

STUDIES IN INDIAN ECONOMICS

EDITED BY

C. N. VAKIL

UNIVERSITY PROFESSOR OF ECONOMICS, BOMBAY

No. 9

STUDIES IN INDIAN ECONOMICS

A series of volumes dealing with the Economic history and problems of Modern India.

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C. N. VAKIL

UNIVERSITY PROFESSOR OF ECONOMICS, BOMBAY

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**ORGANISATION AND FINANCE
OF
INDUSTRIES IN INDIA**

BY
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AND
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EDITOR'S PREFACE

The question of the industrial development of this country has been in the forefront since the policy of discriminating protection was adopted. Rapid changes in industrial activities have occurred in the leading countries of the world which affect us directly or indirectly. In spite of differences of views regarding the exact method which may be adopted for bringing about the growth of industries in this country, the fact that such a growth should be brought about is accepted on all hands. The growth of industries in other countries has led to many problems both of policy and organisation, and the economic history of these countries is full of lessons from which those like us who come later in the field may profit. It is in the fitness of things therefore, that a systematic study of the different aspects of this problem be made with a view to form correct ideas for the ordered growth of industries, and the removal of difficulties and obstacles as far as possible.

Some effort in this direction has been made in this series. In a former volume entitled 'The Growth of Trade and Industry in Modern India,' an introductory survey of facts relating to the principal industries in the country was made. This prepared the way for the consideration of the question of industrial policy which was discussed in another volume namely, 'Industrial policy of India with special reference to Customs Tariff.' It was indicated in the Preface to the latter volume that the forward industrial policy, which was advocated therein, would not by itself be sufficient to develop industries in the country. It was necessary along with such a policy to solve problems relating to the organisation and finance of industries. These problems have attracted great attention in recent times partly in the form of investigations by the Banking Committees, and partly in the form of legislation, which has brought about important changes in the Companies Act.

The present volume aims at the discussion of questions relating to the organisation and finance of industries. The authors have

approached the question in an unbiassed manner, and have not hesitated to point out defects and suggest radical remedies. The impression is easily formed that while we insistently ask the State to help by adopting a forward industrial policy, we should at the same time be prepared to put our house in order by removing all those weaknesses and deficiencies which have crept into our industrial organisation. Some of these can be removed only by enlightened public opinion and by improved methods on behalf of those who are in charge of industries. It is to be expected that in view of the general awakening in the country for economic progress, greater interest will be taken in problems of this nature, which otherwise become the concern of the few.

The present work in its original form was done in the form of theses for the M. A. degree of this University by Messrs. D. R. Samant and M. A. Mulky during the years 1930-33. The material of these two theses was subsequently co-ordinated for the purpose of this volume. While this was being done Dr. P. S. Lokanathan's book on 'Industrial Organisation in India,' was published in 1935. Though the general object of Dr. Lokanathan is similar, his approach and emphasis on different aspects of the problems are different. He is more concerned with the organisation of industries and less with their financial problems. He devotes considerable space to the managing agency system, to describe which, he draws largely on the experience of certain European houses working mainly in Calcutta. The object of the present volume is wider, because while it gives due consideration to the problems of the managing agency system, it considers other equally important allied problems both of finance and organisation. It also discusses the position of small industries which does not find place in Dr. Lokanathan's work. These observations are made not with a view to criticise Dr. Lokanathan's work, but to point out the differences in the treatment of the two volumes, and the fact that the material part of the work was done before Dr. Lokanathan's volume was published.

The co-ordination of the work of Messrs. Samant and Mulky, and its revision for the press was unfortunately delayed because of the absence from India of Mr. Mulky. Mr. Samant had therefore, to undertake the greater amount of responsibility in this connection. So far as the actual division of work between the two authors is

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concerned it may be mentioned that chapters I-V, VII and VIII are written by Mr. Samant and chapters VI, IX, X and XI by Mr. Mulky. Advantage has however, been taken of this delay in incorporating in the book an appendix giving a survey of important changes in the Companies Act, which affect the organisation and finance of industries in India. Mr. Samant is responsible for the appendix.

It may be added that academic workers writing on subjects of practical importance have naturally to depend on the co-operation of the men of affairs not only for information but also for that outlook which is born of experience. Though efforts were made to obtain such co-operation in writing this work, they were not always successful. It is to be expected that those in trade and industry take a broader view of things, and do not discourage such efforts, because the systematic study of their daily work, is bound to be beneficial to all concerned.

C. N. Vakil.

*School of Economics & Sociology,
University of Bombay,
15th January 1937.*

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APPENDIX

THE INDIAN COMPANIES' AMENDMENT ACT, 1936

While the book was in the press the Indian Companies' Act was amended by the Indian Legislature. This Act, which is known as the Indian Companies Amendment Act of 1936, has, we are glad to say, brought about in the industrial organisation of the country certain salutary changes, the necessity of many of which we had occasion to indicate in the body of the book. The new Act no doubt is a great step forward on the former legislation and should, if ingenious businessmen and lawyers are not able to find loopholes frustrating its aim, prove helpful in bringing about a healthy growth of joint-stock organisation. And we have every hope that Government will not lose time in removing the loopholes, if any, that may defeat the intentions of the Legislature.

We propose to review briefly the more important changes made by this Act. The extent of the changes effected can well be imagined by the fact that it runs into 123 sections with a considerable number of subsections in some of them. We do not wish to discuss here all these changes. In the first place, with many of them, especially with those concerning Banks and Private Companies, we are not directly concerned; secondly, certain sections deal with details of legal and accountancy provisions, which need not be discussed here. We propose to discuss only those sections which are likely to bring about in the organisation and finance of industrial concerns changes which are important from an economic point of view.

These changes can be divided into certain groups such as those concerning (1) mushroom companies, (2) fraudulent companies (3) the issue and contents of prospectuses, (4) disclosure of financial position to shareholders, (5) shareholders' control over the management, (6) managing agents (7) winding up of companies, (8) banks and so on.

MUSHROOM COMPANIES

The first thing that any legislation in matters economic must aim at is to stop the wastage of existing resources of material well-

being. Such wastage takes place, in the field of industries, when ever any industrial scheme is not able to add to the wealth of the nation. The first duty of a piece of economic legislation, therefore, is to stop the expenditure of resources on all such unfruitful schemes. The Act under consideration attempts to do this, so far as joint-stock organisation is concerned, by discouraging mushroom companies. Such companies not only result in wastage of the assets expended on them, but they entail still greater loss in so far as they frighten the investing public, and make it difficult to find capital even for deserving industrial schemes. This impediment in the way of industrial progress must therefore be checked as effectively as possible. The checks exerted by the former Company Law were weak, and hence the history of the industrial progress of our country shows that whatever advancement we have made is at a great cost. The present legislation no doubt is an improvement in this respect over the former one.

The companies which owing to insufficiency of funds are not able to start work or even though they start working are required to close down soon owing to financial difficulties, are called mushroom companies. Such companies are started with a motive, usually an honest one, to work some attractive schemes but they rarely achieve the goal owing to insufficiency of funds. Naturally the resources spent on such schemes are lost as they are not able to yeild any return to the owners. In our first chapter we have shown that the promotion of such mushroom companies cost the Indian investing public nothing less than 64 crores during the short post-war boom period.

In the fifth chapter, while discussing the problem of raising initial capital we have shown how companies are started without raising sufficient capital. Such enterprises are of course foredoomed to fail; some of them do not even start work but are wound up before that. The former law had no provision to check such activities; on the other hand it encouraged them. The peculiar provisions of the minimum subscription clause contained in it made it possible for the organisers of such schemes to get out of the activities without any loss to themselves. We have already shown in the said chapter how by keeping the minimum low, the organisers could utilise the money raised from the shareholders to defray the payment to be made to them, on account of their

personal and material services. The organisers of unsound companies thus did not run any great risk. In such cases it is the outside investors who lost their money, and in order to avoid such loss we had suggested that no company should be allowed to proceed to allotment of shares unless the subscription guaranteed the supply of funds sufficient to satisfy the needs for fixed and working capital. And we are glad to say that the new Act contains provisions on these lines.

The amended Act now lays down that in fixing the minimum subscription, the directors must see that the raised funds would provide (a) the purchase price of any property purchased or to be purchased; (b) the preliminary expenses; (c) commission for procuring subscriptions for any shares in the company; (d) repayment of moneys borrowed by the company in respect of any of the foregoing matters; and lastly (e) working capital.¹ This provision will no doubt make it difficult to start concerns with insufficient funds; but it will not prove as beneficial as it seems at first sight. Its effect is weakened to a great extent by the proviso which leaves the directors free to raise the necessary capital in ways other than by issuing shares, for instance, by issuing debentures or by accepting deposits or borrowing loans.²

This freedom to raise capital in ways other than by issuing shares not only weakens the provision but may even frustrate its aim. The directors, for instance, may declare that they have secured a certain proportion as deposits from the agents, and require only a certain proportion as share capital, and when they have secured subscription for that small amount of shares, may proceed to allotment. Later on it may so happen that the managing agents who are the promoters and creditors may decide to wind up the concern, and may withdraw their deposits and appropriate the share money for their expenses and commission, the shareholders in the end losing their money.

In the same chapter on Initial Capital, we have also shown how certain other countries have made legal provision regarding raising

¹ cf. Section 10 I (2).

² "..... the amount stated in the prospectus as the minimum amount which in the opinion of the directors must be raised by the issue of share capital in order to provide the sums or, if any part thereof is to be defrayed in any other manner, the balance of the sum required to be provided in respect of the matters specified in subsection (2)" Section 101 (1).

a substantial portion of capital out of share issue. Such a provision is quite necessary in this country, and this would have been achieved if the suggestion in the Bill as originally introduced had been accepted. It was originally suggested that the subscribed capital must either be sufficient to meet the expenditure for all the heads mentioned above or "83½ per cent. of the share capital offered to the public for subscription whichever is higher." It was also suggested that at least 25% of the subscribed capital must have been paid for or received in cash by the company. This part of the section would have ensured financial soundness to a greater degree, but unfortunately it was deleted by the Select Committee.

This provision is likely to result in one more disadvantage. It gives good opportunity to the agents to keep the concerns indebted to them. In one of the sections¹ relating to the managing agency contract, it is provided that at the time of determination of the contract, the agents must be paid back all dues belonging to them. The clause relating to minimum subscription as finally passed gives the managing agents an opportunity to keep the concerns heavily indebted to them from the very beginning. As such loans would be spent in fixed assets it will be impossible to pay off the loans without winding up the concerns unless some other financier comes forward to advance the necessary amount, or it is raised by issuing debentures. In the former case the financier will demand the agency rights and in that case it will mean little benefit. As regards the second possibility it is easy to imagine how difficult it is for the disorganised and scattered shareholders to carry out such a financial scheme in the face of opposition from well organised and powerful management. This clause thus gives a good opportunity to the managing agents to make their contracts almost permanent. These defects could have been avoided by making it obligatory to start a company only with owned capital, or at least with a large proportion of owned capital.

PREVENTION OF FRAUDS

Another way in which the waste of assets is prevented is through suppression of fraudulent concerns. Like mushroom concerns fraudulent concerns also involve a great loss of capital

¹ cf. Section 87A (4).

resources. The harm done by both these types of companies does not remain restricted only to the actual loss of capital involved in them but spreads much beyond that. They create a bad name for industrial investments and discourage the supply of capital for industrial purposes.

Just as under the former Act there was no direct check over promotion of mushroom companies, so also there was no special provision to check the activities of fraudulent company organisers and managers. The only way open for the aggrieved party under the existing conditions is to seek redress under the Penal Code. But to file a criminal suit against a man in a responsible position involves great difficulty. The amendments introduced by the new act have made it more easy to check the perpetration of frauds.

According to the new Act the Registrar of joint-stock companies is authorised to investigate into cases of fraud brought to his notice by any creditor or contributory and after enquiring to make a report to the Local Government.¹ The Local Government on its part has been authorised to launch a prosecution at the cost of the state against those, who as a result of investigations are considered guilty of any offence.² According to this Act the responsibility of the aggrieved party ends on bringing to the notice of the Registrar the suspected acts of fraud.

THE ISSUE AND CONTENTS OF THE PROSPECTUSES

After suppressing the mushroom and fraudulent concerns, the next step is to see that the rest of the concerns are conducted on honest and efficient lines. The most important feature of joint-stock organisation is that those who supply the capital cannot have a direct and constant control over the management of the concern. The management thus having no financial stake in the concern are likely to be careless and even fraudulent in their work. The best way to check and suppress such activities is to bring the affairs under greater supervision and control of the shareholders. The shareholders being scattered and unable to go into the details of the working of the concern, it must be made legally binding upon the management to keep the owners informed of their activities.

¹ cf. Section 137 (a) (3) and (b) (6).

² cf. Section 141 (a)

Under the former Company Law there was no provision whereby the managers were required to keep the owners informed of the affairs, and consequently the shareholders generally did not know anything except that they received or did not receive dividends. As a result, there was a great demand for greater control by the shareholders on their concerns, and the new Act is a great step forward in that direction.

The first provision in this respect is in regard to the particulars to be disclosed in the prospectus. The prospectus is the document which gives the necessary information about the proposed company to the prospective investors. It is therefore only just that the shareholders should get accurate and honest information about the enterprises in which they intend to participate. In order to meet this demand certain provisions are made in the new Act to make the information more exhaustive and accurate. For instance, it is made necessary to disclose in the prospectus the agreement regarding the appointment and remuneration of the managers or managing agents.¹ In our chapter on the Managing Agency System we have shown how the different provisions relating to the appointment and remuneration of the agents were not disclosed to the shareholders, who, going by the statements in the prospectus, remained almost in the dark about such matters. The managing agents by different provisions in the agency agreement usurp too much power and render the shareholders powerless in controlling them. Similarly, by different financial provisions the agents involved the concerns under great financial obligation to themselves. This agreement being not easily available to them, the shareholders used to purchase the shares in blissful ignorance about all these conditions. An agency agreement is a contract between the shareholders and the managing agents; and it is therefore only just that both the parties should be fully aware of the conditions of the contract.

The provision made by the new Act in this respect is not quite satisfactory. The relevant section only says that the prospectus should contain "any provision in the articles or in any

¹ Section 93 (1) (C) states that the prospectus must contain "any provision in the articles or in any contract as to the appointment of managers or managing agents and the remuneration payable to them."

contract as to the appointment of managers or managing agents and the remuneration payable to them." This provision is likely to be interpreted as requiring statements of the names of the agents and the percentage of the profits to be paid to them as remuneration for managerial services. But in our chapter on the Managing Agency System, we have shown how the managing agents make money in so many different ways. They want commission for securing capital, fixed and working, for purchasing machinery and raw materials, for arranging sales, for carrying out insurance, for maintaining a head office, and sometimes even for labourers employed and the payments made to them. Such commissions are likely to be considered as payments not for managerial services, but for each different respective service, and therefore need not be included in the prospectus which requires the statements of payments for managerial services only. It is of course difficult to understand what is the managing agents' conception of their managerial duties and functions. It would have been better therefore, if it were specifically provided that the prospectus should mention all sorts of payments to which the managing agent is entitled. No fair minded person would say that the managing agents should render any service gratis to the client concern. What is equally fair is that the shareholders should have a clear idea of the financial obligations that they undertake when they purchase the shares.

Whenever underwriters are employed, the directors must disclose in the prospectus the names of the underwriters and their remuneration. Besides this the directors must also include a statement to the effect that the underwriters possess sufficient means to fulfil the obligations undertaken by them.¹ This provision regarding underwriters is important. When it is declared that the issue has been underwritten, it means that the enterprise will not remain without being started for want of funds. Naturally, it becomes easy to sell the shares of such a concern. In the end if the underwriters are not able to fulfil their undertaking and the outside subscription does not warrant a successful conduct of the enterprise, those who had purchased the shares on the understanding that the whole issue had been underwritten stand to suffer. It is therefore

¹ cf. Section 93 (ee).

proper that the investors should know more about the financial and social position of the underwriters, so that they might be in a better position to decide about the possibility of the undertaking being fulfilled by them.

All these provisions are intended to give the prospective investor more or less a clear and accurate idea as to the financial position of the concern in which he intends to invest his money. But we do not think that they will serve any great purpose.

In our chapter on Initial Capital we have shown how the properties are likely to be transferred to a new company at an exorbitant price and in that case the concern is likely to suffer from financial scarcity if not bankruptcy, and stressed the necessity of ascertaining the propriety of the price to be paid in such cases. But this suggestion does not find a place in the new Act. The provisions described above will at the best enable the prospective investors to form some idea as to whether the price paid or to be paid is reasonable or otherwise. These provisions thus will prove useful only from the point of view of those who can understand such things; for others it is of little use. In all probability those provisions will prove as useless and unimportant as that about the minimum subscription in the former Act. Legal provisions which are meant to be of use to guide those who understand the things generally prove useless in the case of those who do not understand the same. In the latter case the law must not only provide for the disclosure of the facts, but must also provide for passing a judgment on the same. In the book while discussing the problem of stock-watering, we have described how in other industrialised countries, the state has made provisions to ascertain that the prices paid for properties acquired by joint-stock companies are not unreasonable¹. Some provision on these lines is quite essential in this country; and it is regrettable that an opportunity to accomplish this was lost. Owing to the general ignorance of business matters on the part of our investors, such a provision was all the more urgent.

DISCLOSURE OF FINANCIAL POSITION TO SHAREHOLDERS

Just as the new Act intends to give the prospective investor full information about the financial position of the concern in

¹ See the chapter on Initial Capital.

which he intends to invest, so also it contains certain provisions which are intended to keep the shareholders fully informed about the financial position of the concerns in which they have already invested their money. As the shareholders cannot themselves manage the affairs of the company, the same has got to be left in the hands of the executive appointed by them. And the question of seeing that the executive work is done in the interest of the shareholders has proved a hard nut to crack in the field of company law. Two different ways are devised to accomplish this. Either the executive is obliged by the law to manage the concern in a way which is considered to be beneficial to the owners, or they are obliged to keep the owners informed of the affairs, so that the latter being fully aware of the working of the concern should be in a position to bring about changes which they deem to be desirable. The provisions made by our company law in this respect belong to the latter type. The rules regarding the periodical supply of information about the finances of the concern to the shareholders have been made much more strict under the new Act.

Under the old Act the only source for the shareholders to get information about a going concern was the balance sheets published by it. But the balance sheets, as they are published at present, are aimed more at hiding the situation than at disclosing it. It will be difficult even for an expert accountant, not to speak of a layman, to form a correct opinion about a concern by reading balance sheets in the present form. The new Act has brought about some salutary changes in this situation. First of all, it has improved the form of the balance sheet to some extent.¹ The new form provides for greater details regarding certain points such as reduction of capital assets, debts, investments etc., which will prove useful to the shareholders. But still the supply of information provided by that form is not exhaustive and clear. The only noteworthy feature about the form is that its observance has been made more strict.

But the Act has made some important improvements in other directions. So far the shareholders had to remain satisfied only with the balance sheet. But under the new Act the compilation and circulation of three other documents have been made com-

¹ See Section 132 (1) and (2) and the form F from Schedule III.

pulsory. For instance, every balance sheet must be accompanied by a copy of the auditor's report.¹ Hitherto the shareholders were required to go to the registered office of the company to see the auditor's report. The auditor's report if it is drawn carefully and conscientiously, will help the shareholders to study the balance sheets more correctly. The auditors must also certify as to the correctness of the accounts and also their conformity with the law.² Besides, they are entitled to receive the notice of and to attend any general meeting of the company, at which any accounts examined or reported on by them are to be considered. In such meetings they are entitled to make any statement or explanation they desire with respect to the accounts.³ But this provision is not likely to be effective. The auditor's report to be of any importance must contain an impartial scrutiny of the actions of the management, and the satisfactory discharge of this duty depends upon the extent to which they are free from the control of the management. Not much importance can therefore be attached to this provision, until the management is deprived of their voice in the election of the auditors. Owing to the same circumstances, nothing important can be expected even from the provision entitling the auditors to appear before the shareholders in the general meetings. Here also they cannot be ordinarily expected to be impartial to the management. All the same it would have been better if the appearance of the auditors in the shareholders' meeting had been made compulsory. Under the provision explained above the appearance of the auditors has been left to the will of the auditors who except under very exceptional circumstances cannot be expected to attend the meetings and to incur the odium of the displeasure of the management by criticising their actions.

As a matter of fact it ought to have been made compulsory for the auditors to appear before the shareholders and to explain to them their findings. In short, the provisions regarding the written and oral report of the auditors will not prove effective. In the second chapter of the book while speaking about the auditors we have shown how even some big concerns reduce auditing to a mere farce. And this they can do as they wield a preponderant voice

¹ cf. Section 131 (3).

² cf. Section 145 (2) (b).

³ cf. Section 145 (4).

in the appointment of the auditors, and naturally the latter cannot be expected to be impartial to the former under such circumstances. If the auditors are to be of any use, they must be made quite independent of the management. Only then can they be expected to discharge their duties efficiently and impartially.

The new Act has made it necessary for the management to prepare and circulate profit and loss account in addition to the balance sheet.¹ Under the old Act the submission of profit and loss account was left to the will of the management. This account must show, in a classified form, the amount of gross income, distinguishing the several sources from which it has been derived, and the amount of gross expenditure, distinguishing the expenses of establishment, salaries and other matters.² Such an account of income and expenditure will be more comprehensible to the shareholders than the too technical and obtruse balance sheet. The profit and loss account must also contain particulars regarding the total of the amount paid whether as fees, percentage commission or otherwise to the managing agents, if any, and the directors respectively as remuneration for their services, and the total of the amount written off for depreciation.³ The importance of this provision will depend upon the extent to which it will be able to reveal the amount of money made by the agents in different ways out of the client concerns. For instance, if it means a complete disclosure of the total income of the managing agent from that particular concern, then it will have some salutary effects. In our chapter on the managing agency system, we have shown in how many different ways, the agents derive income from the client concerns. The disclosure of all such payments received by the managing agents will prove beneficial, in so far as it will exercise an indirect check upon the tendency of the agents to squeeze money out of the client concerns. The disclosure of the payment made to the directors will also prove useful in so far as it will make it possible to compare the total costs of the directorate with the services received from that body. This will discourage the practice of forming too large a board, for considerations other

¹ cf. Section 131 (1).

² Section 17 (2) has made compulsory the Regulation 107 which contains the above provisions.

³ cf. Section 13 (32).

than its services to the concern. Another noteworthy provision about the profit and loss account is the statement of the depreciation written off. This provision is not likely to prove of any great use. It will have at the best only an indirect effect in so far as it will give prominence to the depreciation item. But this cannot mend the present negligence regarding depreciation provision. The absence of a proper provision for depreciated assets is one of the greatest defects of our industrial finance,¹ and this situation can be improved only by making it compulsory for every concern to set aside every year, a certain percentage of the assets as depreciation reserve. So long as this has not been done, mere disclosure of the facts will prove of little use.

Besides these documents, the directors must work out and circulate among the shareholders their own report, which was not compulsory under the old Act, regarding the financial condition of the concern.² This report must contain statements regarding the amount which they recommend should be paid by way of dividends and the amount which they propose to carry to the different reserves. This compulsion upon the directors to inform and explain their policy to the shareholders is likely to yield a double advantage. It will exert an indirect influence upon the attitude of the directors in so far as they will have to be more careful about their actions, being required to intimate and explain the same to the shareholders. From the point of view of the shareholders, it is always advantageous to have as much information as possible about the concerns in which they have invested their money.

One more important provision to be mentioned in this connection is that all these reports and statements must be sent to the shareholders at least fourteen days before the meeting at which they are to be discussed. Previously, this time limit was only of seven days and the shareholders hardly got any time to consider the information supplied to them before the meeting was held.

One noteworthy addition belonging to this group of informative provisions discussed so far deserves mention here. The new Act provides that a register should be maintained containing the particulars of the contracts entered into between the company and

¹ See the chapter on Administration of Earnings.

² cf. Section 131 A (1).

any of its directors, and it should be open to the inspection of the shareholders.¹ This provision will give the shareholders an idea of the financial relations of the directors with the concern. Besides, it will make the directors more cautious about their dealings and also will give an opportunity to the shareholders to scrutinise and if necessary to nullify or rectify any unfair bargains.

All these provisions are intended to enable the shareholders to have as clear an idea as possible about the finances of their enterprise. Formerly, a balance sheet, which was prepared more to misguide than to guide, was the only source of financial information for the shareholders. Some better managed concerns no doubt supplemented the balance sheet with profit and loss account. But there being no obligation to issue the latter statement, most of the companies avoided the trouble of preparing and issuing it. The information supplied by both these documents will be made more comprehensible by the directors' report, which will enable the shareholders to know the policy and actions of the executive which were responsible for the position stated in these documents.

All the provisions regarding the supply of financial information to the investors, at all stages, which we have discussed so far, are of an informative nature. They are only intended to supply the information to the prospective as well as existing shareholders. The supply of such information is useful only if the persons for whom it is meant are able to read it in the proper light. Besides, it can prove of any use only when the shareholders wield effective control over the executive, and can bring about desirable changes. But where the owners do not wield an effective and immediate control, the actions of the executive must be restricted and directed by the law. In the second chapter, we have shown how the shareholders even in forward countries like England, find it difficult to exercise an effective control over the management. In India the management is still more beyond the control of the shareholders, first, owing to the existence of the managing agency system and secondly, owing to the general ignorance and inefficiency of the shareholders. Under these circumstances, it would have

¹ cf. Section 91 (A) (3).

been better if the management had been obliged to follow certain salutary financial policies laid down by law.

SHAREHOLDERS' CONTROL OVER THE MANAGEMENT

After enabling the shareholders to have a full knowledge of the financial position of a concern, the next sphere for reforms was to enable them to have control over its management. In a joint-stock company the shareholders who are the owners cannot have a direct control over the enterprise. Their powers are delegated to the boards of directors who manage the affairs of the concerns on their behalf. The management and ownership of a joint-stock company being thus separated, the managers are likely to be careless and fraudulent in their work. And in order to avoid such a situation it is necessary to bring the management as much under the control of the owners as possible. The management of a joint-stock company is ordinarily vested in the hands of the board of directors and the control of the owners over the affairs of the company will depend upon the extent of their control over these boards of directors. Under the former law the boards of directors were formed in such a way that the shareholders could exert very little control over them. This control was materially curtailed owing to the present form of the managing agency system, whereby the majority of the directors were nominated by the managing agents. Such directors being beyond the control of the shareholders, the concerns were managed by persons who could hardly be called the representatives of the shareholders. But the new Act brings about some improvement in this situation. In the first place it is provided that every company, must have at least three directors.¹ No more will it be possible to manage a company with only two directors. It is further provided that two-thirds of the directors of a company started under the new Act shall be liable to have their office terminated by rotation.² By another provision it is laid down that the managing agents cannot have more than one-third of the directors nominated by them.³ This is a step in the right direction, because it will act as a check on the directors who cannot have a permanent position. Besides

¹ c.f. Section 83 (A) (1).

² cf. Section 83 (B) (2).

³ cf. Section 87 I.

it may be noted that in view of regulations 78 and 81 all the directors will have to retire at the first annual general meeting.

The control of the shareholders on the directors is further strengthened by enabling them to remove an undesirable director by passing an extraordinary resolution to that effect.¹ Under this provision the directors will have to think twice before disregarding the will of the shareholders. A director will have to vacate his office even if he absents himself from three consecutive meetings of the Board, or for a continuous period of three months, whichever is longer, without leave of absence from the board.

The new Act not only attempts to make the directors more active in their duties but it has also increased the responsibilities of their office. No more is it legal to exempt the directors, managers, auditors or any other officers of the company from, or indemnifying him against, any liability in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.² In the second chapter while discussing the relations of directors with companies, we have shown how the directors were relieved of their responsibilities by special provisions in the Articles of Association. We have suggested that such attempts to relieve the directors of their proper responsibility should be made illegal. The present section carries out this suggestion. The effect of this provision will be to eliminate from the boards of directors persons who do not understand their duties properly; and those who accept the responsibility of directorship will be more vigilant about the acts of the managers or managing agents.

Not only has it been made more difficult for the directors to shirk the responsibility of discharging their duties carefully and conscientiously, but many additional responsibilities are also imposed upon them by the new Act. For instance, the responsibility of keeping proper books of account has been cast upon them, and if any director fails to take reasonable steps to secure compliance by the company with the requirements of this section he is liable to a heavy fine.³ In cases where there are managing agents, the managing agents are held responsible for keeping proper books

¹ cf. Section 86 (G).

² cf. Section 86 (C).

³ cf. Section 130 (3).

and the directors are relieved of this responsibility.¹ This provision will result in the maintenance of books of accounts in proper order. Under the former Act there was no such obligation upon the directors. Though Section 230 of that Act provided that every company should maintain proper account books, still neither the agents nor the directors were held responsible for the maintenance of such books. They were relieved even of what indirect responsibility they bore in this respect being the supreme managerial authority, by providing an indemnity clause in the Articles. Under these circumstances, proper account books were not maintained, with the result that in many cases of frauds, it was difficult to trace the culprits.² In this connection, the directors are further required to supply to the Official Liquidator a full statement disclosing in detail the affairs of the company to enable him to have a clear idea as to the company's financial position.³

When the shareholders elect a director they do so because they have confidence in the honesty, integrity and business ability of the person. It showed therefore a complete disregard of duty and responsibility for a director to assign his office to any person who was not able to win the confidence of the shareholders. Such acts on the part of the directors testify the general complaint that though in theory the directors are the representatives of the shareholders, in practice they completely disregard them. But the new Act makes certain provisions whereby the directors cannot afford to forget that they are the representatives of the shareholders. No more, for instance, is it possible for the directors to assign their office to any other person, without the consent of the shareholders expressed by a special resolution.⁴

The provisions discussed so far attempt to bring the directors under a greater control of the shareholders and to increase the responsibilities of their office. The Act further attempts to restrict the directors from taking undue advantage of their position in

¹ cf. Section 130 (3).

² Some interesting examples of such mismanagement will be found in the lecture of Mr. S. S. Engineer, a member of a well-known auditing firm in Bombay, delivered on 25th April 1930, at the time of the first Annual Social of the Incorporated Accountants' Association, Bombay.

³ cf. Section 177 (1) (2).

⁴ cf. Section 86B.

making money. They are, for instance, prohibited from holding any office of profit under the company except that of a managing director or manager or a legal or technical adviser or a banker without the consent of the company in a general meeting. The office of managing agents is not considered an office of profit under the company.¹ So also the directors are precluded from entering into any contract for sale, purchase, or supply of goods and materials with the company without the Board's consent.²

In our chapter on the managing agency system, we have shown how the managing agents and their friends or nominees on the board entered into contracts with the company for the sale of the manufactured goods or the supply of raw materials or machinery, usually to the disadvantage of the shareholders. Under the former Act when the managing agents could have a majority of their nominees on the board all such contracts meant more or less a distribution of spoils among themselves. But the situation will be different under the new Act. Now there will be a majority of the representatives of the shareholders who can ordinarily be expected to protect the interests of their electors. It is further provided that an interested director shall not be counted for the quorum, which will make it difficult to pass such a resolution in the absence of some directors.³ The protection given by these sections gains strength from the obligation to disclose all such contracts to the shareholders, a provision which we have already discussed. All the same it must be admitted that the protection given by the necessity of securing the consent of the board for such contracts cannot be said to be adequate under the existing circumstances. It would have been better if the consent of the shareholders were made necessary in such matters.

The present Act prohibits a company from advancing loans to a director or guaranteeing any loans made to him or to a firm of which he is a partner or to a private company of which such a director is a director.⁴ This provision is important in so far as it precludes the directors from utilising the funds belonging to the companies under their direction for their personal use. Such trans-

¹ cf. Section 86E.

² cf. Section 86F.

³ cf. Section 91B (2).

⁴ cf. Section 86D.

actions were not rare, and their effects were not infrequently detrimental. The money was usually lent at a very low rate, and losses from default were not uncommon.

Two more important amendments were moved containing further limitations on the powers of the directors, but they were thrown out by the Assembly. One of them attempted to limit the number of concerns of which a man could be director. For instance, it was suggested that a man could not be a director of more than twenty companies. In the second chapter of the book while referring to this question we have shown how companies cannot derive benefit even from able directors if they serve on the boards of many companies at the same time. It does not require any great imagination to realise that a man, whatever his ability, cannot discharge his duties efficiently if he is required to serve on the boards of 60 to 80 companies at a time. The result is that such a person, in spite of his ability, proves of little use to any of them. These persons would have proved more useful if they had restricted their activities to a limited number of concerns voluntarily. The present method has created almost a class of directors in industrial centres like Bombay and Calcutta. The business ability of many able persons outside this class is being wasted for want of opportunity. If these directors had restricted their activities to a few concerns, their own services would have been more effective, and this would have left opportunities for other persons with merit and ability. Of course it must be admitted that the provisions of the new Act discussed so far, which increases the responsibilities and duties of the directors, will have an indirect effect upon checking this tendency. So also the provisions intended to bring the directors under a greater control of the shareholders will make it difficult for a few favourite persons to secure membership of the boards. Henceforward the election of the directors will be related to a greater extent to the active services that they can render to the concerns under their directorship. Similarly the increased responsibilities of the director's office will have an effect upon limiting the number of boards on which a man can serve. But this result would have been more assured if the law had limited the number of directorships that a man can undertake.

The second provision which was thrown out by the Assembly,

was regarding the disclosure by a director every year of his dealings in the shares of the company. The underlying idea in making this suggestion was to prevent directors from speculating in the shares of the companies of which they were the directors. In the second, the third and the fifth chapters we have shown how the directors and managing agents by taking advantage of their position and knowledge of the financial conditions of the concerns, deal in the shares, generally to the detriment of the interests of the outside shareholders. It is quite essential to have some legal check on such activities. It is argued in this respect that if they are prohibited from doing this themselves, they will do the same through their nominees. Though this is true to some extent, a legal provision restricting the directors from such activities with heavy penalty for any attempts to frustrate it would have proved of great benefit. There being at present no restrictions on their activities in this matter, they take an undue advantage of their position. The directors, having greater knowledge of the finances of the concern can know the future trend of the prices of the company's shares and use this knowledge in share speculation, making profits at the cost of the shareholders. Sometimes they go still further and actually manipulate the finances so as to be advantageous for their dealings. The result of all such practices is that they create a bad name for industrial investment; the persons who are expected to encourage industrial investment thus in practice discourage it. The existing conditions therefore prove the necessity of prohibiting the directors from dealing in the shares of the companies under their directorships.

MANAGING AGENTS

It is for the first time in the history of company legislation in India that statutory recognition has been given to managing agents and the managing agency system.¹ Though the managing agency system has been a feature of joint stock organisation in India ever since its introduction, still strangely enough this institution was not recognized in law till recently. This is a good example of how legislation in India is many times of imitative and exotic nature without proper co-ordination of the circumstances existing in this country. It is believed by some that this

¹ cf. Section 2 (9A).

"definition makes it clear beyond doubt that except to the extent to which the directors might themselves delegate their functions to the agents the agents would be under their control and direction."¹ But this is a wrong idea. The definition as such makes no changes in the past and present position of the agents and the directors respectively. The definition as given in the Act runs as follows, "managing agent means a person, firm or company entitled to the management of the whole affairs of a company by virtue of an agreement with the company, and under the control and direction of the directors except to the extent, if any, otherwise provided for in the agreement". This definition clearly shows that far from the powers of the agents being limited by the directors the powers of the directors are limited by the will of the agents as formulated in the agency agreement. The directors will have to accept their appointment with their powers vis-a-vis those of the agents as specified in the agency agreement. The definition of the managing agents, therefore, in no way brings the agents under greater control of the directors, it only gives legal recognition to an institution which so far was not recognised in law at all.

The important provisions applicable to managing agents are contained in subsections 87A to 87 I. The first provision in this respect relates to the period of managing agency contract. It is provided that a managing agent shall not be appointed to hold office for a period of more than twenty years at a time;² so also no managing agent appointed before the commencement of the Act can continue after twenty years from its commencement.³ It is further provided that the termination of the managing agents' office under the above rule shall not take effect until moneys payable to the managing agents for loans or remuneration are paid.⁴

In our chapter on the Managing Agency System we have shown how the agency agreements under the old Act were formed for long periods of forty to sixty years, and in some cases they were even permanent and non-terminable. After showing the dis-

¹ cf. Indian Companies Act overhauled and Amended, Article V, Times of India Nov. 11, 1936.

² cf. Section 87 A (1).

³ cf. Section 87 A (2).

⁴ cf. Section 87 A (4).

advantages of such long period contracts, we stressed the necessity of limiting these contracts to shorter periods. We therefore welcome the change introduced by the new Act. But we are doubtful about the efficacy of these provisions in practice.

The termination of the managing agents' contract, as, said above, is to be effective only when all moneys payable to the managing agents for loans or remuneration are paid. We have more than once shown how the managing agents try to keep the client concerns deeply indebted to them.¹ Under these circumstances it will be very difficult for any concern to pay off the loans due to the agents.² This provision will give a greater impetus to the tendency of keeping the client concerns indebted to the agents; and in this respect it is likely to prove more harmful than beneficial as it encourages unsound financial practices.

A transfer of office by a managing agent has been made void unless approved by the shareholders in a general meeting.³ This provision is important. In our chapter on the managing agency system we have shown how by one of the sections of the agency agreement the managing agents took to themselves the right of transferring the agency to any party they liked, and the shareholders were rendered powerless in such matters. After discussing the injustice and ill effects of such practice, we suggested that such transfers should be rendered void unless approved by the shareholders and this is accomplished by the said provision. Similarly, a charge or assignment of managing agents remuneration has also been rendered void.⁴

By a further clause it is provided that if a company is wound up either voluntarily or by the court before the termination of the contract with the managing agents, then the managing agents have a right to receive compensation provided that the winding up is not due to negligence or default on their part.⁵ As in business matters it is very difficult to prove negligence or default in a court of law, the payment of compensation in all such cases will be a

¹ See for instance our chapters on Managing Agency System and Initial Capital.

² See *Supra* discussion regarding the Minimum Subscription Clause.

³ cf. Section 87 B. (C).

⁴ cf. Section 87 B. (d).

⁵ cf. Section 87 B (d).

permanent feature. It is also a point worth considering whether the possibility of getting compensation will not tempt the agents to accelerate the downward movement of the business in order to wind it up before the termination of the agency contract. Besides, as the remuneration of the agents is payment for their active services to the business during a specific period, there does not seem to be sufficient ground for compensation when the business ceases to exist and the services end. If at all any compensation was thought proper the law, in view of the too heavy compensation demanded by the agents in such cases, ought to have restricted the limit of such compensation. For instance, it ought to have been laid down that the compensation should not exceed the annual minimum remuneration or the average annual remuneration.

It is further provided that the appointment, dismissal and variation of the contract of the managing agents cannot be valid, unless approved by the company by a resolution to that effect.¹ But a proviso has been added to this clause to the effect that it does not apply to the appointment of a company's first managing agent made prior to the issue of the prospectus. This proviso which was introduced by the Select Committee has deprived the clause of most of its importance. We do not therefore agree with those who call this "an extremely important provision." It only means that the dismissal of the existing managing agents or the appointment of new ones or any changes in the agency contract must be referred to the shareholders for their approval and cannot be carried out by the directors themselves. But when the shareholders have a majority of their representatives (under this Act) on the board, and the interested parties are prohibited from voting it is of little importance to refer such matters to the shareholders when it has been approved by their representatives.

This section would have proved of great importance had it been kept as introduced in the original Bill, in which case, it would have been applicable even to the appointment of the first managing agent. The select committee by introducing the proviso eliminated the appointment of the first managing agent from the provision of this section. The Select Committee perhaps thought that as the preliminary appointment is announced in the prospectus

¹ cf. Section 67 B (f).

it becomes known to the shareholders when they purchase the shares.¹ But we have already shown how scanty information regarding the agency contract is supplied in the prospectus. There is no exaggeration if we say that the shareholders purchase the shares with gross ignorance about the contents of the agency contract. As the shareholders are a party to the contract it is proper that they should have a full knowledge of its contents. With the same view we suggested that the agency contract should not be considered valid unless it was approved by the shareholders in the first general meeting.² Supposing there arises disagreement between the proposed managing agent and the shareholders, the former should sever his connection with proper remuneration for his services rendered up to that time. This will even be in keeping with the principles of sound finance. It is always better that the preliminary expenses should be met in the beginning and should have no connection with the later finance of the company. The select Committee by introducing the proviso lost a great opportunity of bringing about an important change in our industrial organization and finance.

After making provisions for appointment, duration and removal of the managing agents the act refers to the problem of the remuneration of the agents. And in this respect it is laid down that the remuneration of the managing agents shall be a sum based on a fixed percentage of the net annual profits of the company, with provision for a minimum payment, together with an office allowance.³ It is further provided that any stipulation for remuneration additional to that provided by this section shall not be binding on the company unless sanctioned by a special resolution of the company.

In our chapter on the Managing Agency System, while discussing the respective merits of the three principal systems of remunerating the managing agents, viz. commission on production, commission on sales, and commission on profits, we have shown that

¹ The Select Committee have made the following remarks regarding this section, "We," they observe ".....have also saved from its operation those preliminary appointments announced in a prospectus, which it would be impracticable to hold in abeyance until the first general meeting." Report of the Select Committee.

² See the chapter on the Managing Agency System.

³ cf. Section 87 C (1).

⁴ cf. Section 87 C (2).

the system of paying in the form of a certain percentage on the profits is the best of the three. It is therefore good that this system has been made obligatory on all companies, unless otherwise sanctioned by the shareholders themselves. Another salutary feature about this provision is the definition of "net profits." Under the former law the definition of the term net profits was left to the sweet will of the managing agents, and as we have shown in the third chapter it was often defined in a way prejudicial to the shareholders. From this point of view, it is good that the Act has laid down a definition of the expression "net profits" for the purpose of calculating the remuneration of the managing agents. This definition is an improvement over the one usually laid down by the managing agents in the agency contract. It is now laid down that "net profits" means the profits of the company calculated after allowing, inter alia, for depreciation and bounties or subsidies received from Government.¹ The exclusion of depreciation charges from 'net profits' though theoretically correct is likely to have a bad effect under the existing circumstances. The managing agents, as they stand to lose commission on the amounts set aside for depreciation, will always attempt to lessen the depreciation charges in order to increase their commission, and this will result in causing a greater neglect of the depreciation provision than is found at present. The only check on the managing agents in this respect will be the possible majority of the directors elected by the shareholders. But nothing great can be expected from this possibility. This exclusion of depreciation charges would have been all right if the law had made a specific provision for building up an adequate depreciation reserve. In the absence of any such provision the new Act will have the effect of encouraging the neglect of a proper provision for depreciation.

Besides the commission on profits, the agents are entitled to get additional remuneration in the form of an office allowance. In our chapter on the Managing Agency System we have shown how the office allowance means nothing but extra remuneration for the agents. The new Act by giving legal sanction to office allowance will make the practice universal. At present many big concerns do not charge anything on this account. The Ahmeda-

¹ cf. Section 87 C (3).

bad mill agents, for instance, so far did not stipulate for an office allowance. If at all it was thought improper to burden the agents with expenses incurred on account of the client concerns, it ought to have been provided that the office allowance should be certified by the auditor as bona fide expenses incurred for the particular concern.

A company is prohibited from making or guaranteeing any loan to the managing agents.¹ This is rather an important provision. In our chapter on the Administration of Earnings we have shown how the managing agents sometimes borrow money out of the reserves of a client concern on a nominal rate of interest, and how afterwards if the agents are not able to meet their liabilities the concerns become ruined. Similarly the client concerns are made to guarantee the loans incurred by the agents for their personal use. In such cases too the concerns not quite unoften are required to sustain a heavy loss owing to the inability of the agents to meet their liabilities. It is therefore a good thing that companies are saved from such losses in future.

By a further subsection it is provided that the managing agents shall not enter into any contract for the sale, purchase or supply of goods and materials with the company except with the consent of three-fourths of the directors present and entitled to vote on the resolution.² In our chapter on the managing Agency System we have shown how the agents entered into contracts with the companies for the sale of manufactures, or the purchase of raw materials or machinery. In all such contracts there arises a conflict between the interests of the company and those of the agents, and consequently invariably the interests of the former suffer. It is therefore good that certain restrictions are put on all such contracts. But it is doubtful whether the protection given by the restrictions provided by this section will prove quite effective under the existing circumstances. Of course the adequacy or otherwise of the protection given by this provision will depend upon the composition and integrity of the board of directors. It, no doubt, would have been better if such contracts were subjected to the approval of the shareholders, and were made liable to be renewed every year.

¹ cf. Section 87 (D) I.

² cf. Section 87 D (5).

In our chapter on the Administration of Earnings we have shown how the funds belonging to one company were being lent to or deposited with another company under the same management. But such practices will not be possible under the new Act which provides that no company shall make any loan to or guarantee any loan to any company under the management of the same managing agent.¹ This provision thus puts an end to what is known as inter-depositing system, the evil effects of which we have discussed in the above mentioned chapter. One important evil effects of this practice was that it often ruined a good concern which was entangled, to save a bad one, in the interests of the managing agents. The prohibition of such inter-lending therefore will prove of great value.

Similarly a company is prohibited from purchasing shares or debentures of any company under the management of the same managing agent, unless the purchase has been previously approved of by a unanimous decision of the board of directors of the purchasing company.² No more will the managing agents, thus, be able to invest the funds of one company into another and in this way to add to their own business.

A managing agent is prohibited under the new Act from issuing debentures.³ While discussing the financial relation between the agents and their client concerns we have shown how the agents change their loans into debentures to the loss of the shareholders.⁴ It is a good thing that such practices are now rendered illegal. The managing agent's power of investing the funds of the client concerns has also been restricted by the new law. They have now no power to invest the funds except with the authority of the directors and within the limit fixed by them.⁵ This restriction on the powers of agents regarding the investment of the funds belonging to the client concerns will have a salutary effect in so far as the investment of such funds cannot be influenced by the personal interests of the agents.

By one of the sections, which was considered by the select committee to represent "an entirely new departure,"⁶ it is provided

¹ cf. Section 87 E.

² cf. Section 87 F.

³ cf. Section 87 G.

⁴ See the chapters on Managing Agency System and Working Capital.

⁵ cf. Section 87 G.

⁶ See the report of the Select Committee on the Bill.

that the managing agents should not on his own account engage in any business which is of the same nature as and directly competes with the business carried on by the client company.¹ The aim of this provision is quite obvious. When the personal interest of the managing agent conflicts with that of the client concern, it is but natural that the agent's personal interests should predominate and the interest of the client concern should suffer. It is therefore good that such conflicts are avoided and the interests of the client concern are freed from being made subservient to those of the agents.

The provisions regarding the managing agency system which we discussed so far show that the present Act, is a great step forward in this matter. It, first of all, as previously mentioned, gives statutory recognition to the institution of managing agents and then attempts to purge the system of certain features, which experience had shown to be harmful. Though there is room for further improvement, a step in the right direction has been taken, and let us hope that this legislation will prove of benefit to the healthy growth of industries in the country.

¹ cf. Section 87 H.

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(The letter n after a figure denotes footnote)

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