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Court : Delhi

Decided On : Nov-25-1974

Reported in : [1975]45CompCas429(Delhi); ILR1975Delhi305

Judge : V.S. Deshpande and; B.C. Misra, JJ.

Acts : Companies Act, 1956 - Sections 9

Appeal No. : Company Appeal No. 6 of 1974

Appellant : Globe Motors Ltd.

Respondent : Globe United Engineering and Foundry Co. Ltd

Advocate for Pet/Ap. : G.L. Sanghvi,; S.B.P. Singh,; K.K. Bhatia,;

Judgement :

V.S. Deshpande, J.

(1) The question for decision involving construction of sections 9, 36, 85, 100, 102, 205, 211 (read with Schedule VI), 217 and 511 of the Companies Act, 1956 (hereinafter called 'the Act') is whether the holders of preference shares carrying a right to a fixed cumulative dividend payable when the company is going concern only out of profits earned and when dividend is recommended to be paid by the directors in a general meeting are entitled during the winding up of the company to the arrears of the fixed cumulative dividend in view of Article 7 of the Articles of

Association out of the assets of the company which did not make any profits at any time at all.

(2) The appellant company Messrs. Globe Motors Limited arc the equity shareholders of Respondent No. 1 Messrs. Globe United Engineering & foundry Company Limited. Respondents 2 to 7 are the holders of the company's (Respondent 1) preference shares carrying a fixed cumulative dividend as per Article 7(i) of the Articles of Association which is as follows:

'THEPreference shares shall confer on the holders thereof the right to a fixed cumulative preferential dividend of 9.5 per cent per annum free of Company's tax but subject to deduction of taxes at source at the prescribed rates on the capital paid up thereon, and in the event of winding up, the right of re-payment of capital and arrears of dividend whether earned, declared or not, up to the commencement of the winding up in priority to the equity shareholders.'

ASthe expected foreign technical collaboration did not materialise, the company did not go into business at all but went into voluntary liquidation which was later put under the supervision of the Court. The liquidator made a reference to this Court under section 518 of the Act as to whether the preference shareholders of the company were entitled to the payment not only of their share capital but also of the arrears of the fixed cumulative dividend thereon before any payment is made to the equity shareholdars out of the assets of the company in liquidation. The learned Company Judge answered the question in the affirmative relying mainly on the unanimous opinions of writers on British company law based on English decisions. Hence this apepal by the equity shareholders.

(3) Shri G. L. Sanghi for the appellant urges that the answer to the above question should be governed not so much by the weight of the British text books and precedents but by the provisions of our Companies Act which may be dissimilar. Shri D. S. Dang for the respondents submitted that the provisions of our Companies Act would lead to the same conclusion. In the light of their arguments and our own further thinking, we shall consider the question in depth primarily on the construction of the relevant provisions of the Companies Act and Article 7 and then sec if the British precedents and the opinions of well known authors lead to

the same conclusion.

(4) We first start with the premise that the company and its shareholders are two different legal entities. When the company was incorporated, it adopted its Memorandum and Articles of Association. including Article 7. These were the statutory terms of contract governing the relationship between the company and the shareholders. Persons who contributed the preference share capital became members of the company on these terms, The effect of the memorandum and article of association is stated in section 36(1) of the Act as follows:

'SUBJECTto 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.'

(5) The expression 'subject to the provisions of this Act' recalls section 9 of the Act which is as follows:

'SAVEas otherwise expressly provided in the Act (a) the provisions of this Act shall have effect notwithstanding anything to the contrary contained in the memorandum or article 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 aforesaid shall, to the extent to which it is repugnant to the provisions of this Act, become or be void, as the case may be.'

(6) At the first blush, one may think that every provision of the Act would override every provision in the articles to the extent of repugnancy between the two. We would like to emphasise that this is not so. The reason is that the Companies Act, like all law relating to companies, consists of two distinct parts, namely, (1) relating to the formation and the management of a company as a going concern, and (2) relating to its winding up. The difference between the two is the same as between

running and stopping. The memorandum of a company sets forth the objects to be achieved by the working of the company during its life time. It does not usually provide for what is to happen during its winding up. Parts I to Vi of the Companies Act contain provisions regulating the formation and the management of companies. Part Vii relates to the winding up of companies. Similarly, the majority of the articles of association concern with the formation and working of the company while article 7 consists of two parts, the first part relating to the company as a going concern and the second part relating to its winding up. The existence of two distinct provisions in the same article strikingly brings out the contrast between the working of the company and its winding up. The effect is that some provisions of the company law and of the articles would apply exclusively to a company which is a going concern while the other provisions would apply only to a company in liquidation.

(7) It is in this background that section 511 has to be read which is as follows :

'SUBJECTto the provisions of this Act as to preferential payments, the assets of a company shall, on its winding up, be applied in satisfaction of its liabilities pan passu and, subject to such application, shall, unless the articles otherwise provide, be distributed among the members according to their rights and interests in the company.'

Subject to the making of preferential payments (e.g., under sections 520 and 530), the assets of the company are distributed among the members according to their rights and interests in the company unless the articles otherwise provide. The rights and interests of the members in the company are based both on the provisions of the Act and of the articles of association. In striking contrast with section 9 and 36, the articles prevail over the second part of the section 511. Since sections 9 and 36 ensure the superiority of the provisions of the Act as against the provisions of the articles, the obvious difference between them and the provisions of section 511 securing the superiority of the articles over its second part can be understood only on the hypothesis that sections 9 and 36 relate to those provisions of the Act which apply to the working of a company as a going concern while section 511 refers only to those provisions of the Act which apply during the

winding up of the company. This is why the former override the articles while the latter is subject to the articles.

(8) The prospectus was issued in 1967 long after the terms of. the contract between the company and the members were settled by the articles which were finalised in 1963. The representation made in the prospectus inviting the public to subscribe capital and buy the shares of the company would not change the terms of the contract between the company and the members which are already settled.

(9) The prospectus did not become a contract between the company and the members inasmuch as the subscribers buying the shares did so with the knowledge that the contract would consist of the memorandum and the articles of association and not of the representations made in the prospectus. Any variation between the language of the prospectus and article 7(i) is, thereforee, to be construed as the article prevailing over the prospectus.

(10) Originally, the statutes relating to companies in England made provisions only for the formation and the woking of the companies. Insolvent companies were left to be governed like ordinary persons by the law relating to insolvency. It was only later that it was realised that a company may have to be wound up even though it may not have become insolvent. This led to statutory provisions for the liquidation of companies. Historically, thereforee, the conception of a limited liability company is essentially one of a working company which, as a legal person; functions side by side with natural rsons. Just as a natural person is governed fully by laws of contract and property before insolvency but is not governed without modifications by them during insolvency, similarly a company is governed by such provisions of the Companies Act and the articles as are applicable to its working but is governed by a totally different set of provisions and articles which apply during its liquidation. The fundamental difference between the law governing the working of a company and the law governing its liquidation was recognised by Lord Macnaghten in the leading decision of the House of Lords in Birch v. Cropper, (1889) 14 A.C. 525 as follows:

'WHENthe company is wound up, new rights and liabilities arise... while the company is a going concern no capital can be returned to the shareholders,

except under the statutory provisions in that behalf . . . . In the case of winding up everything is changed. The assets have to be distributed.'

The distinction was also emphasised in a subsequent leading decision of the House of Lords in Scottish Insurance Corporation v. Wilsons & Clyde Coal Company, (1949) A.C. 462. The counsel on both sides emphasised the distinction between 'the rights of stockholders to dividends while the company is a going concern and their rights in a liquidation first to return of capital and secondly to surplus assets' (page 471) and 'the status and rights of the preference stockholders in the company as a going concern .... and the statement of the rights of the preference stockholders in a liquidation' (pages 474 and 475). The contrast was put in a literary flourish as follows :

'THEREis no known status of a company being moribund or comatose. Either it is in liquidation or it is not and the members when they join it contract on the basis of these two alternatives There is no half-way househalf law, half fact and almost wholly picturesque language.'

(page 475).

(11) The contract between the preference shareholders and the company is contained in article 7(i) reproduced above. The first part of article 7(i) obviously refers to the company as a going concern. What is the meaning of 'the right to a fixed preferential cumulative dividend' conferred on the preference shareholders? It means that the company must pay every year to the preference shareholders dividend at a fixed rate. Why is the dividend to be 'cumulative' and 'preferential' The reason is that another primary principle of company law both in our country and in England is that the capital of a company must be maintained. Sections 100 to 102 ensure that the capital of a company is not to be reduced except with the consent of a competent court, If any dividend were to be paid by a company as a going concern without making any profits, then such dividend would come out of the capital of the company. This would result in a reduction of the capital without the consent of the court and would be illegal even if such a payment were to be provided for in the memorandum and articles of association which themselves would be overridden by sections 100 and 102. If this was so why was it necessary

to enact further section 205 to ensure that no dividend shall be paid except out of profits The reason seems to be that the word 'profits' is itself capable of having different meanings depending on the different methods of how they are calculated (Gore-Browne on Companies, 42nd Edition, pages 285 291 and 618 to 624). This is why section 205 specifies how the profits out of which dividends can be paid are to be ascertained. Even if profits are earned by a company, it may not choose to distribute dividends out of them. It is, thereforee, for the Board of Directors to recommend the payment of dividend in a general meeting under section 217. These provisions of the Act restrict the contractual right of a preference shareholders to the fixed dividend during the working of the. company. But the second part of artiele 7(i) relates to the winding up of the company and gives the preference shareholder 'the right of re-payment of capital and arrears of dividend whether earned, declared or not'. This is the crucial provision in the contract between the preference shareholders and the company on the true construction of which the decision of the appeal depends. Let us, thereforee, understand the meaning of every important word in it. What is the meaning of 'dividend' As poined out by Buckley on the Companies Acts (13th Edition, page 895) 'pyinologically a dividend is the 'dividendum', the total divisible sum. but in its ordinary sense it means the sum paid and received as the quotient forming the share of the divisible sum payable to the recipient'. From the point of view of the company, the profits are earned and divided. The profits or a part of the profits may, thereforee be the dividend to the company. The word 'earned' qualifying the word 'dividend' may, thereforee, mean either of the two things depending on whether it is used in relation to the company or in relation to the preference shareholders. A company cams dividend in the sense of earning profits. A preference shareholder earns dividend in the sense that the contract between him and the company embodied in article 7(i) gives him the right to the dividend. What is the nature of this right The phases through which a contractual right passes till it is enforced by the receipt of a payment of money are described by Hidayatullah, C. J., in H. Madhuv Rao Scindia v. Union of India, : [1971]3SCR9 , as follows :

'THEdynamic theory of obligations regards a debt a a claim to an equivalent in value to a floating charge against the generality of things which arc the properties of the debtor' From this developed the notion of a credit-debt where property rights

arise from a promise, express or implied in respect of ascertained or readily ascertained sums of money. Thus a debt or a liability to pay money passes through four stages. First there is a debt not yet due. The debt has not yet become a part of the obligor's 'things' because no net liability has yet arisen. The second stage is when the liability may have arisen but is not either ascertained or admitted. Here again the amount due has not become a part of the obligor's things. The third stage is reached when the liability is both ascertained and admitted. Then it is property proper of the debtor in the creditor's hands. The law begins to recognise such property in insolvency, in dealing with it in fraud and creditors, fraudulent preference of one cerditor against another, subrogation, equitable estoppel, stoppage intransitu, etc. A credit-debt is then a debt fully provable and which is fixed and absolutely owing. The last stage is when the debt becomes a judgment debt by reason of a decree of a Court. Thus an American Judge held 'outstanding uncollected accounts' as property (Standard Marine Insurance Co. v. Board of Assessors. 123 La 717. (4). It is because of this that the French Law includes such obligations in mobiles.'

(12) What is the reason why in the first part of article 7(i) only the word 'dividend' is used while in the second part of article 7(i) the words 'arrears of dividend' are used The answer is given by Professor R. R. Pennington in his 'Company Law', 3rd Edition. The learned author deals with the company as a going concern at page 180 and observes as follows :

'IT is common to speak of the unpaid balance of preference dividend as 'arrears' but this is misleading because it conveys the impression that the unpaid balance is a sum of money which the company already owes the preference shareholders. The preference dividend only becomes owing when (a) there are profits available to pay it, and (b) it has been properly declared in accordance with the articles, unless they dispense with a declaration, and when there are arrears of preference dividends ex hypothesi one or other or both of these things have not happened.'

(13) This is why the first part of article 7(i) docs not talk of arrears of dividend but merely emphasises that the dividend is cumulative. That is to say, even if a dividend is not declared and paid in one year, the right to it continues to

accumulate till the whole accumulation is declared and paid later. Strictly speaking when the company is a going concern, unearned and undeclared dividend is not due and does not amount to arrears. But the situation is completely changed during the winding up. At page 186 Professor Pennington comments on an article under which arrears of preference dividend are payable in a winding up in the following words :

'UNDERsuch a clause unpaid preference dividends are payable for periods up to the repayment of the preference capital, even though the dividends have not been declared, and even though the company did not earn sufficient profits to pay them while it was a going concern.'

(14) The learned author does not dispute the use of the word 'arrears' as applied to a company in liquidation and thus recognises the fundamental difference between the two situations. The same dividend which is not payable during the life of a company as not having been earned or declared becomes payable with all the arrears during liquidation even if it is not earned or declared.

(15) Section 85 of the Act defines 'preference share capital' and expressly recognises the distinction between the right of a preference shareholder to the payment of a dividend when the company is a going concern and to the same right when the company is in liquidation.

ITreads as follows : Preference share capital' means, with reference to any company limited by shares, whether formed before or after the commencement of this Act, that part of the share capital of the company which fulfills both the following requirements, namely : (a) that as respects dividends, it carries or will carry a preferential right to be paid a fixed amount or an amount calculated at a fixed rate, which may be either free of or subject to income-tax; and (b) that as respects capital, it carries or will carry, on a winding up or repayment of capital, a preferential right to be repaid the amount of the capital paid up or deemed to have been paid up, whether or not there is a preferential right to the payment or either or both of the following amounts, namely : (i) any money remaining unpaid, in respect of the amounts specified in clause (a), up to the date of the winding up or repayment of capital ; and (ii) any fixed premium or premium on any fixed scale,

specified in the memorandum or articles of the company.

(16) The words 'whether or not there is a preferential right tothe payment of.....any money remaining unpaid in respect of the amounts specified in clause (a)' arc decisive. They recognise that a contract between the preference shareholder and the company may provide the payment of unpaid preferential dividend on a preference share capital during the winding up. Because they apply only during the winding up proceedings, they are not subject either to section 205 or to section 217 which restrict payment of dividends to earning of profits and to the declaration of dividends. Article 7(i) is, thereforee, clearly authorised by section 85(1)(b)(i) .It is to be noted that the words 'the amounts specified in clause (a)' in section 85(1)(b)(i) simply mean the amount of preferential dividend calculated at the fixed rate. They do not import the restrictions imposed by sections 205 and 217 on the payment of such amount. These restrictions would be implied in section 85(1)(a) which refers to the company as a going concern but not in section 85(1)(b) which refers to it during liquidation. Had section 85(1)(b)(i) been subject to sections 205 and 217, it could not have permitted a contract to provide for payment of dividend to preference shareholders during winding up. Such a provision could be permitted by contract only because sections 205 and 217 are not applicable during winding up. Section 205(1) says 'no dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2)'. The determination of profits for a particular year after providing for depreciation can only be the act of a company which is a going concern. Section 217(1) refers to a report by the Board of directors placed before a general meeting. But the Board of directors becomes extinct and is replaced by the liquidator during the winding up proceedings. None of these sections can, thereforee, apply during winding up. They do not, thereforee, restrict or affect the right of the preference shareholders to the payment or arrears of dividend during winding up.

(17) The reason why article 7(i) is so worded is historical. Formerly, the English judges were also dominated by the idea that dividends not being payable except out of profits could not be paid during winding up if no profits had been made. This

view was expressed in Re W. L Hall & Co. Ltd. (1909) 1 Ch. 521 (4A). The distinction between the company as a going concern and a company during liquidation was, however, soon realised and this decision was dissented from successively in the subsequent decisions in Re New Chinese Antimony Co. Ltd., (1916) 2 Ch. 115, (5), in Re Springbok Agricultural Estates. Ltd., (1920) I Ch. 563, (6) and finally in Re Wharfedale Brewery Co., Ltd., (1952) 2 All England Reports 635, (7), all of which suggested or concluded that arrears of dividend were payable to the preference shareholder during winding up irrespective of profits having been made. This view was followed in India by K. K. Desai, J. of the Bombay High Court in Re The Bombay Chlorine Products Ltd., (1965) 35 Company Cases 282(8). The same view was also expressed in Re F. De long & Co. Ltd., (1946) 1 All E.R. 556(9), and in Re E. W. Savory Ltd., (1951) 2 All E.R. 1036(10). It is in the light of this development of judicial decisions that Palmer's Company Precedents, 17th Edition, states the following conclusion at pages 779-780 :

'PRIMAfacic a preference dividend in payable only out of the profits made whilst the company is a going concern, and it wants special provision to give the holders a right to have the arrears paid out of assets in winding up if by the articles arrears are to be paid, they may be payable although no profits have been made'.

(18) Shri Sanghi suggested that the words in article 7(i) 'arrears of dividend whether earned, declared or not' should not be literally construed. He put forward the distinction between the earned and the unearned income, the former being due to appreciation of the assets of the company. He argued that the latter part of article 7(i) only meant that dividend was payable whether profits were by way of earned or unearned income or not. He maintained, thereforee, that if the profits were not made by a company at all, then dividend was not payable in winding up. Firstly, the expression 'earned, declared or not' is not accidental but deliberate. The juxtaposition of the words 'earned' and 'declared' recalls the two limits on payment of dividend when the company is a going concern, namely, non-earnig of profits and non-declaration of dividends referred to in sections 205 and 217 of our Act. The word 'earned' is not, thereforee, used in contradistinction to the word 'unearned',

(19) While the company is a going concern, it has to prepare a balancesheet annually as per section 211 and Schedule Vi to the Companies Act. The left side of the balance-sheet shows the liabilities and the right side shows the assets. As remarked by Professor Pennington at page 600 of his book referred to above, 'the left hand side of a balance-sheet is often misleadingly referred to as the liabilities side; it is certainly true that the company's debts and liabilities appear there but so also do other items such as paid up capital and reserves which are not liabilities owed by the company but represent the interest of its shareholders in its undertaking. The left hand side of a balance-sheet should be regarded as a statement of the way in which the company's assets shown on the right hand side would be applied if the company were wound up immediately'. Item No. (13) (3) under the heading 'Provisions' on the side of the liabilities in the statutory form of balance-sheet in Schedule Vi is as follows -

'ARREARSof fixed cumulative dividends'.

(20) An explanatory note added to it says that 'the period for which the dividends are in arrear .....shall be stated'. This is a statutory recognition of the fact that in the balance-sheet of a company, provision has to be made for payment of the liability consisting of the arrears of fixed cumulative dividends. This may or may not mean that there is an enforceable debt due to a preferential shareholder against a company while it is a going concern. But it does mean that a provision has to be made by the company for the payment of the arrears of cumulative dividend in its balance-sheet with a view to provide for payment of such cumulative dividends in the event of winding up. Shri Sanghi then argued that the English decisions should not be allowed to influence the construction of Article 7(i) inasmuch as there was no provision in the English Companies Act, 1948 corresponding to section 205 of our Companies Act. This argument ignores the fact that Article 116 of Table A of Schedule 1 of the English Companies Act corresponds to section 205 of our Companies Act.

(21) The reason why the distinction between profits on the one hand and the capital and the other assets of the company on the other hand is important when the company is a going concern disappears when the company is in liquidation is

that in liquidation the whole of the property of the company is treated as its assets without any difference between the sources from which the assets have accrued to the company. Shri Sanghi contended that even during liquidation a distinction between the different sets of assets could be made according to their sources. He relied on the special definition of a 'dividend' in the Income Tax Acts by which Income-tax could be imposed on that part of the assets of a company in liquidation which could be traced to the profits made by the company [Hari Prasad Jayantilal & Co. v. Income-lax Officer, 19662 S.C.R. (11), Bharat fire and General Insurance Co. v. The Commissioner of Income Tax, : [1964]53ITR108(SC) and Kantilal Manilal v. The Commissioner of Income Tax, : [1961]41ITR275(SC) . But these very decisions show that such a distinction could be made during winding up only for the purposes of taxation and that it was not relevant for the purposes of the distribution of the assets of the company.

(22) On the other hand, in ./. K. (Bombay) (P) Ltd. v. New Kaisei-i- Hind Spg. Wvg. Co. Ltd., : [1969]2SCR866 , the Supreme Court recognised the distinction between a company as a going concern and the company during winding up, in the following words :

'THEvery object for which the company existed and which also was the assumption on which the scheme was framed ceased to exist..... The effect of a winding up order is that except for certain preferential payments provided in the Act the property of the company is to be applied in satisfaction of its liabilities pan passu. Pan passu distribution is to be made in satisfaction of the liabilities as they exist at the commencement of the winding up.'

Applying this principle to our case, it is apparent why some but not all rights created during the working of the company survived after the winding up order is made. Those rights which concern the working of the company do not survive. For, the very objects of the company ceased. On the other hand, those rights which are expressly meant to be worked out only during winding up of the company survived and become enforceable after the winding up, e.g., the right to the preferential payment of cumulative dividends to preference shareholders being a right which becomes enforceable only during the winding up.

(23) Lastly, Shri Sanghi stressed that this was a very exceptional case. The company did not go into business at all. In such a case cumulative dividends to preference shareholders should not be paid out of capital. We do not see, however, any differences between such a company and a company which has made no profits and which may have run into losses. In either case the cumulative dividend shall have to be paid out of the capital of the company. The rule against reduction of capital or non-payment of dividends except from profits ceases to apply during winding up simply because the very object of winding up is to obliterate all distinctions in the kinds of assets and to apply the assets under section 511 of the Companies Act.

(24) For the above reasons, the answer given to the reference made by the liquidator by the Learned Company Judge, namely, that the arrears of dividends on preference shares are payable during the winding up under Article 7(i) is upheld. The appeal is dismissed. The parties to bear their own costs.