

PART-II

Corporate Organisation, Finance and Trade

CHAPTER 7

FORMATION OF A COMPANY

PROMOTERS

The steps which are required from the time a business idea originates to the time, a company is legally ready to commence business are referred to as stages in the formation of a company. Those who are taking these steps and the associated risks are promoting a company and are called its promoters.

FORMATION OF A COMPANY

Formation of a company is a complex activity involving completion of a lot of legal formalities and procedures, which are: (i) Promotion; (ii) Incorporation; (iii) Subscription of capital; and (iv) Commencement of business.

As far as the private limited companies are concerned only the first two stages mentioned above are appropriate. In other words, a private company can start its business immediately after obtaining the certificate of incorporation. As it is prohibited to raise funds from public, it does not need to issue a prospectus and complete the formality of minimum subscription. A public company, on the other hand, goes through the capital subscription stage and then receives the certificate of commencement. Thus, it has to undergo all the four stages.

PROMOTION OF A COMPANY

Promotion is the first stage in the formation of a company. It involves conceiving a business idea and taking an initiative to form a company so that practical shape can be given to exploiting the available business opportunity.

A promoter is said to be the one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose. Thus, apart from conceiving a business opportunity the promoters analyse its prospects

and bring together the men, materials, machinery, managerial abilities and financial resources and set the organisation going.

As per section 69, a 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.

After thoroughly examining the feasibility of the idea, the promoters assemble resources, prepare necessary documents, give a name and perform various other activities to get a company registered and obtain the necessary certificate enabling the company to commence business. Thus, the promoters perform various functions to bring a company into existence.

FUNCTIONS OF A PROMOTER

The important functions of promoters may be listed as below:

(i) Identification of business opportunity: The opportunity may be in respect of producing a new product or service or making some product available through a different channel or any other opportunity having an investment potential.

(ii) Feasibility studies: It may not be feasible or profitable to convert all identified business opportunities into real projects. The promoters, therefore, undertake detailed feasibility studies to investigate all aspects of the business they intend to start.

(a) Technical feasibility: Sometimes an idea may be good but technically not possible to execute. It may be so because the required raw material or technology is not easily available.

(b) Financial feasibility: Every business activity requires funds. The promoters have to estimate the fund requirements for the identified business opportunity. If the required outlay for the project is so large that it cannot easily be arranged within the available means, the project has to be given up.

(c) Economic feasibility: Sometimes it so happens that a project is technically viable and financially feasible but the chance of it being profitable is very little. In such cases as well, the idea may have to be abandoned.

(iii) Name approval: Having decided incorporate to a company, the promoters have to select a name for it and submit, an application to the registrar of companies of the state in which the registered office of the company is to be situated, for its approval. The proposed name may be approved if it is not considered undesirable.

It may happen that another company exists with the same name or a very similar name or the preferred name. In such cases the proposed name is not accepted but some alternate name may be approved.

Therefore, three names, in order of their priority are given in the application to the Registrar of Companies.

Name Clause

A name is considered undesirable in the following cases:

(a) If it is identical with or too closely resembles the name of an existing company

(b) If it is misleading.

(c) If it is violative of the provisions of 'The Emblem and Names (Prevention of Improper Use) Act 1950, as given in the schedule to this Act. The Act also prohibits use of any name which may suggest patronage of Government of India, or any state government or any local authority.

(iv) Fixing up Signatories to the Memorandum of Association: Promoters have to decide about the members who will be signing the Memorandum of Association of the proposed company. Usually the people signing memorandum are also the first Directors of the Company. Their written consent to act as Directors and to take up the qualification shares in the company is necessary.

(v) Appointment of professionals: Certain professionals such as mercantile bankers, auditors etc., are appointed by the promoters to assist them in the preparation of necessary documents which are required to be with the Registrar of Companies.

(vi) Preparation of necessary documents: The promoter takes up steps to prepare certain legal documents, which have to be submitted under the law, to the Registrar of the Companies for getting the company registered. These documents are Memorandum of Association, Articles of Association and Consent of Directors.

Documents required to be submitted

A. Memorandum of Association: Memorandum of Association is the most important document as it defines the objectives of the company. No company can legally undertake activities that are not contained in its Memorandum of Association. As per section 2(56) of The Companies Act, 2013 “ 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. The Memorandum of Association contains different clauses, which are given as follows:

(i) The name clause: This clause contains the name of the company with which the company will be known, which has already been approved by the Registrar of Companies.

(ii) Registered office clause: This clause contains the name of the state, in which the registered office of the company is proposed to be situated.

(iii) Objects clause: It defines the purpose for which the company is formed. A company is not legally entitled to undertake an activity, which is beyond the objects stated in this clause.

(iv) Liability clause: This clause limits the liability of the members to the amount unpaid on the shares owned by them.

(v) Capital clause: This clause specifies the maximum capital which the company will be authorised to raise through the issue of shares. The said company cannot issue share capital in excess of the amount mentioned in this clause.

The Memorandum of Association must be signed by at least seven persons in case of a public company and by two persons in case of a private company.

B. Articles of Association: Articles of Association are the rules regarding internal management of a company. According to section 2(5) of The Companies Act, 2013, 'articles' means the article 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.

C. Consent of Proposed Directors: Apart from the Memorandum and Articles of Association, a written consent of each person named as a director is required confirming that they agree to act in that capacity

and undertake to buy and pay for qualification shares, as mentioned in the Articles of Association.

D. Agreement: The agreement, if any, which the company proposes to enter with any individual for appointment as its Managing Director or a whole time Director or Manager is another document which is required to be submitted to the registrar for getting the company registered under the Act.

E. Statutory Declaration: A declaration stating that all the legal requirements pertaining to registration have been complied with is to be submitted to the Registrar with the above mentioned documents for getting the company registered under the law.

F. Receipt of Payment of fee: Along with the above-mentioned documents, necessary fees has to be paid for the registration of the company. The amount of such fees shall depend on the authorised share capital of the company.

POSITION OF PROMOTERS

Promoters undertake various activities to get a company registered and get it to the position of commencement of business. But they are neither the agents nor the trustees of the company. They can't be the agents as the company is yet to be incorporated. Therefore, they are personally liable for all the contracts which are entered by them, for the company before its incorporation, in case the same are not ratified by the company later on. Also promoters are not the trustees of the company. Promoters of a company enjoy a fiduciary position with the company, which they must not misuse. They can make a profit only if it is disclosed but must not make any secret profits. In the event of a non-disclosure, the company can rescind the contract and recover the purchase price paid to the promoters. It can also claim damages for the loss suffered due to the non-disclosure of material information. The company may also remunerate the promoters for their efforts by paying a lump sum amount or a commission on the purchase price of

property purchased through them or on the shares sold. The company may also allot shares or debentures or give them an option to purchase the securities at a future date.

INCORPORATION

After completing the aforesaid formalities, promoters make an application for the incorporation of the company. The application is to be filed with the Registrar of Companies of the state within which they plan to establish the registered office of the company along with other necessary document.

- 1. The Memorandum of Association duly stamped, signed and witnessed.**
- 2. The Articles of Association duly stamped and witnessed as in case of the Memorandum.**
- 3. Written consent of the proposed directors to act as directors and an undertaking to purchase qualification shares.**
- 4. The agreement, if any, with the proposed Managing Director, Manager or whole-time director.**
- 5. A copy of the Registrar's letter approving the name of the company.**
- 6. A statutory declaration affirming that all legal requirements for registration have been complied with. This must be duly signed.**
- 7. A notice about the exact address of the registered office may also be submitted along with these documents. It can be submitted within 30 days of the receipt of the certificate of incorporation.**
- 8. Documentary evidence of payment of registration fees.**

When the Registrar is satisfied, about the completion of formalities for registration, a Certificate of Incorporation is issued to the company, which signify the birth of the company.

Preliminary Contracts

During the promotion of the company, promoters enter into certain contracts with third parties on behalf of the company. These are called preliminary contracts or pre-incorporation contracts. These are not legally binding on the company. A company after coming into existence may, if it so chooses, decide to enter into fresh contracts with the same terms and conditions to honour the contracts made by the promoters.

EFFECT OF THE CERTIFICATE OF INCORPORATION

A company is legally born on the date printed on the Certificate of Incorporation. It becomes a legal entity with perpetual succession on such date. It becomes entitled to enter into valid contracts. The Certificate of Incorporation is a conclusive evidence of the regularity of the incorporation of a company.

Both public and private companies are required to obtain the certificate for commencement of business within 180 days of its incorporation. Once the certificate for commencement of business is issued by Registrar of companies it can undertake their business operations.

Director Identification Number (DIN)

Every individual intending to be appointed as director of a company shall make an application for allotment of Director Identification Number (DIN) to the Central Government in prescribed form along with fees. The Central Government shall allot a Director Identification Number to an application within one month from the receipt of the application.

No individual, who has already been allotted a Director Identification Number, shall apply for, obtain or possess another Director Identification Number.

CAPITAL SUBSCRIPTION

A public company can raise the required funds from the public by means of issue of securities (shares and debentures etc.). For doing the same, it has to issue a prospectus which is an invitation to the public to subscribe to the capital of the company and undergo various other formalities. The following steps are required for raising funds from the public:

(i) SEBI Approval: A public company inviting funds from the general public must make adequate disclosure of all relevant information. This is necessary for protecting the interest of the investors. Prior approval from SEBI is, therefore, required before going ahead with raising funds from public.

(ii) Filing of Prospectus: A prospectus is 'any document described or issued as a prospectus including any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any securities of, a body corporate'. Therefore, there must not be a mis-statement in the prospectus and all material significant information must be fully disclosed.

(iii) Appointment of Bankers, Brokers, and Underwriters: Raising funds from the public is a stupendous task. The application money is to be received by the bankers of the company. The brokers try to sell the shares by distributing the forms and encouraging the public to apply for the shares. If the company is not reasonably assured of a good public response to the issue, it may appoint underwriters to the issue. Underwriters undertake to buy the shares if these are not subscribed by the public. They receive a commission for underwriting the issue. Appointment of underwriters is not necessary.

(iv) Minimum Subscription: According to the Companies Act, this is called the 'minimum subscription'. As per the SEBI Guidelines the limit of minimum subscription is 90 per cent of the size of the issue. Thus, if applications received for the shares are for an amount less than 90 per cent of the issue size, the allotment cannot be made and the application money received must be returned to the applicants.

(v) Application to Stock Exchange: An application is made to at least one stock exchange for permission to deal in its shares or debentures.

(vi) Allotment of Shares: Till the time shares are allotted, application money received should remain in a separate bank account and must not be used by the company.

A public company may not invite public to subscribe to its securities (shares, debentures etc.). Instead, it can raise the funds through friends, relatives or some private arrangements as done by a private company. In such cases, there is no need to issue a prospectus. A 'Statement in Lieu of Prospectus' is filed with the Registrar at least three days before making the allotment.

DIFFERENCE BETWEEN MEMORANDUM OF ASSOCIATION AND ARTICLES OF ASSOCIATION

Basis of Difference	Memorandum of Association	Articles of Association
Objectives	Memorandum of Association defines the objects for which the company is formed.	Articles of Association are rules of internal management of the company.

Position	This is the main document of the company.	This is a subsidiary document.
Relationship	Memorandum of Association defines the relationship of the company with outsiders.	Articles define the relationship of the members and the company.
Validity	Acts beyond the Memorandum of Association are invalid and cannot be ratified.	Acts which are beyond Articles can be ratified by the members.

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