

Module 2: Formation of Companies

5. Promotion - Role of promoters - Incorporation - Capital subscription - Commencement of business - Pre-incorporation and provisional contracts

Promotion

Promotion is the first stage in the formation of a company. It involves identifying a business opportunity and taking the necessary steps to establish a company.

The process includes conceiving the business idea, conducting feasibility studies, arranging capital, preparing documents, and registering the company.

Example: A group of entrepreneurs deciding to start an e-commerce company and taking steps to register it.

Role of Promoters

A promoter is a person who undertakes the task of forming a company and brings it into existence.

Functions of Promoters

- Conceive the business idea
- Conduct market and feasibility studies
- Select the company name
- Arrange initial capital
- Prepare incorporation documents
- Appoint professionals such as lawyers and auditors
- Obtain registration

Duties of Promoters

Promoters stand in a fiduciary relationship with the company, meaning they must act honestly and in the company's interest. They must:

- Avoid secret profits
- Disclose personal interests
- Act in good faith

Example: A promoter purchasing land for a future company must disclose any profit earned from the transaction.

Incorporation

Incorporation is the legal process of registering a company under the Companies Act.

After incorporation, the company becomes a separate legal entity.

Steps in Incorporation



Effect of Incorporation

- Company acquires legal existence
- Separate legal entity is created
- Perpetual succession begins
- Limited liability becomes available

Example: Once incorporated, the company can enter into contracts in its own name.

Capital Subscription

Capital subscription refers to raising funds from shareholders by issuing shares.

A company needs capital to start and operate its business.

Sources of Capital Subscription

- Equity shares
- Preference shares
- Private placement
- Public issue

Example: A company issuing shares to investors to raise ₹10 crore for expansion.

Commencement of Business

Commencement of business refers to the stage where a company starts its actual business activities after satisfying legal requirements.

For certain companies, specific declarations and compliance requirements must be completed before business operations begin.

Example: A manufacturing company begins production after completing incorporation and obtaining necessary approvals.

Pre-incorporation Contracts

Pre-incorporation contracts are agreements entered into by promoters on behalf of a company before it is legally incorporated.

Since the company does not exist at the time of the contract, it generally cannot be bound by such contracts.

Features

- Made before company formation
- Entered into by promoters
- Company is not originally a party to the contract

Example: Promoters renting office space before company registration.

Provisional Contracts

Provisional contracts are contracts entered into after incorporation but before obtaining the right to commence business (where applicable).

These contracts become binding only after the company becomes entitled to commence business.

Example: A company ordering machinery before obtaining final approval to begin operations.

6. Document of Companies: Memorandum of Association - Contents and alteration - Doctrine of Ultra Vires

Memorandum of Association (MOA)

The Memorandum of Association is the most important document of a company. It defines the company's constitution and specifies the scope of its activities.

It acts as the charter of the company. Any activity beyond the MOA is generally not permitted.

Example: If a company is formed to manufacture textiles, it cannot legally start a banking business unless its objects permit it.

Contents of Memorandum of Association

Name Clause

Specifies the name of the company.

Registered Office Clause

Specifies the state in which the registered office is situated.

Objects Clause

Defines the objectives and activities of the company.

Liability Clause

States the liability of members.

Capital Clause

Specifies the authorized share capital.

Subscription Clause

Contains the details and signatures of subscribers.

Alteration of Memorandum of Association

The MOA can be altered according to the provisions of the Companies Act.

- **Alteration of Name Clause:** Requires special resolution and approval where necessary.
- **Alteration of Registered Office Clause:** May require approval depending on the nature of the change.
- **Alteration of Objects Clause:** Requires special resolution.
- **Alteration of Capital Clause:** Requires compliance with legal procedures.

Example: A company changing its name from ABC Pvt Ltd to ABC Technologies Pvt Ltd.

Doctrine of Ultra Vires

The term "Ultra Vires" means "beyond the powers."

Under this doctrine, any act performed beyond the powers specified in the Memorandum of Association is void and cannot be ratified.

Purpose

- Protect shareholders
- Protect creditors
- Ensure proper use of company funds

Effects of Ultra Vires Acts

- Void and unenforceable
- Cannot be ratified by shareholders
- Directors may become personally liable

Example: A company formed for manufacturing furniture investing company funds in unrelated speculative banking activities beyond its objects clause.

7. Articles of Association - Contents and alteration - Distinction between Memorandum and Articles - Constructive notice of Memorandum and Articles - Doctrine of Indoor management

Articles of Association (AOA)

Articles of Association contain the internal rules and regulations for managing the company.

While the MOA defines what the company can do, the AOA defines how it will do it.

Example: Rules regarding meetings, voting rights, and appointment of directors are usually found in the AOA.

Contents of Articles of Association

- **Share Capital:** Rules regarding issue and transfer of shares.
- **Meetings:** Procedures for conducting meetings.
- **Directors:** Appointment, powers, and duties of directors.
- **Voting Rights:** Rules regarding voting by members.
- **Dividends:** Procedures for declaring dividends.
- **Accounts and Audit:** Maintenance and auditing of accounts.

Alteration of Articles of Association

The AOA can generally be altered by passing a special resolution. However, alterations should not:

- Violate the Companies Act
- Conflict with the MOA
- Be fraudulent
- Oppress minority shareholders

Distinction between Memorandum and Articles

Memorandum of Association	Articles of Association
Charter of the company	Internal rules of management
Defines external powers	Defines internal procedures
Superior document	Subordinate to MOA
Specifies scope of activities	Specifies management methods
Difficult to alter	Comparatively easier to alter

Constructive Notice of Memorandum and Articles

The doctrine of constructive notice assumes that every person dealing with a company has knowledge of its MOA and AOA because these documents are public records. A person cannot claim ignorance of their contents.

Example: If a contract violates the powers granted in the MOA, an outsider cannot later claim that they were unaware of the restriction.

Doctrine of Indoor Management

This doctrine protects outsiders dealing with a company. While outsiders are presumed to know the company's public documents, they are not expected to know internal procedures. Therefore, outsiders can assume that internal requirements have been properly complied with.

Importance

- Protects outsiders
- Facilitates business transactions
- Balances the doctrine of constructive notice

Example: If directors obtain a loan without completing an internal approval process, the lender may still be protected if acting in good faith.

8. Prospectus - Contents - Liabilities for misstatement

Prospectus

A prospectus is a document issued by a public company inviting the public to subscribe to its shares or debentures. It provides information necessary for investors to make informed investment decisions.

Example: Before an IPO, a company issues a prospectus explaining its business and financial position.

Contents of Prospectus

- **General Information:** Details about the company.
- **Capital Structure:** Information regarding share capital.
- **Objectives of the Issue:** Purpose for raising funds.
- **Financial Information:** Financial statements and performance.
- **Risk Factors:** Potential risks associated with investment.

- **Management Details:** Information about directors and key personnel.
- **Project Details:** Details regarding proposed projects.

Liabilities for Misstatement

If a prospectus contains false or misleading statements, responsible persons may be held liable.

Types of Liability

- **Civil Liability:** Investors can claim compensation for losses.
- **Criminal Liability:** Penalties may be imposed for fraudulent statements.

Persons Liable

- Directors
- Promoters
- Experts
- Persons authorizing issue of prospectus

Example: A company falsely claiming high profits in its prospectus may face legal action from investors.

9. Share Capital-Public Issue of Shares- Book Building-Listing of Shares

Share Capital

Share capital refers to the capital raised by a company through the issue of shares. It represents the ownership interest of shareholders.

Types of Share Capital

- Authorized Capital
- Issued Capital
- Subscribed Capital
- Called-up Capital
- Paid-up Capital

Public Issue of Shares

A public issue occurs when a company invites the general public to purchase its shares. The main objective is to raise capital.

Advantages

- Access to large funds

- Increased public recognition
- Growth opportunities

Example: A company launching an Initial Public Offering (IPO).

Book Building

Book building is a process used to determine the price of shares during a public issue. Investors bid within a specified price range. The final issue price is determined based on investor demand.

Benefits

- Market-based pricing
- Better price discovery
- Efficient allocation

Example: Most modern IPOs use the book-building process.

Listing of Shares

Listing means admitting a company's shares for trading on a stock exchange.

Advantages

- Liquidity
- Easier transfer of shares
- Increased credibility
- Access to future capital

Example: A company's shares being listed on the National Stock Exchange of India.

10. Share Certificate and Share Warrant- Buyback of Shares

Share Certificate

A share certificate is a document issued by a company as evidence of ownership of shares.

Contents

- Name of shareholder
- Number of shares

- Share certificate number
- Company details

Example: A shareholder holding 500 shares receives a share certificate as proof of ownership.

Share Warrant

A share warrant is a negotiable instrument showing title to shares. The holder of the warrant is treated as the owner of the shares. Traditionally, share warrants enabled easy transfer of ownership.

Buyback of Shares

Buyback means repurchasing shares by a company from its existing shareholders.

Objectives

- Increase earnings per share
- Improve share value
- Utilize surplus funds
- Reduce excess capital

Advantages

- Enhances shareholder value
- Improves financial ratios
- Signals management confidence

Example: A company buying back its own shares from investors through a buyback offer.

11. Dematerialization and Rematerialization of Shares-Transfer and Transmission of Shares

Dematerialization of Shares

Dematerialization is the process of converting physical share certificates into electronic form. Shares are held electronically in a Demat account.

Advantages

- No risk of loss or theft
- Faster transfer
- Reduced paperwork

- Improved safety

Example: An investor converting physical share certificates into digital holdings.

Rematerialization of Shares

Rematerialization is the reverse process of converting electronic shares into physical share certificates.

Purpose

- Obtain physical certificates
- Meet specific investor requirements

Transfer of Shares

Transfer of shares means voluntary transfer of ownership from one person to another. It usually occurs through sale, gift, or exchange.

Features

- Voluntary act
- Requires transfer procedure
- Common in listed companies

Example: An investor selling shares through a stock exchange.

Transmission of Shares

Transmission refers to the transfer of shares by operation of law due to death, insolvency, or succession. Unlike transfer, it is not voluntary.

Example: When a shareholder dies, shares may pass to legal heirs.

Difference Between Transfer and Transmission

Transfer of Shares	Transmission of Shares
Voluntary	Involuntary
Occurs through agreement	Occurs by law
Consideration usually involved	No consideration
Transfer deed required	Legal proof required
Common in trading	Occurs on death or insolvency

Example: Selling shares in the market is a transfer, while inheriting shares from a deceased parent is transmission.

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