and participate in general meetings of shareholders.

The second principle relates to the equitable treatment of shareholders, including minority and foreign shareholders. To this end, there should be an adequate system to prohibit transactions through the abuse of officers, employees, and controlling share holders, which are against the primary interests of the company or shareholders. There should be enhanced disclosure where it seems that such actions might occur, and there should be prohibition of special benefits to specified shareholders.

The third principle is the relationship with stakeholders in corporate governance. Whilst Corporate Governance should help to create corporate value and jobs, the fact that companies sustain and improve their strengths and enhance value over time is 'the result of the provision of company resources by all stakeholders', so the establishment of good relationships with stakeholders is important. To this end, companies should cultivate a corporate culture and internal systems, which respect the various stakeholder groups and ensure timely and accurate disclosure of information relating to them.

The fourth principle relates to disclosure and transparency. Companies should ensure timely and accurate disclosure on all material matters, including the financial state and performance of the company and ownership distribution, through both quantitative and qualitative disclosures. The company should seek to ensure that investors can access information easily and that there is equal access to information. Internal systems should seem to ensure the accuracy and timeliness of disclosure.

The final principle relates to the responsibilities of the board of directors, auditors, board of corporate auditors, and other relevant groups. Corporate governance should enhance the supervision of management by the aforementioned groups and ensure their accountability to shareholders. Systems should be developed, or enhanced, to ensure that these requirements can be met.

Finally, it is important to note that the legal framework in Japan, via the Commercial Code Revision on Boards (2003), provides for two corporate governance structures: a corporate auditors' system, consisting of general meetings with shareholders, the board of directors, representative directors, executive directors, corporate auditors, and the board of corporate auditors, and a committees system, where there are general meetings of the shareholders, the board of directors, and committees composed of members of the board of directors (nomination committee, audit committee, and compensation committee), representative executive officers, and executive officers. It is up to the company which system it chooses. In each case, the general meeting of shareholders is the decision-making body on matters of fundamental importance to the company. A key difference between the two structures is that companies with a committee system need to re-elect their directors annually through the general meeting of shareholders, because the board of directors has the authority regarding the definitive plan for the distribution of profit, whereas in the corporate auditors' system, this power lies with the general meetings of shareholders.

Charkham (2005) discusses the various changes that have taken place in the context of Corporate Governance in Japan and states:

The important part the banks played has greatly diminished. In its place there are now better structured boards, more effective company auditors, and occasionally more active shareholders. An increase of interest, and, where appropriate, action on their part, might restore the balance that the banks' withdrawal from the scene has impaired.

Ahmadjian and Okumura (2006) also discuss the changes that have taken place in Japan in recent years:

Over the last decade, the debate on corporate governance has contrasted two extremes - whether to become "like the US" or retain the post-war Japanese system of governance. Yet, as we noted earlier, retaining the "traditional" post-war governance system is no longer an option, since it has been severely weakened by the demise of the role of the main bank, unwinding of cross-shareholdings, changes in accounting standards and increased investment by foreigners.

It is interesting to note that Japan is now using poison pills much more to ward off hostile takeover bids (an undesirable development), whereas it does not have the huge problems associated with perceived excessive director remuneration as its directors are not paid the vast multiples of the salary of the ordinary employees as this would be considered culturally unacceptable.

In 2008, the Asian Corporate Governance Association (ACGA) published its 'White Paper on Corporate Governance in Japan'. It states, While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large in three ways:

- By not providing for adequate supervision of corporate strategy;
- By protecting management from the discipline of the market, thus rendering the development of a healthy and efficient market in corporate control all but impossible;



- By failing to provide the returns that are vitally necessary to protect Japan's soda!safety net-its pension system.

It then advocates six areas for improvement: shareholders acting as owners; utilizing capital efficiently; independent supervision of management; pre-emption rights; poison pills and takeover defences; shareholder meetings and voting.

## 9.6 CORPORATE GOVERNANCE IN INDIA

Following on from a period of economic downturn and social unrest in 1990-1, the Indian Government introduced a programme of reforms to open up the economy and encourage greater reliance on market mechanisms and less reliance on government. Further reforms were aimed at making the public sector more efficient and divestment of government holdings was initiated. There were also reforms to the banking sector to bring it into line with international norms, and to the securities market, with the Securities and Exchange Board of India (SEBI) becoming the regulator of the securities market.

The securities market was transformed as disclosure requirements were brought in to help protect's shareholders interest. Kar (2001) mentions how 'foreign portfolio investment was permitted in india since 1992 and foreign institutional investors also begun to play an important role in the institutionalization of the market'. All the reforms above led to a much improved environment in which Corporate Governance was able to develop.

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India has a range of business forms, including public limited companies, which are listed on the stock exchange, domestic private companies and foreign companies. Ownership data is difficult to find because the number of studies carried out in this area is few, however it is clear that, as the economy has opened up, so the institutional investors are increasing their share of the market.

The confederation of indian industries published a *Desirable Corporate Governance in India -A Code* in 1998 and a number of forward-looking companies took its recommendations on board However, many companies still had poor governance practices, which led to concerns about their financial reporting practices, their accountability, and ultimately to losses being suffered by investors, and the resultant loss of confidence that this caused.

SEBI formally established the Committee on Corporate Governance in May 1999, chaired by Shri Kumar Mangalam Birla. The *Report of the Kumar Mangalam Birla Committee on Corporate Governance* (hereinafter the report) was published in 2000.

The Report emphasizes the importance of corporate governance to future growth of the capital market and the economy. Three key aspects underlying corporate governance are defined as accountability, -transparency, and equality of treatment for all stakeholders.

**Table 13.2** Summary of key characteristics influencing Indian Corporate Governance

Feature	Key characteristic
Main business form	Public limited company
Predominant ownership structure	Corporate bodies; families; but institutional investors' ownership increasing
Legal system	common law
Board structure	Unitary
important aspect	some aspects of the code are mandatory recommendations

The impact of corporate governance on both shareholders and stakeholders is mentioned, although the corporate objective is seen as one of maximizing shareholder value, and indeed the Committee views the fundamental objective of Corporate Governance as 'enhancement of shareholder value, keeping in view the interests of other stakeholders'. The Committee feels that companies should see the Code as 'a way of life'. The recommendations apply to all listed private and public sector companies, and are split into mandatory requirements (ones that the committee sees as essential for effective corporate governance) enforceable via the listing rules.

In January 2013, the Securities and Exchange Board of India (SEBI) had released its 'Consultative Paper on Review of Corporate Governance Norms in India' to align the existing corporate governance norms in India with the then existing Companies Bill, 2012 and other international practices. Consequent to the enactment of the Companies Act, 2013 ('the Act'), the SEBI Board has on 13 February 2014, approved the proposals to amend the corporate governance norms for listed companies in India. The amendments shall be applicable to all listed companies with effect from 1 October 2014.

### Applicability of Clause 49

The Clause 49 of the Listing Agreement shall be applicable to all companies whose equity shares are listed on a recognized stock exchange. However, compliance with the provisions of Clause 49 shall not be mandatory, for the time being, in respect of the following class of companies:

- (a) Companies having paid up equity share capital not exceeding ₹10 crore and Net Worth not exceeding ₹25 crore, as on the last day of the previous financial year;

Provided that where the provisions of Clause 49 becomes applicable to a company at a later date, such company shall comply with the requirements of Clause 49 within six months from the date on which the provisions became applicable to the company.

- (b) Companies whose equity share capital is listed exclusively on the SME and SME-ITP Platforms.

The company agrees to comply with the provisions of Clause 49 which shall be implemented in a manner so as to achieve the objectives of the principles as mentioned below. In case of any ambiguity, the said provisions shall be interpreted and applied in alignment with the principles.

#### A. The Rights of Shareholders

The company should seek to protect and facilitate the exercise of shareholders' rights. The company should provide adequate and timely information to shareholders. The company should ensure equitable treatment of all shareholders, including minority and foreign shareholders.

#### B. Role of stakeholders in Corporate Governance

The company should recognise the rights of stakeholders and encourage cooperation between company and the stakeholders.



### **C. Disclosure and transparency**

The company should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company.

### **D. Responsibilities of the Board**

Members of the Board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the company.

The Board and top management should conduct themselves so as to meet the expectations of operational transparency to stakeholders while at the same time maintaining confidentiality of information in order to foster a culture for good decision-making.

### **E. Composition of Board**

The Board of Directors of the company shall have an optimum combination of executive and non-executive directors with at least one woman director and not less than fifty percent of the Board of Directors comprising non-executive directors.

Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case the company does not have a regular non-executive Chairman, at least half of the Board should comprise independent directors.

Provided that where the regular non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the company shall consist of independent directors.

### **F. Independent Directors**

For the purpose of the clause A, the expression 'independent director' shall mean a non-executive director, other than a nominee director of the company:

- (a) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
- (b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;  
(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
- (c) apart from receiving director's remuneration, has or had no material pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
- (d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

### **G. Limit on number of directorships**

A person shall not serve as an independent director in more than seven listed companies. Further, any person who is serving as a whole time director in any listed company shall serve as an independent director in not more than three listed companies.

### **H. Maximum tenure of Independent Directors**

The maximum tenure of Independent Directors shall be in accordance with the Companies Act, 2013 and clarifications/circulars issued by the Ministry of Corporate Affairs, in this regard, from time to time.

### **I. Non-executive Directors' compensation and disclosures**

All fees / compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government.

Provided further that independent directors shall not be entitled to any stock option.

### **J. Audit Committee**

#### **(i) . Qualified and Independent Audit Committee**

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.
2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
3. The Chairman of the Audit Committee shall be an independent director;
4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
5. The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
6. The Company Secretary shall act as the secretary to the committee.

#### **(ii) Meeting of Audit Committee**

The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

#### **(iii) Powers of Audit Committee**

The Audit Committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

#### **(iv) Role of Audit Committee**

The role of the Audit Committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;



2. Recommendation for appointment, remuneration and terms of appointment of auditors of the company;
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors;
4. Reviewing, with the management, the annual financial statements and auditor's report thereon before submission to the board for approval, with particular reference to:
  - (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013
  - (b) Changes, if any, in accounting policies and practices and reasons for the same
  - (c) Major accounting entries involving estimates based on the exercise of judgment by management
  - (d) Significant adjustments made in the financial statements arising out of audit findings
  - (e) Compliance with listing and other legal requirements relating to financial statements
  - (f) Disclosure of any related party transactions
  - (g) Qualifications in the draft audit report
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval;
6. Reviewing, with the management, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;

#### **K. Nomination and Remuneration Committee**

The company through its Board of Directors shall constitute the nomination and remuneration committee which shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. Chairman of the committee shall be an independent director.

Provided that the chairperson of the company (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such Committee.

#### **L. Subsidiary Companies**

At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non-listed Indian subsidiary company.

The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

#### **M. Related Party Transactions**

A related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.

For the purpose of Clause 49 (VII), an entity shall be considered as related to the company if:

- (i) such entity is a related party under Section 2(76) of the Companies Act, 2013; or

- (ii) such entity is a related party under the applicable accounting standards.

#### **N. Disclosures**

Disclosure relating to –

- A. Related Party Transactions
- B. Disclosure of Accounting Treatment
- C. Remuneration of Directors
- D. Management
- E. Shareholders
- F. Proceeds from public issues, rights issue, preferential issues, etc.

#### **O. CEO/CFO certification**

The CEO or the Managing Director or manager or in their absence, a Whole Time Director appointed in terms of Companies Act, 2013 and the CFO shall certify to the Board that:

- (i) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :
  - 1. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
  - 2. these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
- (ii) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.
- (iii) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- (iv) They have indicated to the auditors and the Audit committee:
  - 1. significant changes in internal control over financial reporting during the year;
  - 2. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
  - 3. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

#### **P. Report on Corporate Governance**

There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in **Annexure - XII to the Listing Agreement** and list of non-mandatory requirements is given in **Annexure - XIII to the Listing Agreement**.

The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in **Annexure – XI to the Listing Agreement**. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.



## Q. Compliance

The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

The non-mandatory requirements given in **Annexure - XIII to the Listing Agreement** may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

### 9.7 CORPORATE GOVERNANCE IN USA

#### **“The world moves forward on the character of good men” —Rev. Edmund A. Walsh. S. J.**

The period between thursday, august 2, 2012 and saturday, august 4, 2012 was an auspicious time in the practice of internal auditing in Ghana. during that time, The Institute of Internal Auditors (Ghana), hosted Mr. Philip tarling, the 2012-2013 Global chairman of the institute of internal auditors (iia) worldwide, the first by a Global Chairman. During his visit, Mr. Tarling delivered a public lecture at the British Council Hall, Accra, on the topic “Expanding the Frontiers of Internal auditing – A perspective from the Global Chairman”. He also held sessions with key stakeholders of the profession in the country including chief executive officers, their chief internal auditors and IIA representatives from the West African Institutes. A presidential dinner was held in his honour.

The Institute of Internal Auditors is the global body for the internal audit profession. Established in 1941, The Institute of Internal Auditors (IIA) is an international professional association with global headquarters in altamonte springs, Florida, USA. The IIA is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security. Historians have traced the roots of internal auditing to ancient times, as merchants verified receipts for grain brought to market. The real growth of the profession occurred in the 19th and 20th centuries with the expansion of corporate business. Demand grew for systems of control in companies conducting operations in many locations and employing thousands of people. Traditionally, internal auditing has been concerned with accounting and financial activities. Historically, internal auditing emerged to satisfy some well defined management needs in the areas of accounting and financial matters. Management needed to satisfy itself whether:

- (a) The assets of the entity were properly protected;
- (b) The policies of the entity were being complied with;
- (c) Financial records were accurate and reliable.

Additionally, prevention and detection of fraud was a major focus of management. In that environment, the internal auditor was a financially oriented person with limited responsibility in the management process. He was seen more as a policeman and a checker and less as a co-worker. Internal auditing was also seen as an extension of external auditing.

The role of the internal auditor has been changing greatly over a period of time, leading to a greater reliance on him by management and the expansion of the internal audit function. This has resulted from the complexity of modern day businesses which are taking the form of multiple multi-national business units as well as the additional demands on management from various stakeholders. Competition dictates that organizations should be managed more effectively and efficiently if they are to survive and achieve growth. There is the need to optimize business performance and obtain

operational excellence through greater effectiveness and efficiency. Cost reduction schemes must be implemented. Introduction of information technology into business operations have also brought its own challenges. There is therefore the need for greater protection against inefficiency, misconduct and fraudulent and illegal practices. Along the line, the realization dawned that the internal auditor could play an enhanced role in offering expanded protection all the new challenges facing management have therefore dictated the changing role of the internal auditing. Modern internal auditing today reflects two broad roles: assurance and consulting. Today, internal auditing has moved from the more routine compliance level when it used to be integrated with regular accounting activities where it was carried out entirely or substantially only in the strictly financial areas to higher levels in all operational areas of management where it has established itself as a valued and respected part of top management practice. Apart from compliance reviews and analysis of financial information, the modern internal auditor performs other functions as the examination and assessment of risk management, emerging technologies, and global issues.

The year 1941 marked a major turning point. Victor Z. Brink authored the first major book on internal auditing. And at the same time, John B. Thurston, internal auditor for the North American Company in New York, had been contemplating establishing an organization for internal auditors. He and Robert B. Milne had served together on an internal auditing subcommittee formed jointly by the Edison Electric Institute and the American Gas Association, and they agreed that further progress in bringing internal auditing to its proper level of recognition would be best made possible by forming an independent organization for internal auditors. When Brink's book came to the attention of Thurston, the three men got together and found they had a mutual interest in furthering the role of internal auditing.

As an organizing committee, Brink, Milne, Thurston, contacted a small group of internal audit practitioners throughout the United States who expressed interest in forming a national – even international – organization for internal auditors. The IIA's certificate of incorporation was filed on November 17, 1941, and just prior to the first annual meeting on December 9, 1941, the Williams Club located at 24 East 39th Street in New York City, 24 charter members were accepted for membership. Thurston was elected as the first president of The IIA. Membership grew quickly. It went from the original 24 members to 104 by the end of the first year, to 1,018 at the end of five years. By 1957, membership had expanded to 3,700 and 20 percent were located outside of the United States. More than 70 years later, the IIA is a dynamic global organization with more than 175,000 members worldwide. Today, many people associate the genesis of modern internal auditing with the establishment of the IIA.

The Institute of Internal Auditors (Ghana) was formally registered in April 2001 in Ghana under the Professional Bodies Registration Decree, 1973 (NRCD 143) as a professional association dedicated to the promotion and development of the practice of internal auditing in Ghana. The institute was formally inaugurated on Friday, May 13, 2005 by the then Hon. Minister of Finance & Economic Planning on behalf of His Excellency the President of the Republic of Ghana. The IIA (Ghana) is a full-fledged member institute of the Global Internal Audit family. It also actively pursues collaboration and partnership with sister national institutes, particularly the African institutes. IIA Ghana is a founding member of AFIIA – the African Federation of Institutes of Internal Audit, and currently represents West Africa on its governing council.

IIA Ghana is governed by a nine-member council supported by the immediate Past-President of the Institute who is an ex-officio member. The present Council (2011-2012) comprising the following members, was elected in February 2011 and will serve until the 2012 annual General Meeting, which will be held in February 2013:

- (a) Eric N. Yankah (**President**);
- (b) Richard Ntim (**Vice President**);
- (c) Juliet Aboagye-Wiafe (Mrs.);
- (d) Thomas M. Atuam;
- (e) Elsie Bunyan (Mrs.);



- (f) Leonard B.L. Donkoh;
- (g) Rebecca a. Lomo (Ms.)
- (h) Kofi Okofo-Dartey;
- (i) Daniel Kwame Opare;
- (j) John Djanie (**Immediate Past President**)

### **BY Kwame Gyasi**

On November 16, 2012, Institutional Shareholder Services Inc. (“ISS”) released the 2013 Updates to its U.S. **Corporate Governance** Policy (the “2013 Updates”). The 2013 Updates will be effective for shareholder meetings on or after February 1, 2013, unless otherwise noted below.

### **Issues affecting advisory votes on executive compensation**

Investors continue to rank executive compensation as the top **corporate governance** topic. the 2013 Updates to the pay-for-performance evaluation undertaken in advance of an advisory “say-on-pay” vote on executive compensation refine how the subject companies’ peer groups are selected, adjusting the criteria in an effort to include within the relevant peer group companies that have more in common with the subject company. The 2013 Updates also add the concept of “realizable pay” to the qualitative analysis for large cap companies.

### **Peer Groups**

The 2013 Updates generally retain the methodology used by iss in 2012 to evaluate a say-on-pay proposal, utilizing both a quantitative and qualitative analysis to assess the alignment between pay and performance and determine the recommendation of iss on the proposal. As part of the quantitative analysis, the previous methodology focused the selection of a peer group on the subject company’s Global Industry Classification Standard (“GICS”) industry group. The GICS classification, however, does not always capture the multiple business lines in which a company operates, which may lead to the omission of direct competitors from a company’s peer group or the inclusion of companies without much relation to the business of the subject company.

The 2013 Updates expand the scope of companies selected for a peer group. Instead of relying on only the company’s GICS classification, the 2013 Updates provide for use of the peers from the subject company’s GICS group as well as from GICS industry groups represented in the peer group the company has self-selected in benchmarking its executive compensation, while maintaining approximate proportions of these industries in the final peer group. The new methodology additionally focuses initially at an 8-digit GICS level rather than more specific levels, to be better aligned in terms of industry. ISS will prioritize for inclusion peers that (a) maintain the subject company near the median of the peer group in revenue/asset size, (b) are in the subject company’s peer group and (c) have chosen the subject company as a peer. iss’ selection criteria will continue to focus on companies that are reasonably similar in industry profile, size and capitalization.

Other changes to the peer group methodology include using slightly relaxed size requirements, especially at very small and very large companies, and using revenue instead of assets for certain financial companies.

### **Realizable Pay**

The 2013 Updates expand the list of qualitative factors used to analyze pay-for-performance alignment at large cap companies to include “realizable pay”, which may ultimately mitigate or exacerbate pay-for-performance concerns. While the grant date pay disclosed in a company’s summary compensation Table reflects the intent of the Compensation Committee’s pay decisions, it does not necessarily reflect the final payouts of performance awards or changes in value due to gains or losses in the subject company’s stock price.

Realizable pay will consist of the sum of relevant cash and equity-based grants and awards made during the specific performance period being measured, based on equity award values for actual

earned awards, or target values for ongoing awards, calculated using the stock price at the end of the performance measurement period. Stock options and SARs will be re-valued using the remaining term and updated assumptions, as of the performance period, using the Black-Scholes option pricing model.

### **Golden Parachute Proposals**

The Dodd-Frank Act requires companies to hold separate shareholder votes on potential "golden parachute" payments when they seek approval for mergers, sales and certain other transactions. In determining the recommendation with respect to a golden parachute proposal, the 2013 Updates include the consideration of any existing change-in-control arrangements maintained with named executive officers, rather than focusing only on the new or extended arrangements. The list of features considered problematic has been refined. Recent amendments that incorporate problematic features will tend to carry more weight in the overall analysis. However, close scrutiny will also be given if multiple legacy problematic features are present.

### **Issues affecting votes on Director Nominees in Uncontested elections**

#### **Hedging and Pledging**

current iss policy provides for the recommendation of a negative vote for directors, whether individually or as part of a committee or the entire board, due to material failures of risk oversight at the company. The 2013 Updates expand the examples of a failure of "risk oversight" to include, among other things, the hedging of company stock and the significant pledging of company stock as collateral for a loan.

These practices are seen as severing the alignment of interests between the officers and directors and the shareholders. Hedging of company stock at any level and in any form poses enough of a problem to warrant a negative vote recommendation. For companies in which officers or directors have pledged company stock as collateral, ISS considers the following factors in determining vote recommendations for the election of directors:

- Presence in the company's proxy statement of an anti-pledging policy that prohibits future pledging activity;
- Magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume;
- Disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time;
- Disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock; and
- Any other relevant factors.

### **Majority Supported Shareholder Proposals**

As the expectations of institutional investors, and the responsiveness of issuers, regarding majority supported shareholder proposals continue to advance, ISS has adjusted its policies accordingly. Beginning with board elections in 2014, ISS will recommend a negative vote on individual directors, committee members or the entire board, as appropriate, when the board has failed to take sufficient action on a shareholder proposal that received the support of a majority of the shares cast on such proposal in the previous year.

The 2013 Updates allow for greater flexibility in recommending a vote against only certain board members, rather than the full board. The 2013 Updates also provide more guidance for evaluating the sufficiency of a company's response to a majority supported shareholder proposal. Responses that involve less than full implementation of the proposal will be evaluated on a case-by-case basis, considering the following the factors:

- The subject matter of the proposal;



- The level of support and opposition provided to the resolution in past meetings;
- Disclosed outreach efforts by the board to shareholders in the wake of the vote;
- Actions taken by the board in response to its engagement with shareholders;
- The continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and
- Other factors as appropriate.

The revised FAQs to be issued by ISS in December may provide more guidance with respect to the implementation evaluation.

### **Overboarded Directors**

Current ISS policy recommends a negative vote on directors who are CEOs of other public companies and sit on board of more than two public companies besides their own – with the withhold recommendation only covering their outside boards. The 2013 Updates eliminate the previous exception that counted the boards of a public company parent and its public company subsidiary as a single board so long

As the parent owned at least 20% of the subsidiary. The 2013 Updates now count these parent and subsidiary boards as two separate boards.

### **Shareholder Proposals Addressing Social and Environmental Issues**

#### **Environmental, Social, and Governance Compensation-Related Proposals**

The 2013 Updates modify ISS policy from generally recommending a vote against to making a vote recommendation on a case-by-case basis with respect to proposals that link executive compensation to sustainability criteria, including various environmental and social criteria. As these non-financial performance metrics become more common among certain industries, specifically the extractive industry sectors, and are increasingly addressed in international investor initiatives, the 2013 Updates recognize the increasing interest of institutional investors in sustainability issues as part of the evaluation process.

### **Lobbying**

The 2013 Updates provide for vote recommendations on a case-by-case basis when evaluating proposals requesting information on a company's lobbying activities. The 2013 Updates clarify the scope and focus of lobbying activities covered, adding indirect lobbying activities as well as lobbying procedures and principles to the list that previously included only direct lobbying and grassroots lobbying within the specific policy.

New corporate legislation comes into effect in the Netherlands on 1 October 2012 and 1 January 2013. It is important to be aware of this as it concerns, amongst other things, **Corporate Governance** issues.

The new management and supervision act (including the one tier board)

As of 1 January 2013 there will be a new **Corporate Governance** and supervision act. It affects public companies ("NVs") and private companies with limited liability ("BVs"); some clauses are also applicable to foundations.

The most important changes are:

- One tier board versus two tier board: in addition to the two tier board, the one tier board is now established. Until today, only a two tier board, with the management board and the supervisory board as a separate body, was laid down in Dutch law. This new law brings the possibility, with certain limitations, to create a board with executive management board members and non-executive (supervisory) management board members, both with their own duties. We are coming closer to the US and the UK. The one tier board differs from the two tier board in that the non-executive members in a one-tier board system are part of the management board and are therefore subject to director's liability.

- **Conflict of Interest:** the members of the management board and the supervisory board who have an (in) direct conflict of interest can no longer be part of the decision-making process regarding the underlying specific subject.
- **Composition:** for so called large entities there are new rules relating to the composition of the management and supervisory board. The number of permitted positions is limited. Furthermore, in large nvs and Bvs (and structure regimes) at least 30% of the positions on the management board and supervisory board must be held by women and at least 30% by men. This is done to stimulate the appointment of women on the company boards. It is, initially, a temporary rule (up to 1 January 2016).
- **Responsibility:** on the basis of the new legislation reference can be made to allocation of tasks in the articles of association. Although under Dutch law a division of tasks does not prejudice the joint responsibility of all members of the management board, it might under circumstances help by the so called individual exculpation possibility.
- **Employment:** management board members of listed companies will no longer be protected against dismissals or in case of illness, as the relationship between a board member and a listed company can no longer be based upon an employment agreement (but only on a management (service) agreement).

There are transitional provisions, but some clauses will apply immediately.

### **A Dutch BV is much more flexible as per 1 October 2012**

On 1 October 2012 the Flex BV act entered into force. This Flex BV act brings major changes for BVs.

Some corporate provisions have changed while other have been deleted.

Amongst other things, amendments relate to the introduction of non-voting shares, capital requirements, the appointment of directors and supervisory board members, distributions, capital reduction, repurchase, vacancy of managing directors, financial assistance and convening general meetings.

The new legislation applies to all Bv's as of 1 october 2012.

### **Conclusion**

Please review the current articles and decision making arrangements of your Dutch BV/NV in light of the possible consequences, and consider bringing the articles of association in line with new (coming) dutch law.

## **9.8 CORPORATE GOVERNANCE AND INTERNAL AUDITORS**

### **9.8.1 Internal Audit/Cost Audit**

The subject matter of cost audit can never be studied independently of the cost accounting framework. The evolution of cost management domain in our country can be traced to four stages in brief:

- (i) The first stage was the decade of 1950 and 1950s :This was the period of setting up of industrial activities and cost plus regime. The genesis was the demand for very many products for which the government administrated Fair Prices. This was the time when the the Bureau of industrial costs and Prices(Now-known as Tariff Commission) was set up by the government. The ICAI itself came into being during this time. In the matter of fixation of administrative prices the Governemnt was adviced by the the then Bureau of Industrial Costs and prices(BICP) now the role of BICP is taken over by the Tariff commission and the National Pharmaceutical Pricing Authority(NPPA since 1997 for advicisng the Government in fixation of prices of Bulk drugs and their formulations )
- (ii) The second stage was between of 1970 and 1985s :The period between 1970s and mid-1980s was an era of cost, volume and profit analysis, as an integral part of the cost accounting function. This was the time when the country was in sellers' market.

- (iii) The third stage was between of 1985 and 1990s :During the period between mid-1980s, the concept of Zero Based Budgeting, Capacity Utilisation and Product Profitability gained importance with the onset of global competition. This was also a period when the quality movement started gaining momentum with an entirely structured methodology departing from a quality control syndrome to a quality management paradigm.
- (iv) The fourth stage is since 1991: The period starting from early 1990s onwards witnessed the dawn of an era of liberalization and global competition in the strictest sense. This brought in the necessity to move towards market-driven prices, where the end price was determined by the customer in the domestic and international markets.

The now well-known target costing became the mantra in business and industry in the domestic as well as international markets. The full impact of global competition came into play during this period and what we find today is that the entire business activity revolves around cost, quality and delivery – be it manufactured goods or services. the country is already on its mission of restructuring on the above parameters for being on world class wavelength.

### **9.8.2 COST AUDIT METHODOLOGY**

The cost audit methodology as structured originally under section 233B of the bill has the following two perspectives:

- The attestation of cost structure
- The efficiency review perspective, which is more methodology driven.

In a period of price control and administered interventions attested cost structure had a major role to play and hence the attestation perspective got the emphasis. The profession had to play a major role of verifying and validating the cost figures in the selected industries before they were submitted to the government. The efficiency review was relatively less emphasized and, therefore, did not receive much impetus in the form of new auditing techniques and methodology. We now need to develop a new vision and strategy for cost audit mechanism.

With the economy moving away from being a centrally controlled model to competitive, relatively free market model, the role of cost quality and timely delivery have become the basis for survival. The role of efficiency review from angles of quality, cost and delivery has assumed utmost importance today.

The concept of corporate governance, which has been attracting a lot of hype and public attention these days is nothing new and quite a few of the progressive firms even in our country have voluntarily been practicing good corporate governance. SEBI has enlisted the services of CRISIL and ICRA for retaining good corporate governance.

Desirable corporate governance and practices need legal support as well as evolution of internal standards-where the more progressive elements and the corporate sector design best practices that are constantly updated to complement and enhance legal provisions. Nations that have good corporate practices do not rely exclusively upon law. Conversely, those with poor records have never evolved internal codes of best practice. The question before us now is as to how the objectives of cost audit can be revisited to suit Corporate Governance and evolves related practices with or without the required legal support.

### **9.8.3 Internal Audit for Governance**

Traditionally, the expression, 'internal audit' refers to an audit conducted on behalf of the management to ensure that the existing internal controls are adequate and effective; the financial accounting and other records and reports show results of actual operations accurately and promptly; and each unit of the organization follows the policies and procedures as laid down by the top management. Thus, during initial stages, the internal auditor's significant emphasis was on detection of errors and frauds focussed on financial aspects of the enterprise.

Over a period of time, the participation in non-financial areas increased rapidly since the business scene was changing very fast. Pressure on the managements was building up due to enormous growth of organisations in size and operations. The complexity of business activities and voluminous transactions led to increasing dependence on large number of people. It was in this context that the management recognised the possibility of utilising the services of internal audit department in a much more effective manner, and this was possible with only a little extra expenditure. It was strongly felt that the expertise built by the internal auditor in financial operations should be equally useful for non-financial operation of the enterprise as well. This is how in the expression given in the question all three words viz. "accounting", "financial" and "other operations" stand on equal importance. The Statement of Responsibilities of Internal Auditor issued in 1971 by the Institute of Internal Auditors, USA cut the umbilical cord to the books of account and simply defined internal auditing as, Internal auditing is, "the review of operations as a service to management". With this revision of definition, it was made clear that accounting activity is also one of the operational areas of the entity like production, research and development, personnel, marketing, etc. In 1981, the definition was modified as under:

"Internal auditing is an independent appraisal function established within the organization to examine and evaluate its activities as a service to the organisation. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls."

With this, internal auditing came to be recognised as a management resource- an important part of the total internal control system for which management is primary responsible. Today, the total range of services rendered by the internal auditor covers both protective needs and constructive needs stressing on performance and operations. Specifically, the range of activities as outlined in the Statement of Responsibilities of Internal Auditors is as follows:

- (i) Reviewing and appraising the soundness, adequacy and application of accounting, financial, and other operating controls, and promoting effective control at reasonable cost.
- (ii) Ascertaining the extent of compliance with established policies, plans and procedures.
- (iii) Ascertaining the extent to which company's assets are accounted for and safeguarded from losses of all kinds.
- (iv) Ascertaining the reliability of management data developed within the organisation.
- (v) appraising the quality of performance in carrying out assigned responsibilities.
- (vi) Recommending operating improvements.

A close examination of those services help us in identification of primary protective services viz second, third and fourth, and those that are primarily directed to further improvement in operations (i.e. the first, fifth, and sixth).

The modern concept of internal auditing suggests that internal auditing need not be confined to financial transactions and that its scope may be extended to the task of reviewing whether the resource utilisation of the enterprise is efficient and economically. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of management. In this sense, the internal auditor performs what is known as 'Operational audit' or 'Management audit'. Thus, the expression makes it clear that the scope of activities of internal auditor is not restricted to financial areas but extends to non-financial areas as well.

(Note: Recently, the Institute of Internal Auditors itself has revised the definition of Internal Auditing. The revised definition is:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process).

#### **9.8.4 Compliance Procedures and Evaluation of Internal Controls:**

AAS-1 on “Basic Principles Governing an Audit” states that, “the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are well in place and effective. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions :

Existence - that the internal control exists.

Effectiveness - that the internal control is operating effectively.

continuity - that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures in the form of test checking, walk through of records and procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures. It may be noted that assessment of the Internal Control system is a pre-requisite for an auditor before formulating his audit programme and strategy. The extent of audit checking and audit strategy depends upon the health of Internal control system. If the Internal Control system established in an organisation is sound the Auditor can take the calculated risk of test checked audit instead of in-depth audit strategy in respect of areas where the internal control system is strong and concentrate more time and efforts on other vulnerable areas where evidence of strong internal control systems are lacking. A auditor drawing his audit plan and strategy without assessing the health of internal control system runs the risk of non-detection of non-compliance areas.

#### **9.8.5 Nature of Internal Auditing**

The Institute of Internal Auditors has defined Internal Audit as - Internal Auditing is an independent appraisal activity within an organization for the review of operations as a service to management. It is a managerial control which functions by measuring the effectiveness of other control.

There are various definitions of Internal Auditing prevailing, which can be stated as follows:-

1. Internal audit is a management tool, performed by employees of the organization to ensure correctness in accounting data and to detect fraud by way of periodical review of organizational system and procedures.
2. Internal audit is a continuous and systematic process of examining and reporting the operations and records of a concern by its employees or external agencies specially assigned for this purpose. It is, in essence, auditing for the management and its scope may vary depending upon the nature and size of the concern.
3. It is a control system concerned with examination and appraisal of other control mechanisms.
4. Internal audit is an extension of and as such is complimentary to statutory audit.

In short internal audit means appraisal of control techniques employed by a firm and its performance.

#### **9.8.5.1 Necessity of Internal audit to Management**

Internal Audit has become an important management tool for the following reasons :-

1. It ensures compliance of companies (auditors report) order 2003.
2. Internal Auditing is a specialized service to look into the standards of efficiency of business operation.
3. Internal auditing can evaluate various problems independently in terms of overall management control and suggest improvement.
4. Internal audit's independent appraisal and review can ensure the reliability and promptness of MIS and the management reporting on the basis of which the top management can take firm decisions.
5. Internal Audit system makes sure the internal control system including accounting control system in an organization is effective.
6. Internal Audit ensures the adequacy, reliability and accuracy of financial and operational data by conducting appraisal and review from an independent angle.
7. Internal Audit is an integral part of "Management by System".
8. Internal Audit can break through the power ego and personality factors and possible conflicts of interest within the organization.
9. It ensures compliance of accounting procedures and accounting policies.
10. Internal auditor can be of valuable assistance to management in acquiring new business, in promoting new products and in launching new projects for expansion or diversification of business.

#### **9.8.5.2 Scope of Internal auditing**

The Institute of Internal Auditors defines scope of internal auditing as "The examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance.

Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance.

According to The Institute of Internal Auditors, internal audit involves five areas of operations, which can be discussed as follows :-

- (a) Reliability and Integrity of Financial and operating Information:** Internal Auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.
- (b) Economical and Efficient Use of Resources:** Internal auditor should ensure the economic and efficient use of resources available.



- (c) **Compliance with Laws, Policies, Plans, Procedures, regulations:** Internal auditor should review the systems established to ensure compliance with those policies, plans and procedures, law and regulations which could have a significant impact on operations and should determine whether the organization is in compliance thereof.
- (d) **Accomplishment of established Goals for operations:** Internal auditor should review operations, programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.
- (e) **Safeguarding of assets:** Internal auditor should verify the existence of assets and should review means of safeguarding assets. The business transactions of an organization may be broadly divided into phases.
1. **Planning stage:** It usually culminates in an authorization from the appropriate level of management in the organization. At this stage, the decisions are issues like whether or not to make or buy, whether or not to undertake a new project or export etc. These are more of managerial decisions and the scope of internal audit is often not much practical, in the initial stage unless it takes to what is called management audit.
  2. **Execution Stage:** This stage is the stage of recording in the various books of accounts, which only for correctness and classification of expenditure under the same heads as those mentioned in the project report. At this stage the scope of internal audit emerges out of need for correctness of accounts and proper classifications of heads in a designed manner.
  3. **Reviewing Stage :** The third and final stage deal with reviewing the transaction and here internal audit is intimately concerned. At this stage internal audit embraces the following main functions :-
    - (a) Scrutiny of the records of an undertaking to assess the reliability of the information contained therein.
    - (b) Examination of the documentary evidence from which the records are written up.
    - (c) Detection and prevention of error and fraud
    - (d) A general examination of the financial statements prepared from the records to ascertain whether a true and fair view has been given about the financial position at a specific date.

Internal auditing therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the Books of Accounts but also with appraisal of procedure with a view to effecting change for better efficiency, where possible.

A proper organizational status for the internal auditing department ensures its relative independence so that it can carry out its work freely and objectively and render impartial and unbiased reporting. The functions,

Responsibilities and authority of the Internal Auditing Department should be clearly and specifically laid down in a written document. the chief internal auditor should have a direct communication with the Board of directors, or CEO.

He should submit periodic reports to the Board highlighting the various significant audit findings.

### 9.8.5.3 Internal Auditing Function

It is an accepted fact that internal auditing function to be effective, must be independent of the activities to be audited. For this, internal audit department must have some accepted standing in the organization. But it cannot be a fully independent department for obvious reasons. total independence would be as elusive as a perfect vacuum. Complete independence would imply freedom from all types of dependency including financial dependency. Hence as long as Internal Audit Department would remain a part of the organization and receives its life blood from the enterprise, it must forgo some independence. A compromising situation is, therefore, desirable. the department must have the greatest amount of practical independence in the real world situation to protect it from having to

compromise with audit objectives. The necessity of the practical independence is being recognized more and more by the modern business concerns and the percentage of firms where the auditing organization reporting to vice-president/the board is on the increase. A very convenient agreement would be auditing organization answerable to an officer whose own status would be sufficiently high to enable him to consider the internal audit report and taken action on the audit recommendations. Preferably such officer should be a member of a Board's Auditing Committee.

The role of internal auditor is in the process of being properly recognized. the growing size, technological advancement and the complexities in running an organization has made it imperative on the part of the progressive management to recognize and utilize the services of the internal auditor as a tool of management control. Many of the constraints and bottlenecks in proper management of business can be overcome through the constant appraisal and review of the operations with the help of the internal auditor.

The auditor's role should be defined in the written document to be approved by the management and The Board of directors. such a documentation should include, *inter alia*, the following vital aspects :-

- (a) Organisational status and position to be indicated in the organization chart.
- (b) Defining the scope of internal audit operations.
- (c) Authorise the internal audit department to have access to all records, personnel and properties.
- (d) A declaration to be known to all personnel in the organization at all levels, for their cooperation and coordination for all activities of internal audit operation. at times there is an uneasy feeling that the internal auditor is an interloper, reporting to management of the inefficiencies or deficiencies of the departments audited by him. The internal auditor a helping tool to management in prompting efficiency and cost reduction and hence, if he cannot drive away the resentment and/or criticism of others, the purpose of audit may get frustrated. In fact the internal auditor has to get cooperation from employees of other departments, who have to sincerely believe in his honesty of purpose. the internal auditor should be placed in such a status in the organizational set up so that he can be an effective instrument of management control process.

We often remark, the tree is known by the fruits it yields. Internal audit department by virtue of its important position, have access to all books and records. If like a professional doctor, the department can ascertain the ill health of the organization related through various area of inefficiency and can suggest medicine-like tips in the form of recommendations, which give positive result, the status of the department is bound to go high, and the CIA would definitely occupy a key position in the management team.

The chief of internal auditor should submit annually to management for approval and to the Board for its information a summary of the department's audit work schedule, staffing plan, and financial budget. He should also submit all significant interim changes for approval and information.

The chief of internal auditing should submit activity reports to management and to the Board annually or more frequently and recommendations and should inform management and the Board of any significant deviations from approved audit work schedules, staffing plans and financial budgets, and the reasons for them.

#### **9.8.5.4 Planning and Process of the Internal Audit Project**

The advantages and disadvantages of a standard audit project is a subject of continuous debate amongst Internal Auditors. No planned audit project can be totally applicable without any variation in accounting procedures that are found, in an organization even if there exists a reasonable measure of standardization.

However, it has been experienced that in a well established organization where system of internal checks are adequate, the most effective auditing can be conducted by apportionment of audit time approximately 2/3rd. over a Standard Internal Audit Programme adopted to local circumstances and

1/3rd to whose accounting features that appear to auditor the merit of special audit attention.

The advantages of a standard project are as follows :-

1. It provides the internal audit staff, a framework for his activities in logical sequence.
2. It indicates lesser test checking which is necessary on the assumption that the internal check system is adequate.
3. It is of a big help and support to the external auditor who chalks out his own audit programme auditable avoiding duplication area.
4. It enables a balanced audit to be achieved at each accounting point, also in the entire organization.
5. It also guides the Internal Auditor on the subject of recommendations.

It must be remembered that planning the audit project is mental process but a planned audit project is not a substitute for thinking.

### **Audit Programme**

An audit Programme is a detailed plan of audit assignment to be completed, specifying the methods and procedures to be followed for completing the work of vouching and verification satisfactorily by available staff within stipulated period of time audit Programme is nothing but a plan or programme prepared by auditor for completion of audit specifying the responsibilities of each staff.

In short, before the work of an audit commenced, the auditor should chalkout a programme as to what work is to be done by his assistants and by himself and the time by which the work is to be finished. Audit Programme is a guideline to the internal auditor wherein he wishes out for himself his strategies i.e. how to go about the audit work he is going to perform. The Audit Programme serves as a guide in developing the appraisal and review techniques suitable to meet the organizational objectives and results expected by the top management.

Because of the organizational objectives and results expected by the top management. Because of the usefulness it also serves as permanent comparison to indicate the lines on which management can implement and exercise overall controls.

### **Developing The audit Programme**

The auditor should prepare a written audit programme, setting for the procedures that are needed to implement the audit plan. The programme may also contain the audit objective for each and should have sufficient under standing to control the proper execution of the work. In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. the auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistance, and the involvement of other auditors or experts.

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

### **9.8.5.5 Audit Report**

Audit Report will be an indicator of the usefulness of the internal audit functioning in the organization.

Techniques of effective reporting

Before setting out the report writing as well as in the process of report writing the following should be the guidelines :

- Clear thinking

- To whom the report is directed
- Purpose and aim of reporting
- At what stage the report writing to start
- Pattern of presentation
- Keep the reader uppermost in mind
- Translate technical matters to layman's language
- To visualize the reader's viewpoint
- Unbiased approach
- To mention the view point of the auditee
- Impact of the report or, in other words, what be the probable reaction to reporting whether action or decision will follow in quickest possible time or to be treated as of academic interest only.
- To remember the universal saying – “don't jump to conclusions”
- Facts and figures to be in proper sequences
- Cool and calm thinking to have logical and coherent presentation

Proper setting out of internal audit report can be significant if it contains complete and logically developed appraisal with ample background facts and figures. It will be heartening to note if the top management accepted the significance and importance of the internal audit report as a useful tool for future improvements.

The main factors to go into the consideration for the various ways of presentations of written reports are :-

- Nature of business of the organisation.
- Nature of subject or aspect appraised.
- For whom the report is intended.
- Purpose for which the report is prepared.
- Management attitude, directives and needs.
- Internal auditor's approach and caliber.
- Extent of emphasis on audit findings and recommendations.
- Extent of details required by auditee and management.

The usual modern trend in presentation of internal audit report is as follows :-

- Detailed report about the findings, observations and recommendation is submitted to the auditee.
- Aspects which are of minor importance do not appear in the “detailed report” but discussed with all concerned and action taken by the auditee for implementation. These aspects can take the shape of a letter form of report to record the recommendations and the implementation thereof.
- Matters of major importance and on which top management has to take action for implementation of the recommendations are reported as “highlights of the report' to top management.’”

Internal auditor convey his thought and action through discussion and reporting; internal audit reports to be effective, must comply with such fundamentals as : objectives, correctness, conciseness, clarity, courtesy, character (auditor must stand for what he believes), tact and timeliness.

An audit report should contain deficiencies, irregularities and scope for improvement as well as aspects which are efficient and effective.

One view is that the Internal audit reporting should follow the “principle of exception” i.e. the report should deal with only such aspects which are deficient and need improvements. Management cannot afford to spend time on matters which are in order.

Another view is that only reporting the deficiencies or irregularities without giving credit for aspects which are in order may damage the “selling the idea” approach or “advisory role” of the Internal auditor. This sort of reporting may even endanger the Internal audit objectives. In other words, both bad and good need to be reported otherwise the implementations of the recommendations may be adversely affected or delayed. In such a situation, it will be prudent that top management, operating management and the internal auditor must sit in a meeting to decide the pattern of internal audit reporting. In significant reporting or the highlights of the reporting should be summarized briefly at the beginning of the report separately. By explaining findings in non technical language, the Internal auditor gets better results. Many executives have developed the habit of looking for summaries of report, conclusion and recommendations in summary form which will act as a snapshot of the entire findings of the report. The report should never give an impression of uninteresting, lengthy details of tediousness. the auditor should not get too engrossed in detail. Every effort is to be made to give a concise and to-the-point appearance to the report. audit report should stimulate thought and action on the part of management and the operating personnel i.e. report is to infuse ideas to pave the road to solution of problems or inefficiencies.

### **Follow-up of audit report**

Following are the aspects to be taken into account with regard to the follow-up of the Audit Report:-

- (a) Action taken on report-implementation of recommendations ;
- (b) Difficulties faced by auditee in implementing audit recommendations ;
- (c) Importance of follow-up.

The importance and necessity of follow-up arises due to the fact that human tendencies is “resistance to change” and to delay the adoption of audit recommendations. That is why, to reap the full benefits of audit, recommendations are to be implemented without any loss of time. The sooner the recommendations are put to action the better for all in the organization. Unless the observations and recommendations are considered, the objective of appraisal is dissipated. To avoid such unhealthy tendencies, the auditor will have to close and constant follow-up so that :

1. Challenging the validity of recommendations may receive due and timely attention by the auditor.
2. If the auditee finds practical difficulties in implementing audit suggestions may come out with his facts and figures for discussion with his superiors and the internal auditor.
3. Deficiencies and lack of control measures may be rectified without putting the organization into loss monetarily or otherwise.

To ensure that the recommendations being actually put into action, the internal auditor may have to pay a visit to the department/location, which is known as “follow-up visit” if the circumstances warrant.

It must be remembered, in this connection, that the auditor does not have line authority to enforce the recommendations. hence, the auditor in the case of follow up has to act in an advisory capacity, i.e. auditor is to pursue that the recommendations are adhered to if the management so desired.

### **9.8.5.6 Summary Report To Top Management**

It may be the policy of the management to have copies of the Internal audit report in which there might be important findings. In such cases, the copy that might be endorsed to the top management should contain a summary sheet giving gist of the audit report. It should be appreciated that top people are busy and have not much time to spare to go through the detailed report. The list should highlight the conclusion and the remedial suggestions to correct the deficient conditions.

The management would then be able to get an idea of the audit findings easily with minimum loss of time. The necessary details might also be referred to from the detailed report.

Summary reports to management usually would have two distinct functions –

- (i) They would tell what the internal audit department has accomplished when compared to what was planned.
- (ii) They would show conclusions of the auditors in a summarised form.

The significant ones may be advised to be corrected immediately, leaving the less important ones for taking action a bit later.

Such report should be under distinct subheads like the following :-

- (i) Major irregularities needing immediate attention.
- (ii) routine irregularities of consequence.
- (iii) case of supervisory lapses which may result in heavy loss etc.

In the first category irregularities like non-maintenance of stock account of receipt books, meeting departmental expenditure from cash collected in violation of the instructions in this regard may be included. In the second category may come non-posting of entries to make records like stock cards etc. up to date, non-reconciliation of control accounts with the subsidiary ledger etc.

In the third category may be included absence of supervisory check in the cash books, bill register, absence of supervisory percentage checking of the suppliers/contractors bill etc.

#### **9.8.5.7 Communication in Internal Auditing**

The Dictionary meaning of the word “Communication” is correspondence – a means of communicating – a connective passage or channel. the internal auditor remains engaged in auditing various functions and report on different segments of the business organization. His audit findings are reflected in the audit report which is submitted to the departmental heads as well as to the chief internal auditor. These reports, therefore, serve as connecting channel between him and the authorities to whom such reports are submitted.

The chief internal auditor and other auditors should, therefore, be well versed in the art of communication. not only the auditors submit the report, they are also required sometimes explaining some matters included in the Audit Report – sometimes offering clarification to the recommendation made in the audit report etc.

#### **Improving The Auditor-Auditee Relationship**

It may be appreciated that for carrying out internal audit functions properly and efficiently, there should be a cordial relationship between the auditor and the auditee.

The maintenance of good relations between the two would, however, be like a two way traffic. The auditor must kept in mind that he is to sell a product viz the audit service and the customer i.e. the management must be ready to accept the product if it is of standard quality. if the management is really interested in improving the efficiency of the business operation by utilizing this important management tool “(Internal Audit)”, it must appreciate and take action on the Internal Audit Report and findings, if however, the products of audit are useful.

The internal auditor's campaign must be aggressive and dynamic. Each audit performed in traditional financial area must be thorough and sound. Each audit report should show the imprint of professional quality both in terms of form and substance. such audit report would be more useful to the management if the audit is carried out keeping in view the management's view point. It may, therefore, be said that even in the traditional, financial accounting area there is scope for improvement of the audit products.

If the Internal Audit Department can continue its effort in making the audit report more attractive, by carrying out audit keeping in view the management's requirements, the cordial relationship between



the two, that has once grown would continue providing newer scope to the internal audit department for offering better service to the management.

#### **9.8.5.8 Scope of Audit Committee**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. audit committee has a four fold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows :-

- (i) Review of annual financial statements before submission to the Board of Directors.
- (ii) Selection of the statutory auditor
- (iii) Act as lies on between the statutory auditor and Board of directors
- (iv) Administrative control of the internal control functions through the feedback between the Internal auditor and the audit committee.
- (v) Over seeing internal central operation.
- (vi) Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- (vii) Review and approval of financial information for publication
- (viii) Review proposed changes in accounting system and procedures.
- (ix) Help resolve differences between management, internal and statutory auditor.
- (x) Report on the audit committee acting in the annual reports of Board of directors. (xi) Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following :-
  - (a) Audit committee should have the independence of management, statutory auditor and internal auditor. the Board of directors allow full freedom to the audit committee to investigate into any areas of operation.
  - (b) The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
  - (c) There should be a regular line of communication through occasional meetings with the management.
  - (d) There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

#### **9.8.5.9 Internal Audit and the Investigation of Frauds**

In the minds of the public at large and of many clients, the discovery of frauds is the principal function of the auditor, overshadowing his other duties entirely, and although this is far from correct, there can be no question that it is of great importance.

Fraud may be divided broadly into two classes –

1. defalcation, involving either misappropriation of money or goods.
2. the fraudulent manipulation of accounts not involving defalcation.

As regards the first, where accounting staff are not subjected to any form of check, the opportunities of committing fraud are so frequent, and the methods necessary to conceal it so comparatively simple, that it is safe to say that no business of any size could be carried on under such conditions for very long without the risk of fraud taking place. In small business where the individual proprietor is in touch with the whole of the detail, and is able to supervise it effectively, the possibilities of concealing fraud may be remote. as soon, however, as the business increases in size and the proprietor is no longer able to

do this the a check is to be carried out by members of the staff themselves assisted by an independent auditor. Where the staff is sufficiently large to enable the whole of the work to be sub-divided, the auditor should examine carefully the system in force and ascertain it's deficiencies, if any.

The auditor, should pay particular attention to those classes of transactions which offer scope for fraud, the principal of which are cash transactions of one kind or another.

As general principles only are under consideration here, the actual way in which these transactions should be verified will be dealt with in due course but it may be noted that there are two methods by means of which the misappropriation of money may be concealed, the first is by the inclusion of fictitious payments, and the second by the omission of cash received, the latter class being much more difficult to detect.

The second class of fraud entailing the falsification of accounts without corresponding defalcations, is naturally considerable less frequent than the class of fraud above mentioned, but when it does occur it may involve very large amount. It may be done for the purpose of bolstering up a business which is in an insecure condition, in order to maintain the confidence of shareholders, creditors or the public; or it may be done by a manager for the purpose of increasing the apparent profit of the business, thus showing that he has been successful in his management, and possibly increasing the commission on results payable to him; or by directors for the purpose of enabling them to pay dividends which would otherwise not have been possible. Several notable cases of this sort of falsification have occurred. It need only be pointed out here that this form of fraud is often very ingeniously and skillfully concealed, and is in many cases carried out by persons holding positions of the highest trust, and having the entire confidence of directors and shareholders.

The internal audit department has a big role to play in preventing fraud in different organizations, as a part of protective functions. Every big organization has an internal audit manual and such a manual usually outlines the internal audit function in detail vulnerable areas where loss through fraudulent means may arise frequently.

Examples of vulnerable areas are stores receipt/consumption, Cash expenditure, sizeable receipts of cash, civil maintenance jobs etc. The internal audit manual prescribes in detail the manner and procedure as to how internal audit function would be carried out in these areas.

The manual also directs the frequency of such audit.

If internal audit of such areas is done accordingly, the possibility of occurrence of both visible and invisible frauds get eroded.

In discharging his functions in sensible areas as mentioned aforesaid, the auditor has to be extra intelligent and imaginative to enable him to think ahead of many others. However, it needs to be mentioned that the success of internal auditor in preventing fraud is also depending on the cooperation from other departments of the organization.

## 9.9 STATUTORY AUDITS

Continuing globalization will increase the complexity of principles, regulations, and the cultures in which organizations operate. increasing litigation, legislation, and regulations will carry important compliance implications. Ever growing competition will increase the pressure on organizations to enhance productivity.

The principal objectives of the Statutory Audit is to ensure that the financial statements i.e. the Balance Sheet, Profit & Loss Account and Cash Flow Statement give a true & fair view and are free from any material misstatements.

Our approach to Statutory Audit of the financial statements is to provide reasonable assurance that the accounts have been prepared in accordance with the Generally accepted accounting Principles (GAAP) and are free of any misstatements, errors and discrepancies. in addition to the traditional

statutory audit, we also help the clients by monitoring organizational ethics, conducting effective reviews of operational and financial performance, assessing the quality, economy and efficiency of their operations and suggesting continuous improvement strategies in simple terms statutory audit in India is equated with audit under the companies act. Every company incorporated under the companies act is required to get its accounts audited by a chartered accountant in Practice to ensure true and fair view of the accounts. Further, the auditor has to ensure compliance with various provisions of the companies act. Statutory audit ensures reliability of annual accounts of the company for various consumers of Accounts of the Company like government, shareholders, debtors, creditors, bankers etc.

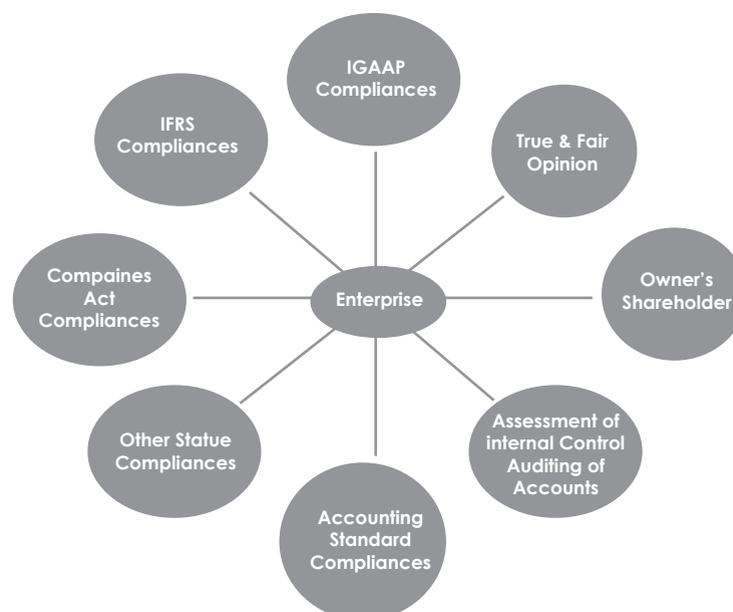
The complexity of Statutory audit Function has increased manifold during recent times. Globalisation, Fast changing Business and Statutory environment combined with need for synchronisation with various global accounting standards and ever increasing reliance on audited accounts by a variety of interested parties has put ever increasing responsibilities on the shoulders of any statutory auditor.

### Objectives of Statutory Audit:

Generally the firm will follow the following steps :

- i. Getting appointment letter and Board resolution copy.
- ii. Getting noc from previous auditor.
- iii. Filling the firm's no disqualification status to the company.
- iv. Filling of Form ADT-1 to ROC
- v. Getting Letter of engagement.
- vi. Assessment of internal control
- vii. Formulation of internal control action plan and calendar.
- viii. conduction audit as per IGAAP companies act icai accounting standards and auditing standards.
- ix. Forming an opinion of financial statement prepared by the company.
- x. Reporting to shareholders.
- xi. Attending AGM.

These can be shown in the following picture.



## **E-Governance**

Several dimension and related factors influence the definition of **E-Governance**. The word “electronic” in the term E-Governance implies technology driven governance. E-Governance is the application of information and communication technology (ict) for delivering government services, exchange of information communication transactions, integration various stand-one systems and services between Government-to-citizens (G2c), Government-to-Business(G2B),Government-to-Government( G2G) as well as back office processes and interactions within the entire government frame work. Through the e-Governance, the government services will be made available to the citizens in a convenient, efficient and transparent manner. The three main target groups that can be distinguished in governance concepts are Government, citizens and businesses/interest groups. In E-Governance there are no distinct boundaries.

Generally four basic models are available-Government to customer (citizen), Government to Employees, Government to Government and Government to Business;

### **Difference between e-governance and e-government**

Both the terms are treated to be the same, however, there is some difference between the two. “E-government” is the use of the ICTs in public administrations- combined with organisational change and new skills- to improve public services and democratic processes and to strengthen support to public policies”. The problem in this definition to be congruent with the definition of E-Governance is that there is no provision for governance of icts. as a matter of fact, the governance of icts requires most probably a substantial increase in regulation and policy- making capabilities,with all the expertise and opinion- shaping processes among the various social stakeholders of these concerns. So, the perspective of the E-Governance is “the use of the technologies that both help governing and have to be governed”.

E-Governance is the future many countries are looking forward to for a corruption free government. E-government is one-way communication protocol whereas E-governance is two-way communication protocol. The essence of E-governance is to reach the beneficiary and ensure that the services intended to reach the desired individual has been met with. there should be an auto-response system to support the essence of E-governance, whereby the Government realizes the efficacy of its governance. E-governance is by the governed, for the governed and of the governed.

Establishing the identity of the end beneficiary is a true challenge in all citizen-centric services. Statistical information published by governments and world bodies do not always reveal the facts. Best form of E-governance cuts down on unwanted interference of too many layers while delivering governmental services. it depends on good infrastructural setup with the support of local processes and parameters for governments to reach their citizens or end beneficiaries. Budget for planning, development and growth can be derived from well laid out E-governance systems.

### **XBRL Web Services :**

Regulators and other government agencies are faced with managing, processing and analysing growing volumes of business information. In the past, information exchange between regulated entities and regulators was typically conducted through the manual exchange of paper based forms. From those forms, regulators applied a range of analytical procedures almost all of which started with the manual transfer of critical information from the relevant forms into storage and analysis applications.

To increase their efficiency and effectiveness, regulators around the world are migrating their processes onto the internet. Many regulators already offer web based forms into which regulated entities can enter their information. This enables regulators to access and re-use reported data in their analytical applications in a more automated manner, reducing processing time, increasing information integrity and improving the timeliness of their own analysis and reporting, all by eliminating manual preparation work.



The paper-to-internet transition introduces two critical issues for regulators. First, assessing whether their paper-based information format is the most effective presentation from the standpoint of re-use, or if the Internet's greater flexibility presents opportunities to enhance regulatory processes and drive down costs through an improved presentation format. second, selecting an internet based communication standard that is the most workable for their needs as well as for those of reporting entities and the regulators' own information recipients.

Ideally, electronic filing forms should be capable of interfacing with a wide variety of software programs that reporting entities use, so that submitting information is as fast, easy and low-cost as possible. In addition, regulators need to deliver information in a format that their audiences in other government areas, the markets and the business community can access easily and cheaply, as well as use at their convenience.

In addition, regulators are confronted with adapting to new reporting requirements, such as international Financial reporting standards, the Basel ii accords, the sarbanes-oxley act of 2002 and more. regulators must use still-unfamiliar data to develop working practices that ensure continuity of oversight and, in the case of international standards, facilitate co-ordination of cross-border interpretations. Transparency and, therefore, trust and confidence in new standards depends on consistent and clear application of standards.

Several regulators around the world have already discovered that the internet can be leveraged to improve information flows and related analytical processes for themselves, as well as for reporting entities on the one hand, and those of other agencies and the public on the other: XBRL Web services. XBRL web services provide a more cost effective and reliable platform for information transfer, in which data is instantly accessible and re-usable across the corporate reporting supply chain — between businesses and regulators, among regulators and between regulators and their audiences in government, the markets and industry.

### **Benefits of XBRL Web services deployment**

Implementing XBRL Web services offers regulators and other government entities the following benefits:

- Automated and more reliable exchange of regulatory and financial information across all software formats and technologies, including the internet.
- Reduced or eliminated manual data re-entry, lowering risks associated with transcription errors.
- Lowered costs of preparing and distributing regulatory reports and related information, such as instructions, definitions, etc.
- Improved access to financial information reported by regulated entities through a format which enhances information re-usability.
- Lowered production costs, greater reliability and faster processing speed for more timely, accurate and informed regulatory assessments.
- Increased efficiency of regulatory assessments and analytics.
- Accelerated changes to and adoption of reporting standards and requirements through an extensible, flexible platform that facilitates and thereby accelerates changes in and adoption of reporting standards.
- Collaborative nature of XBRL process provides regulators with input on the standards via enhanced communication and cooperation between regulators and respective industry organisations.
- Reduced cost of regulation by spreading development and maintenance among collaborating organizations.

XBRL Web services are currently being used in the US, Europe and Asia for several different types of regulatory reporting, including:

- Bank position reports consisting of thousands of individual data points collected by regulatory authorities
- Company financial reports consisting not only of individual data points, but also text disclosures of policies, tabular schedules of assets, consolidations and a myriad of notes under a variety of accounting standards.
- Business statistical information

As regulatory communication with regulated entities, industry groups, the markets and other regulators becomes increasingly critical to the global economy, XBRL Web services offers a compelling alternative to proprietary information standards that isolate agencies from the larger flow of information based on open, collaborative standards.

### **Let us Recapitulate:**

- Corporate governance is “the system by which companies are directed and controlled”. It involves regulatory and market mechanisms, and the roles and relationships between a company’s management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed.
- UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. It operates on the principle of ‘comply or explain’.
- The Companies Act 2006 (c 46) is an Act of the Parliament of the United Kingdom which forms the primary source of UK company law. The key provisions are:
  - The act codifies certain existing common law principles, such as those relating to directors’ duties.
  - It implements the European Union’s Takeover and Transparency Obligations Directives.
  - It introduces various new provisions for private and public companies.
  - It applies a single company law regime across the United Kingdom, replacing the two separate (if identical) systems for Great Britain and Northern Ireland.
  - It otherwise amends or restates almost all of the Companies Act 1985 to varying degrees.
- Corporate Governance in Germany is characterized by a number of unique features, chief among them being the requirement under the German Stock Corporation Law (AktG) that boards of directors are divided into two tiers: a management board (called the Vorstand) which is solely responsible for the management of the company, and a supervisory board (called the Aufsichtsrat), which is charged with overseeing the activity of the management board.
- The main bank system, cross-shareholding and long term employment are usually mentioned as typical features of the Japanese model of corporate governance.
- In the United States, corporations are directly governed by state laws, while the exchange (offering and trading) of securities in corporations (including shares) is governed by federal legislation. Many US states have adopted the Model Business Corporation Act, but the dominant state law for publicly traded corporations is Delaware, which continues to be the place of incorporation for the majority of publicly traded corporations. Individual rules for corporations are based upon the corporate charter and, less authoritatively, the corporate bylaws. Shareholders cannot initiate changes in the corporate charter although they can initiate changes to the corporate bylaws.
- India’s SEBI Committee on Corporate Governance defines corporate governance as the “acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company. “ it has been suggested that the Indian approach is drawn from the Gandhian principle of trusteeship and the Directive Principles of the



India Constitution, but this conceptualization of corporate objectives is also prevalent in Anglo-American and most other jurisdictions.

- Internal auditing activity as it relates to corporate governance is generally informal, accomplished primarily through participation in meetings and discussions with members of the Board of Directors. The internal auditor is often considered one of the “four pillars” of corporate governance, the other pillars being the Board of Directors, management, and the external auditor.
- An audit committee is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure. These committees have a four-fold relationship and therefore, has to interact with management, internal auditor, statutory auditor and the public.
- Our approach to statutory audit of the financial statements is to provide reasonable assurance that the accounts have been prepared in accordance with GAAP and free from errors, misstatements and discrepancies.
- Several dimensions and factors influence the definition of e-governance. The word “electronic” in the term e-Governance implies technology-driven governance. E-Governance is the application of Information and Communication Technology (ICT) for delivering government services, exchange of information communication transactions, integration of various standalone systems and services between Government-to-Citizens (G2C), Government-to-Business (G2B), Government-to-Government (G2G) as well as back office processes and interactions within the entire government framework.
- XBRL is an electronic format for simplifying the flow of financial statements, performance reports, accounting records and other financial information between software programs.
- XBRL defines a consistent format for business reporting and will streamline how companies prepare and disseminate financial data, and how analysts, regulators, and investors review and interpret it.





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# Section C

## ETHICS

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# Study Note - 10

## ETHICS AND BUSINESS



### This Study Note includes

- 10.1 Ethics and Morals
- 10.2 Evolution of Ethics
- 10.3 Application
- 10.4 Business Ethics
- 10.5 Nature of Ethics as Moral Value

### 10. ETHICS AND BUSINESS - INTRODUCTION

The study of ethics is a systematic science. Its scope encompasses all human relationships in a society. Ethics also known as moral philosophy is a branch of philosophy that involves systematizing, defending and recommending concepts of right and wrong conduct. The study of ethics can be divided into four operational areas namely – meta ethics, normative ethics, descriptive ethics and applied ethics.

In this chapter, we will deal exclusively with the concept of ethics. A concept is a mental model or a mental construct. With the mental model of ethics, we can understand the various other concepts that go into its making. Once the complex structure of this model is ready, we can execute it just the way architectural engineers execute blueprints. The task of business ethics is to enable managers to execute these mental models consistently, contingent on business management situations. The consistency must be such that it becomes a universal principle or a point of reference for right or wrong business actions.

Ethics fundamentally comprises of two elements:

Firstly, ethics refers to well founded standards of right and wrong that describe what humans ought to do in terms of rights, obligations, benefits to society, etc.

Secondly, ethics refers to the study and development of one's ethical standards.

So, it is necessary to constantly examine one's standards to ensure that they are reasonable and well founded.

### 10.1 ETHICS AND MORALS

Let us first try to analyse the key terms 'ethics' and 'morals'. Note the linguistic use of the terms – they seem as if they are in the plural form, just as 'economics' or 'politics', but we treat them as singular. Generally, ethics and morals are used as synonyms. There is nothing wrong in such a usage, for after all, the meaning of all words depend on their common usage. However, in formal study, we need to understand the meaning of the terms in a qualified way so as to make our subject of study precise and well defined.

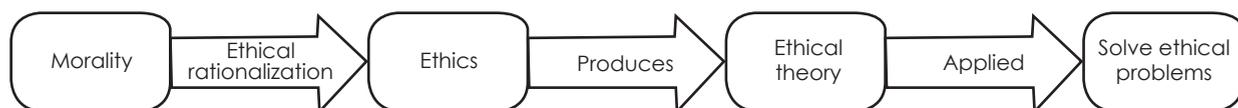


Fig. 10.1

## Meaning

The terms 'ethics' and 'morals' are etymologically, that is, from their very roots or terms, different. The word moral(s) is derived from the Latin root mora/is, which implies custom. In other words, it refers to a behaviour that is accepted or rejected due to an accepted social custom. The word ethics stems from the Greek word ethike, which attributes to a social environment, referred to as ethos or social milieu. This latter meaning embraces much more than mere custom. It refers to everything that is part and parcel of society and not just what is allowed or forbidden. Morality is more concerned with the norms, values and beliefs embedded in social processes which define what is right or wrong for an individual or community.

Another point of difference between the two refers to their usage in ordinary language. For instance, a lawyer defending an alleged rapist would accuse the victim as 'morally fallen' and not as 'ethically fallen'. On the other hand, a committee that is formed to probe the behaviour of the members of Parliament would be called 'ethics committee', not 'moral committee'. The meaning of the word is in its usage. Thus, both these terms have their unique characteristics and applications.

## Usage

However, the terms are intrinsically not different. Both of them refer to the same reality of human actions, which may be characterized as morally or ethically positive or negative as the case may be. It may be true that the terms (ethics and morals) sound different but they refer to the same social reality wherein a certain body of accepted norms forms a code of conduct in society. The actions of the members are described as 'moral' or 'ethical' depending on the linguistic nuances of the meaning in a particular case as well as on the conventional use of the terms. It is in the use of the words in a given context, that the meaning becomes clear.

In academic usage, however, moral behaviour refers to a concrete behaviour such as showing respect to elders. Ethics, on the other hand, is used to mean a discipline or a systematic study of moral behaviour such as justice. People's behaviour in a society can be morally characterized in their day-to-day actions. It is in the classroom that we analyse the ethical significance of these actions.

These terms are generally interchanged with one and the same meaning, that is, to determine whether some human action is right or wrong. They deal with the application of a socially accepted code of conduct. This conduct may be termed as either moral conduct or ethical conduct.

## 10.2 EVOLUTION OF ETHICS

Social conduct has evolved along with the evolution of society. When your elders tell you 'Do not cheat', they are referring to a social code of conduct. Social conduct has developed in society over hundreds of years. The codes of conduct have been passed down from generation to generation, and there is a pattern to the evolution of such codes. Acceptable behaviour is promoted and elevated as a social value, and unacceptable behaviour is rejected and condemned. In ancient India, there was no moral problem with the custom of sati-immolating the wife on the funeral pyre or the deceased husband. But society has evolved humanely and has condemned the act as unacceptable and morally reprehensible.

The laws of a country are based on the customs or moral codes of its society. Penalties are prescribed for bad actions, actions that contradict the established laws. The laws are a measure against those people who cross the limits of the code of social conduct, and ensure that good citizens are protected from the negative consequences of the law-breakers.

The object of the social codes of conduct is to maintain, promote, and elevate harmonious relationships.

'Honour your parents' is one such code. It maintains a peaceful relationship between parents and



children and promotes respect for each other in the family. It is because of its salutary effects, it is considered as one of the fundamental values to be cultivated.

### 10.3 APPLICATION

The relevance of ethics is in its application. Just as when we study the theory of relativity in physics, we ensure that the laws or principles of relativity are applied to the factors and elements being considered, so too in our study of ethics, the universal principles have to be applied to individual contexts and situations. We have to abandon the absolutism of universal principles. For instance, killing a man is wrong. But we approve the killing of the enemy in a war and the government honours the act with medals for bravery. This is due to the fact that such an act has served a higher principle, that is, the protection of countrymen. Ethics, in the practical sense, is also known as moral action and is an applied discipline that deals with a particular human action and also assesses to what extent it is compatible with the general principles.

### 10.4 BUSINESS ETHICS

According to Andrew Crane “ Business ethics is the study of business situations, activities and decisions where issues of right and wrong are addressed.

Raymond C. Baumhart contend – “The ethics of business is the ethics of responsibility. The businessman must promise that he will not harm knowingly”.

Thus, Business Ethics (also called Corporate Ethics) is a form of applied ethics or professional ethics that examines ethical principles and moral or ethical problems that arise in a business environment. It applies to all aspects of business conduct, and is relevant to the conduct of individuals and the entire organizations.

Business ethics concerns itself with adhering to the social principles of the situations in which business takes place. The analysis of this definition leads us to the following discussion.

#### **Business for Profit**

It would seem that business ethics does not come within the confines of ethics. As Adam Smith (1779), the father of modern economics says: ‘People of the same trade seldom come together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.’ People find mechanisms to generate the highest possible returns when conducting business. No one holds it against a worker for demanding higher wages, or a landlord for increasing the rent. Their actions are not considered illegal or unethical. Profits are the just wages for invested capital and entrepreneurship. Hence, these should not be resented and should be left alone outside the boundaries of ethics. Business is for profit; the just reward for doing business lies in the excess returns received on the investment.

#### **Business and Ethics**

No matter how hard one tries, it is impossible to separate life from business. For a businessman, business is life. Mahatma Gandhi (1948) said, ‘It is difficult but not impossible to conduct strictly honest business. What is true is that honesty is incompatible with amassing of large fortune.’ The business world is an important part of society, as it is concerned with the livelihoods of people. Business activity too is subjected to the code of conduct without any exception. People expect businessmen to possess the same rationality as any other citizen. Therefore, there is no separate business ethics for businessmen, as ethics applies to all the activities of people. Consequently, we have to keep business within the bounds of ethics.

### Character of Business

'There are two fools in every market: one asks too little, one asks too much,' so says a Russian proverb. Is there a concept called *balanced profit*? The business in a society reflects its character. Transparency International, in its corruption perception index, gives Finland, Denmark, and New Zealand the first place with 9.4 points; India is way down at 72, with just 3.5 points on a scale of 10. We may gloat over our cultural heritage and religious and ethical glories of the past, but we stand exposed before the world as a corrupt society. Corruption prevails in all walks of life, whether political, social, or economic. If we have to improve our business, we have to improve our business behaviour.

### Professional Ethics

The aforementioned discussion may be understood through the following distinctions: ethics and business ethics. We have studied the distinction between normative and practical ethics and have established that business ethics comes under practical ethics and is applied to a particular activity.

Just as a society functions on the social codes of conduct and a country is governed by its constitution, a business is run on corporate codes. In other words, there is a professional code of conduct for any business. These codes keep evolving as other things around evolve and develop. Therefore, not only should business be defined within the confines of ethics, but it should be practised strictly under its own professional code of conduct. This distinction helps to orient the general principles of ethics and business to a particular activity. The principles, however, do not change. For instance, there is a manager who is doing very well in his career because he is both efficient and honest. To his neighbours and friends, he is not only a very successful businessman, but also a very good family man. To a question asked by a journalist on how he divided.

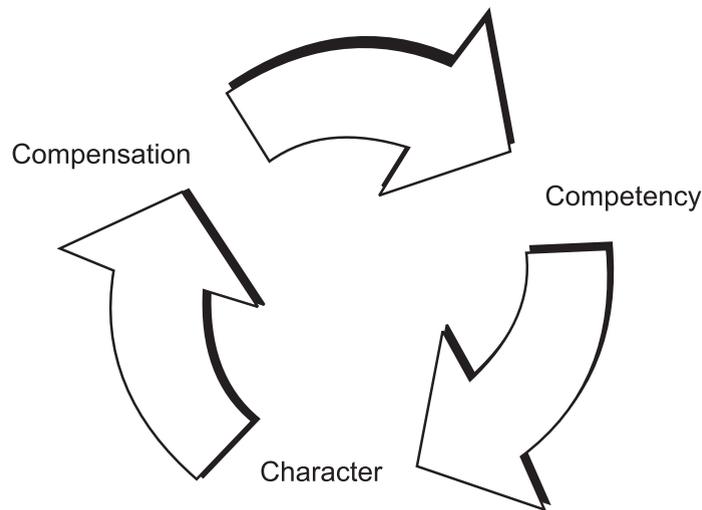


Fig 10.2 Professional characteristics

his time between his family and business despite his busy schedule, he replied, 'Efficiently.' 'What is the secret of your success?' asked the journalist. He replied 'Honesty.' The journalist looked inquiringly as if to say, 'Look, business and family are separate.' The businessman said, 'Both efficiency and honesty work equally well at work and at home.' The character of a true professional remains undivided, whether at work or at home. Our roles may change from time to time and from place to place but the integrity of our character should be maintained.

Business ethics, thus, professionally adheres to a code of conduct that is in accordance with the normative principles. Further, it may be concretely stated that professionals bear the following marked characteristics: (i) competency of educational qualification, (ii) professional skills, and (iii) compensation (salary/remuneration, etc.). See Fig. 10.2.



## Need for Business Ethics

Business ethics is currently a very prominent business topic, and the debates and dilemmas surrounding business ethics have attracted enormous amount of attention from different quarters of organizations and society. Hence, it has emerged as an increasingly important area of study. Some of the major reasons why a good understanding of business ethics is important can be stated as follows:-

- **Stop business malpractices** : Some unscrupulous businessmen do business malpractices by indulging in unfair trade practices like black-marketing, artificial high pricing, adulteration, cheating in weights and measures, selling of duplicate and harmful products, hoarding, false claims or representations about their products etc. These business malpractices are harmful to the consumers. Business ethics help to stop these business malpractices.
- **Improve customers' confidence** : Business ethics are needed to improve the customers' confidence about the quality, quantity, price, etc. of the products. The customers have more trust and confidence in the businessmen who follow ethical rules. They feel that such businessmen will not cheat them.
- **Survival of business** : Business ethics are mandatory for the survival of business. The businessmen who do not follow it will have short-term success, but they will fail in the long run. This is because they can cheat a consumer only once. After that, the consumer will not buy goods from that businessman. He will also tell others not to buy from that businessman. So this will defame his image and provoke a negative publicity. This will result in failure of the business. Therefore, if the businessmen do not follow ethical rules, he will fail in the market. So, it is always better to follow appropriate code of conduct to survive in the market.
- **Safeguarding consumers' rights** : Consumer sovereignty cannot be either ruled out or denied. Business can survive so long it enjoys the patronage of consumer. The consumer has many rights such as right to health and safety, right to be informed, right to choose, right to be heard, right to redress, etc. But many businessmen do not respect and protect these rights. Business ethics are must to safeguard these rights of the consumers.
- **Protecting employees and shareholders** : Business ethics are required to protect the interest of employees, shareholders, competitors, dealers, suppliers, etc. It protects them from exploitation through unfair trade practices.
- **Develops good relations** : Business ethics are important to develop good and friendly relations between business and society. This will result in a regular supply of good quality goods and services at low prices to the society. It will also result in profits for the businesses thereby resulting in growth of economy.
- **Creates good image** : Business ethics create a good image for the business and businessmen. If the businessmen follow all ethical rules, then they will be fully accepted and not criticised by the society. The society will always support those businessmen who follow this necessary code of conduct.
- **Smooth functioning** : If the business follows all the business ethics, then the employees, shareholders, consumers, dealers and suppliers will all be happy. So they will give full cooperation to the business. This will result in smooth functioning of the business. So, the business will grow, expand and diversify easily and quickly. It will have more sales and more profits.
- **Consumer movement** : Business ethics are gaining importance because of the growth of the consumer movement. Gone are the days when the consumer can be taken for ride by the unscrupulous business by their false propoganda and false claims, unfair trade practices. Today, the consumers are aware of their rights and well informed as well as well organised. Now they are more organised and hence cannot be cheated easily. They take actions against those businessmen who indulge in bad business practices. They boycott poor quality, harmful, high-priced and counterfeit (duplicate) goods. Therefore, the only way to survive in business is to be honest and fair. Consumer forums and Consumer Associations are more active and vocal now.

- **Consumer satisfaction** : Today, the consumer is the king of the market. Any business simply cannot survive without the consumers. Therefore, the main aim or objective of business is consumer satisfaction. If the consumer is not satisfied, then there will be no sales and thus no profits too. Consumer will be satisfied only if the business follows all the business ethics, and hence are highly needed.
- **Importance of labour** : Labour, i.e. employees or workers play a very crucial role in the success of a business. Therefore, business must use business ethics while dealing with the employees. The business must give them proper wages and salaries and provide them with better working conditions. There must be good relations between employer and employees. The employees must also be given proper welfare facilities.
- **Healthy competition** : The business must use business ethics while dealing with the competitors. They must have healthy competition with the competitors. Healthy competition brings about efficiency, break complacency and leads to optimal utilisation of scarce resources, hence is always welcome. They must not do cut-throat competition. Similarly, they must give equal opportunities to small-scale business. They must avoid monopoly. This is because a monopoly is harmful to the consumers.

## 10.5 NATURE OF ETHICS AS MORAL VALUE

### Value-free Ethics

It would seem that business is an ethically neutral or value-free activity. In other words, the only value business is concerned with is the monetary value. It is not in the interest of business to mix ethical values. An ancient Arabic wisdom states, 'Live together like brothers and do business like strangers.' Business should be kept free from other social relationships and obligations. The only successful relationship that exists in business is that of a vendor and a customer.

It is also said that 'for the merchant, even honesty is a financial speculation.' Indeed, for a businessman every factor in the business is measured in terms of money. The volatility that we see in the stock market is a clear example of the speculative nature of business, which is directly proportional to the prevailing attitude of the people.

### Concept of Value-free Ethics

Nowadays, we are familiar with 'sugar-free' soft drinks, 'caffeine-free' coffee, and 'alcohol-free' beer. The concept of 'value-free' business ethics appears to be quite appealing to businessmen. It is as though it may be pursued devoid of all rules within a social vacuum. The concept of value-free ethics found application in economics in a rather ironical fashion. Ludwig von Mises known as the father of the Austrian School of Economics, proposed the pure theory of economics, stating that economic concepts are a priori, that is, they are not dependent on experience, but are purely virtual concepts. The concept of choice, for instance, is a pure concept. It is immaterial whether one chooses water or wine, but the concept in itself is free of such particular elements. Hence, choice is value-free (*wertfrei*). Applied to ethics, it would mean that we should be able to study the principles of this discipline, such as goodness, truth, justice, honour, etc. in their pure form.

It is obvious that such value-free ethics, when understood in the right sense, leads us to study meta-ethics or the fundamental principles of ethics as a pure science. However, if we are to apply an ethical standard to such a study, it would be called a pure study of values, not value-free ethics.

### Ethics as a Principle

We have established that social evolution has developed definite principles of civic behaviour, which have attained the status of principles. By principle, we understand that something proceeds and depends on it for its cause. For instance, when one kicks a football, force is the principle that propels it

into motion and the ball remains in motion till the force lasts. In other words, the physical world functions strictly according to the laws of physics. It is expected that people also submit their behavior, both in thoughts and in actions, to these principles. An action is valid as long as it reflects the principle, just as the speed of the moving ball depends on the force it receives.

All moral actions are directed towards their object, the good, which is the principle of all happiness. This is not only the sole purpose of our existence but our co-existence with others as well. We cannot be happy alone; we can only be happy together. The universal idea of the good is applied to individual instances. Individuals are good in their own particular way, and are good in so far as they share the essence of goodness. The universal good is a pure or general idea. It is formed through a process of abstraction of the essence from individuals or particulars.

### Business Ethics as Professional Code

Business ethics is not a pure science but a professional practice, and society expects businessmen to abide by the principles of a civil society, just as it expects professionals from other areas such as medicine, bureaucracy, politics and sports to do so. Thus, instead of a value-free business ethics, we have a value-loaded or value-based business practice.

### The Seven Principles of Public Life

<b>Selflessness</b>	Holders of public office should take decisions solely in terms of the public interest. They should not do so in order to gain financial or other material benefits for themselves, their family, or their friends.
<b>Integrity</b>	Holders of public office should not place themselves under any financial or other obligation to outside individuals or organizations that might influence them in the performance of their official duties.
<b>Objectivity</b>	In carrying out public business including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.
<b>Accountability</b>	Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.
<b>Openness</b>	Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.
<b>Honesty</b>	Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.
<b>Leadership</b>	Holders of public office should promote and support these principles by sound leadership and prove to be an example in whatever they perform.

[Extracted from the "First Report of the Committee on Standards of Public Life" UK May 1995]

### Ethics and Laws- The Interface

Law is essentially an institutionalization or codification of ethics into specific social rules, regulations and prescriptions. Perhaps the best way of visualizing ethics and law is in terms of two intersecting domains as depicted in the following figure:

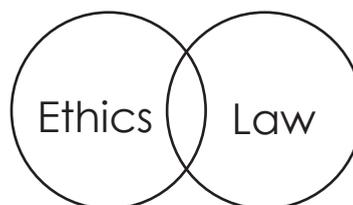


Fig 10.3

Thus, in one sense, business ethics can be said to begin where law ends. Business ethics is primarily concerned with those issues not completely covered by law, or where there is no definite consensus on whether something is right or wrong. Hence, it is often remarked, that business ethics is about the “grey areas” of business where values are in conflict.

**Let us Recapitulate:**

- **Ethics**, also known as **moral philosophy**, is a branch of philosophy that involves systematizing, defending, and recommending concepts of right and wrong conduct.
- **Ethics vs Morals:** *Morals* are beliefs based on practices or teachings regarding how people conduct themselves in personal relationships and in society, while *ethics* refers to a set or system of principles, or a philosophy or theory behind them.
- The object of social codes of conduct is to maintain, promote and elevate harmonious relationships.
- **Business ethics** (also **corporate ethics**) is a form of applied ethics or professional ethics that examines ethical principles and moral or ethical problems that arise in a business environment. It applies to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations.
- **Need or Importance of Business Ethics:**
  - Stop business malpractices
  - Improve consumers confidence
  - Survival of business
  - Protecting consumers rights
  - Protecting employees, shareholders, etc.
  - Develop good relations between business and society
  - Create good image of business
  - Smooth functioning of business
  - Consumer movement
  - Consumer satisfaction
  - Importance of labour
  - Healthy competition
- A code of practice is adopted by a profession or by a governmental or non-governmental organization to regulate that profession. A code of practice may be styled as a code of professional responsibility, which will discuss difficult issues, difficult decisions that often need to be made, and provide a clear account of what behavior is considered “ethical” or “correct” or “right” in the circumstances.

# Study Note - 11

## ETHICAL CONFLICT



This Study Note includes:

- 11.1 Fundamental Principles of Ethical Behaviour
- 11.2 Creating an Ethical Accounting
- 11.3 Unethical behavior
- 11.4 Threats to ethical behaviour
- 11.5 Ethics and Ethical dilemmas
- 11.6 Ethics of Management Accountant Professional

### 11. ETHICAL CONFLICT - INTRODUCTION

An **Ethical conflict** is a complex situation that often involves an apparent mental conflict between moral imperatives, in which to obey one would result in transgressing another. This is also called an **ethical paradox** since in moral philosophy, paradox often plays a central role in ethics debates. The term *dharmasankat* is used in Indian philosophy to represent a moral or ethical dilemma. Etymologically, *dharma* can mean morality, sense of justice, code of conduct, law and other similar concepts; *sankat* implies a trouble or problem.

Ethical conflicts arise when someone has to make a choice between violating or abiding by one or more of their moral principles, leading to a paradox where neither choice leaves the individual satisfied. For example, ethical conflict lies at the heart of situations in which a father steals food to feed his starving family or an employee keeps quiet about someone else's misconduct in the workplace in order to save his own job. Ethical dilemmas often have potentially negative consequences for the decision-maker, especially when it involves work.

There are many types of ethical conflicts in the workplace, however conflicts usually deal with the following categories: fraud, confidentiality, finance and honesty. Fraud occurs when a company knowingly presents information that is incorrect to employees or the public. For example, the energy company Enron fraudulently modified its income statement to appear as if the company was performing better than it actually was. A confidentiality ethical conflict occurs when information is viewed or accessed by a party that should not be privy to that information. Financial conflicts typically involve stealing, either in small or large amounts. For example, taking office supplies from the company supply closet is unethical behavior.

Resolving ethical conflicts may be as simple as a discussion with the party engaging in unethical behavior, or, in extreme circumstances, legal intervention. Ethical conflicts can be prevented in the workplace by using a two-sided approach. One approach is by educating employees about what is considered an ethical conflict. Second, company leaders must set an example for lower-level employees.

Having understood as to what is meant by ethical conflicts, let us understand the fundamental principles of ethical behavior.

### 11.1 FUNDAMENTAL PRINCIPLES OF ETHICAL BEHAVIOUR

- A. **Integrity:** The principle calls upon all accounting and finance professional adhere to honesty and firmness while discharging their respective professional duties:
- Avoid being involved in activities which would impair the goodwill of the organization.
  - Communicate adverse as well as favorable information with those concerned.

- Refuse any favour which could influence his actions in a negative way.
- Refuse to get involved in any activity which would adversely affect objectivity.
- Avoid conflicts and advise related parties on imminent conflicts.

- B. Objectivity:** Communicate information fairly and objectively in a transparent manner.
- C. Confidentiality:** Accounting and financial management should refrain from disclosing confidential information acquired during their work. When such information are to be disclosed to their subordinates in course of their normal work, care should be taken that ultimate confidentiality is maintained. However, an organization must submit information required under a legal obligation or statutory ruling.
- D. Professional competence:** Finance and accounting professionals need to update their professional skills from time to time. It has to be ensured that the client or employer receives competent professional services based upon current and contemporary developments in the related areas.
- E. Obedience to Rules:** Accounting and finance professionals should comply with relevant laws and regulations and avoid such actions which may result into discrediting the profession.

## 11.2 CREATING AN ETHICAL ACCOUNTING ENVIRONMENT

- A. Employee Awareness:** It should be noted and ensured that employees are aware of their legal and ethical responsibilities. Organization should train and motivate employees toward ethical behavior. Top management should initiate steps in developing such an ethical environment.
- B. Encouraging communication:** Ethical organization need to provide channels through which employees could communicate with concerned Managers, for reporting frauds, mismanagement or any other form of detrimental behavior.
- C. Ensuring fair treatment to Whistle Blowers:** A person or an employee who reports fraud, mismanagement or any other detrimental practices to the concerned Managers is called Whistle Blower. Organization should ensure protection and fair treatment to Whistle Blowers to reduce fraud.

## 11.3 UNETHICAL BEHAVIOUR

### 11.3.1 Reasons for Unethical Behaviour

The reasons for which unethical behavior might arise in the organization are:

- A. Over Emphasis on Short Term Profitability:** Manipulating accounting entries to show better profitability (window dressing) to raise further capital from the market.
- B. Ignoring small unethical issues:** Companies need to develop an environment where small ethical lapses are taken seriously so that they do not recur in the future.
- C. Economic cycles:** when the company is doing well, no one is bothered to understand its actual financial position. However, when the economy takes a downward turn, finance and accounting managers may take decisions by compromising over the established principles. To prevent disclosure of unethical problems in times of depression, companies need to be careful and vigilant also during prosperous time periods.
- D. Market complexity:** In the era of globalization and massive cross border flow of capital, accounting rules have become more complex. The complexity of principles and rules and the difficulty associated with identifying abuse are reasons which may promote unethical behavior.
- E. Money - Mindedness:** Most business organizations try to display better financial condition by window dressing. Following such a principle towards "showing profits" rather than "earning profits" leads to unethical accounting and financial practices.

### 11.3.2 Consequences of Unethical Behavior

Unethical behavior has adverse effects on business. Moreover, working for an unethical, deceptive, unfair or dishonest organization requires one to take unethical or compromised decisions which also takes a toll on physical, mental and emotional health of individuals. Firstly, if a company is unethical, the word spreads fast, and the reputation and goodwill of the company is at stake. Such impact can be of a permanent nature destroying the company's reputation possibly forever. Secondly, unethical behavior can also have a detrimental impact on the productivity of a company due to mistrust and lack of faith among the employees. Thirdly, unethical behavior can, not only cause a company to lose good and valuable employees, but also it can be quite difficult to find new employees. Moreover, indulgence in unethical behavior shall not only be instrumental in expediting the cost of training of new employees in terms of money, but also loss of valuable time which could be spent in production. Such disruptions or slowing down of production will result in greater customer dissatisfaction and fewer new customers. It is proved that good ethics carries many benefits, and its violations – penalties, and therefore refraining from unethical behavior should be the **sine-qua-non** consideration for an organization.

### 11.4 THREATS TO ETHICAL BEHAVIOUR

The following types of threats may affect the business environment and influence finance and Accounting professionals.

- (a) **Self-Interest Threats:** Occur as a result of the financial or other interest of Finance and Accounting professional or personal interest of key personnel.
- (b) **Self-Review Threats:** When a previous judgment of the Finance and accounting Professional is to be re-evaluated.
- (c) **Advocacy Threats:** When a professional promotes a position or opinion to such extent that some objectivity may have to be compromised.
- (d) **Familiarity Threats:** When a professional has close relationships with the work environment which may impair his selfless attitude towards work.
- (e) **Intimidation Threats:** when a professional may be prohibited from acting objectively by actual or perceived threat.

#### 11.4.1 Circumstances creating threats

Circumstances leading to actual happening of threats are:

Types of threats	Accounting Professionals working as Consultants or Auditors	Accounting Professionals working as employee
(a) Self interest threat	<ol style="list-style-type: none"> <li>(i) A financial interest in a client.</li> <li>(ii) Undue dependence on fees from a client.</li> <li>(iii) Close business relationship with a client.</li> <li>(iv) Fear of losing a client.</li> <li>(v) Potential employment with a client.</li> <li>(vi) Contingent fees relating to an assurance engagement.</li> </ol>	<ol style="list-style-type: none"> <li>(i) Financial interests, loans and guarantees in the company where the professional is working.</li> <li>(ii) Incentive, compensation, arrangements.</li> <li>(iii) Inappropriate personal use of corporate assets.</li> <li>(iv) Concern over employment security.</li> <li>(v) Commercial pressure from outside the employing organization.</li> </ol>

(b) Self review threat	<ul style="list-style-type: none"> <li>(i) Discovery of a significant error of the work of the professional.</li> <li>(ii) Reporting on the operation of the designed financial systems.</li> <li>(iii) Being a Director or Officer of the client.</li> <li>(iv) Being employed by the client in a position to exert influence over the subject-matter of the engagement.</li> </ul>	(i) When business decisions or data is subjected to review and justification is required to be given by the professional who takes the decisions or prepare the data.
(c) Advocacy threat	<ul style="list-style-type: none"> <li>(i) Promoting shares in a Listed Entity of a client.</li> <li>(ii) Acting as an advocate on behalf of client in litigation or disputes with third parties.</li> </ul>	(i) Influencing organization's finance and accounting reports through misleading statement.
(d) Familiarity threat	<ul style="list-style-type: none"> <li>(i) Close relationship with a Director or Officer of the client.</li> <li>(ii) Accepting gifts or preferential treatment from a client.</li> </ul>	<ul style="list-style-type: none"> <li>(i) In a position to influence reporting of business decisions to benefit close family member.</li> <li>(ii) Long association with business contacts influencing business decisions.</li> <li>(iii) Acceptance of gift or preferential treatment.</li> </ul>
(e) Intimidation threat	<ul style="list-style-type: none"> <li>(i) Being threatened with litigation.</li> <li>(ii) Fear of losing work from client.</li> <li>(iii) Being threatened with replacement.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Fear of loss of job over disagreement about an accounting principle in financial reporting.</li> <li>(ii) Attempt by dominant personality to influence.</li> </ul>

#### 11.4.2 Safeguards to Threats

It is important to have safeguards created by the Finance and Accounting profession, to entify or deter unethical behaviour. Such safeguards to eliminate or reduce threats may classified in two broad categories:

- safeguards created by the Finance and Accounting profession, Legislation or Regulation;
  - safeguards in the work environment.
- a) Safeguards created by the Finance and Accounting profession, Legislation or Regulation:
- Educational, training and experience requirements for entry into the profession.
  - Continuing professional development requirements.
  - Corporate Governance Regulations.
  - Professional standards.
  - Professional or regulatory monitoring and disciplinary procedures.
  - External review of reports by a legally empowered third party.
- b) Safeguards in the work environment:
- The employing organisation's ethics and conduct programs.
  - Employing competent staff.



- Strong internal controls.
- Appropriate disciplinary processes.
- Leadership for cultivating ethical behaviour to encourage employees to act in ethical manner.
- Policies and procedures to implement and monitor the quality of employee performance.
- Timely communication of organisation's policies and procedures.
- Employee training and education on policies and procedures.
- Encourage employees to communicate ethical issues without fear of retribution.
- Organisation's system of corporate overview.

## 11.5 ETHICS AND ETHICAL DILEMMAS

The term 'Ethics' refers to moral principles which guide the conduct of individuals. Ethical behaviour implies actions ought to have taken after considering the impact on society and other stakeholders. Accounting and finance professionals have onerous duty and obligation to report the wrongs, even if they are done at the top. This often brings them into a situation of Ethical dilemmas, which arise when finance and accounting professionals need to choose from amongst alternatives involving: (1) value conflicts among differing interests, (2) correct course of action, (3) interest of all stakeholders in general.

### 11.5.1 Conflict of Interest

A finance and accounting professional has a professional obligation to comply with certain fundamental principles. A 'conflict of interest' arise where the professional have to decide between compliance with principles and actions which are beneficial to the business organization at large.

#### A. In the role of an Independent Consultant:

A finance and accounting professional in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may sometimes even give rise to threats to compliance with the fundamental principles.

#### B. In the role of an employee

A finance and accounting professional working as employee, should support the legitimate and ethical objectives established by the organisation and the rules and procedure drawn up in support of those objectives. He may be pressurized to act or behave in ways which directly or indirectly threaten the fundamental principles. Such pressures may be:

(a) Explicit or implicit,

(b) From a Manager, director or any other concerned person.

(c) A finance and accounting professional may face pressure to:

(i) Act contrary to law or regulation.

(ii) Act contrary to technical or professional standards.

(iii) Facilitate unethical or illegal earnings management strategies

(iv) Lie to, or otherwise intentionally mislead (including misleading by remaining silent e.g. to the auditors, regulators).

(v) Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts (e.g. financial statements, tax compliance, legal compliance, reports required by securities regulators etc.)

### 11.5.2 Ethical Conflict Resolution

Ethical conflict is a situation where the professionals have to decide between compliance with principles and actions which are beneficial to the business organization.

To resolve the conflict, following aspect should be considered:

- (a) Relevant facts;
- (b) Ethical issues involved;
- (c) Fundamental principles related to the matter in question;
- (d) Established internal procedures; and
- (e) Alternative courses of action.

#### 11.5.2.1 Conflict Resolution Process

A finance and accounting professional should determine:

- (a) The appropriate course of action,
- (b) Weigh the consequences of each possible course of action:
  - (i) If the matter remains unresolved, the professional should consult with other appropriate persons within the firm and if required, with persons responsible for governance of the organisation (e.g. Board of Directors).
  - (ii) The following steps are suggested to resolve the issues:
    - (a) **Documentation:** He should document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.
    - (b) **Legal Advice:** If a significant conflict cannot be resolved, a professional may obtain advice from the relevant professional body or legal advisors without breach of confidentiality.
    - (c) **Withdrawal:** If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional should, where possible, refuse to remain associated with the matter creating the conflict, withdraw from the engagement team or specific assignment or resign from the employing organization.

### 11.5.3 Ethical Code & Contract - Differences

Ethical codes or code of ethics are guidelines intended to serve the interests of a profession; its members and communities that are served, and hereby commit oneself to the highest ethical and professional conduct. Ethical codes are adopted by organizations to assist the members in understanding the difference between 'right and wrong', and applying that understanding in decision making. An ethical code generally implies documents at three levels: code of business ethics, codes of conduct for employees, and codes of professional practice. Thus, code of ethics focuses on the social issue of the organization emphasizing on development of business, plan of business development that plans to conduct business at the highest level.

Code of ethics decides the code of conduct for employees, and set out the procedures to be used in specific ethical situations such as conflict of interests and prescribes procedures to determine whether a violation of the code of ethics occurred, and if so what remedies need to be imposed.

Ethical contract is an agreement between two or more parties; whereby parties of the contract are legally bound and committed to its promises. It also takes into consideration reasons for breaches in contract, and the way in which these ethical considerations may impact upon them.

### 11.5.4 Need for Professional Values and Attitudes of Accountants

Finance and accounts are primary business functions with responsibility to function in public interest.

Finance and accounting professionals are regarded very high in terms of professional ethics. However, various accounting scams witnessed during the past few years have cast clouds on the role of finance and accounting professional in providing right information both within and outside their respective organizations.



Importance of Ethics for a Finance and Accounting Professional are:

- A. Need:** Finance and accounting professionals are responsible to act in public interest, not restricted to satisfy the needs of any particular individual or organization. They have to follow ethical principles to achieve their objective of "service in public interest".
- B. Role:** Accounting scandals, use of false and misappropriated accounting information, direct involvement in detrimental activities, refusing to identify frauds and embezzlements reported by employees etc. have led to failure of high-profile organizations. These failures may lead to the negligence of finance and accounting professionals and their ethical conduct may be subjected to sharp criticism.

The International Accounting Education Standards Board has released for public exposure a proposed revision of values and attitudes of professional accountants. It prescribes the attitudes that professional accountants should acquire during the education programme leading to qualification. The regular review and updating of professional values, ethics and attitudes is essential to the development and maintenance of competence. Moreover, increasing competence, improves the quality of financial information- a key component of business decision making. The coverage of values and attitudes in education programs for professional accountants should lead to commitment towards:-

- a) Public interest and sensitivity to social responsibilities.
- b) Continual improvement and lifelong learning. Professional accountants need to operate in dynamic world of change. Good governance, both corporate and public, depends greatly on adherence to a strict code of professional values and attitudes. In such circumstances understanding of ethical principles is essential to enable them to operate effectively with integrity and discernment in an ever changing business environment. The purpose of professional standard bodies is to assist members in such tasks.

## 11.6 ETHICS OF MANAGEMENT ACCOUNTANT PROFESSIONAL

Management Accountants have an obligation to provide services at the highest level of ethics possible. Ethics is an integral part of management accounting, and companies need to develop a code of ethics or conduct, to set the expected ethical behavior for an accountant.

In recognition of this obligation, the Institute of Management Accountants has promulgated the following standards of ethical conduct for practitioners of management accounting and financial management. Adherence to these standards internationally is integral to achieving objective of management accounting.

### **Competence:**

Practitioners of management accounting and financial management have a responsibility to:

- Maintain an appropriate level of professional competence by ongoing development of their knowledge and skills.
- Perform their professional duties in accordance with relevant laws, regulations and technical standards.
- Prepare complete and clear reports and recommendations after appropriate analysis of relevant and reliable information

### **Confidentiality:**

Practitioners of management accounting and financial management have a responsibility to:

- Refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to do so.
- Inform subordinates as appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality.

- Refrain from using or appearing to use confidential information acquired in the course of their work for unethical or illegal advantage either personally or through third parties.

### **Integrity:**

Practitioners of management accounting and financial management have a responsibility to:

- Avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict.
- Refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically.
- Refuse any gift, favor, or hospitality that would influence or would appear to influence their actions.
- Refrain from either actively or passively subverting the attainment of the organization's legitimate and ethical objectives.
- Recognize and and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.
- Communicate unfavorable as well as favorable information and professional judgment or opinion.
- Refrain from engaging or supporting any activity that would discredit the profession.

### **Objectivity:**

Practitioners of management accounting and financial management have a responsibility to:

- Communicate information fairly and objectively.
- Disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

### **Let us recapitulate:**

- **Fundamental Principals of Ethical Behaviour:** Integrity, Objectivity, Confidentiality, Professional competence, Obedience to rules.
- **Reasons for unethical behavior:**
  - Over emphasis on short term profitability.
  - Ignoring small unethical issues.
  - Economic cycles.
  - Market complexity.
  - Money mindedness.
  - Threats to ethical behavior:
    - Self interest threats
    - Self review threats
    - Advocacy threats
    - Intimidation threats
    - Familiarity threats
  - A 'conflict of interest ' arise where professional have to decide between compliance with principles and actions which are beneficial to his /her clients.
  - Steps in conflict resolution: Documentation of discussions held and decisions made, legal advice, and extreme step of withdrawal.
  - There is need to follow professional code of conduct for an accountant.
  - Practitioners of management accounting and financial management have an obligation to the public, their profession, the organization they serve, and themselves, to maintain the highest standards of ethical conduct.