

UNIT I

CORPORATE FINANCIAL SYSTEM

Chapter 1

Corporation (Company)

Meaning of "Corporation"

The term "Corporation" derived from the Latin word "*corpus*", which means "body". It means "any body or institution enjoying perpetual succession and the status of an independent legal entity".

A corporation is a form of business operation that declares the business as a separate, legal entity guided by a group of officers known as the Board of Directors.

A corporation is a firm that meets certain legal requirements to be recognized as having a legal existence, as an entity separate and distinct from its owners.

A corporation is an organization—usually a group of people or a company—authorized by the state to act as a single entity (a legal entity; a legal person in legal context) and recognized as such in law for certain purposes. Early incorporated entities were established by charter (i.e., by an *ad hoc* act granted by a monarch or passed by a parliament or legislature). Most jurisdictions now allow the creation of new corporations through registration.

A corporation is a specific legal form of organization of persons and material resources, chartered by the state, for the purpose of conducting business.

All kinds of businesses around the world use corporations. While its exact legal status varies somewhat from jurisdiction to jurisdiction, a corporation's most important aspect is **limited liability**. This means that shareholders may take part in the profits through dividends and stock appreciation but are not personally liable for the company's debts.

Almost all well-known businesses are corporations, including Microsoft Corporation, the Coca-Cola Company, and Toyota Motor corporation. Some corporations do business under their names and also under business names, such as Alphabet Inc., which famously does business as Google.

Corporations are owned by their stockholders (shareholders) who share in profits and losses generated through the firm's operations, and have three distinct characteristics : (1) **Legal existence** : a firm can (like a person) buy, sell, own, enter into a contract, and sue other persons and firms, and be sued by them. It can do good and be rewarded, and can commit offence and be

punished. (2) **Limited liability** : a firm and its owners are limited in their liability to the creditors and other obligors only up to the resources of the firm, unless the owners give personal-guaranties.

A corporation is a business entity that is owned by its shareholder(s), who elect a Board of Directors to oversee the organization's activities. The corporation is liable for the actions and finances of the business—the shareholders are not. Corporations can be for-profit, as businesses are, or not-for-profit, as charitable organizations typically are.

Company is a Corporation or Body Corporate in India

In Companies Act, 1956, the terms "corporate" and "body corporate" is used for a company.

Body Corporate.—The term "body corporate" is wider in scope than the term company.

The Section 2(7), it is explained that "body corporate" or "corporation" includes a company incorporated outside India but does not include : (a) a corporation sole; (b) a cooperative society registered under any law relating to cooperative societies; and (c) any other body corporate (not being a company as defined in this Act) which the Central Government may, by notification in the Official Gazette, specify in this behalf.

However, Section 2(11) of the Companies Act, 2013 states that "body corporate" or "corporation" includes a company incorporated outside India, but does not include :—

(i) a cooperative society registered under any law relating to cooperative societies; and

(ii) any other body corporate (not being a company as defined in this Act) which the Central Government may, by notification, specify in this behalf.

The words "a corporate sole" have been deleted from the definition of Companies Act, 1956 as the new Act considered "one person company" which means "a company which has only one person as a member" has been considered as a company.

In *S.P. Mittal v. Union of India*, AIR 1983 SC 1, it has been observed that legal concept of a "Corporation" as contemplated in Section 2(7) of Companies Act, 1956, constitutes the following elements; namely—

(a) A continuous identity, i.e., the original members or members or his or their successors are one;

(b) the persons to be incorporated;

(c) name by which the persons are incorporated;

(d) a place; and

(e) words sufficient in law to show incorporation.

✓ (i) **Corporate Sole.**—It refers to a single person constituted as a corporation in respect of some office or function. A Public Trustee, President, Governor, Minister, etc. are good examples. A Corporation sole is not taken as a body corporate for purposes of the Companies Act, 1956, but it is still a legal

person and can be a member of a company.

However, as per Section 2(11) of the Companies Act, 2013, a corporate sole is a company like corporate Aggregate.

Corporation Sole is a Corporation consisting of a single person, who is made a body corporate and politic, in order to give him some legal capacities and advantages, and especially that of perpetuity which as in individual person he could not have.

In *Commissioner of Income Tax v. Godavari Sugar Mills Ltd.*, AIR 1967 SC 556, it has been held that a corporation sole within the meaning of Section 2(7) of Companies Act, 1956 has been described as an incorporated series of successive persons.

In *S. Govinda Menon v. Union of India*, AIR 1967 SC 1274, it has been stated that the distinction between Corporation Sole and Corporation Aggregate within the meaning of Section 2(7) of the Companies Act, 1956 is that the former is not endowed with a separate legal personality, whereas the latter is juristic entity. However, as per Section 2(11) of the Companies Act, 2013, there is no distinction between Corporation Aggregate and Corporate Sole.

(ii) **Corporation.**—"Corporation" an artificial person established for prescribing in perpetual succession certain rights, which, if conferred on natural persons would fail in process of time. The following definition of a corporation was given by Chief Justice, Marshall in the celebrated *Dartmouth College* case : "A corporation is an artificial being invisible, intangible and existing only in contemplation of law. Being, the mere creature of law it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidentally to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important ones, immortality, and if the expression may be allowed, individually; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity, or perpetual conveyance for the purpose of transmitting it from hand to hand. It is clearly for the purpose of clothing bodies of men, in succession with these qualities and capacities, that corporations were invented and are in use. By these means a perpetual succession of individuals are capable, of acting for the promotion of the particular object, like one immortal being."

Corporation is a Body of Politics or Incorporate; so called as the person composing it are made into a body, and of capacity to take and grant etc. Or, it is an assembly and joining together of many into one fellowship and brotherhood, whereof, one is head and chief and the rest are the body; and this head and body knit together, make the Corporation; also it is constituted of several members, like into the natural body, and framed, by fiction of law, to ensure in perpetual succession. [Tomlin's Law Dictionary].

The expression "Corporation" must mean a corporation created by the legislature and not a body or society brought into existence by an act of a group of individuals.

✓ (iii) **Corporate Aggregate.**—It may be defined as "a collection of individuals united into one body having a perpetual succession and an independent legality". It may be a trading or non-trading corporation. Chartered Companies, companies incorporated by Special Acts of Parliament, Companies registered under the Companies Act are examples of trading corporation. Municipal Corporations and Universities are good examples of non-trading corporation.

In *Commissioner of Income Tax v. Godavari Sugar Mills Ltd.*, AIR 1967 SC 556, it has been held that a corporation aggregate within the meaning of Section 2(7) of the Companies Act, 1956, has been described as an incorporated group of co-existing persons.

In *Board of Trustees, Ayurveda and Union Tibia College v. State of Delhi*, AIR 1962 SC 458, it has been observed that a Corporation Aggregate within the meaning of Section 2(7) of Companies Act, 1956, has been defined as, a collection of individuals united into one body under special denomination, having perpetual succession under an artificial form, and vested by the policy of law with capacity of acting in several respects as an individual, particularly of taking and granting property, of contracting obligations and of suing and being sued, of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it either at the time of its creation or by subsequent period of its existence. And it has been further observed that a Corporation Aggregate within the meaning of Section 2(7) of the Companies Act, 1956, may be : (i) a trading corporation, such as (a) Charter Companies; (b) Companies incorporated by Special Act of Parliament; (c) Companies registered under the set of 1956 etc., or (ii) non-trading one, such as : (a) Municipal Corporation; (b) District Boards; (c) benevolent institutions; (d) universities.

★ Advantages and Disadvantages of a Corporation or Company

Advantages of a Company.—The following are the advantages of company form of organisation :—

1. **Independent corporate existence.**—A company is a legal person. It is distinct from its members. It is vested with corporate personality which is independent. The company is at law a different person altogether from the subscribers of the memorandum.

2. **Limited liability.**—Limitation of liability is another major advantage of incorporation. The liability of shareholder is limited to the face value of shares held by him. Under no circumstances, the private property of shareholder can be attached for payment of company debts. If the shares are partly paid, the shareholders may be required to pay the balance unpaid on shares. In no case a shareholder will be called upon to contribute more than the face value of his shares, even if the assets of the company are not sufficient to pay off its liabilities in full.

3. **Perpetual succession.**—A company is an artificial person. It does not have natural death. It enjoys perpetual existence. It is not affected by the death or retirement of its members. This is a special advantage for industries which

require long time to establish and consolidate. The long life of a company enables it to enjoy the fruits of goodwill built over years.

4. Transferability of shares.—Shares of public companies are fully transferable. They can be readily purchased or sold in stock exchange. This ensures liquidity of investment. He can transfer his shares to any person he likes without the consent of other shareholders. This facility has greatly encouraged and stimulated investment in shares of companies.

5. Separate property.—The property of a joint stock company is vested in the corporate body. No shareholder, not even all shareholders can have any right on the property of the corporation or company's assets.

6. Capacity to sue and being sued.—A company can sue and be sued in its corporate name.

7. Bold and risky ventures.—It is only a joint stock company, which can undertake bold and risky ventures. Many risky enterprises like mining, ship-building etc., would not have come into existence but for company form of organisation.

8. Diffused risk.—Companies usually have large number of shareholders. Hence the risk of business can be spread over a number of people. As a result, the risk that each shareholder bears will be small.

9. Professional management.—The formation of a company permits the proprietor of a business to realise his goodwill or to relieve himself of the actual management if he so desires, while retaining the controlling interest in the business. It also enables the employees to become shareholders. The corporate sector is capable of attracting the growing cadre of professional managers. Men of this calibre are not to be formed every day, but when found and supported by capital, they are capable of achieving the very highest success in commercial undertaking.

10. Large capital.—A public company can have any number of shareholders. Hence it can raise any amount of capital required. The shares of companies are generally of small value and therefore, even small investors can purchase shares to the extent their resources permit. The enormous amounts of capital can be collected. Thus, in the matter of raising capital, joint stock company has a definite superiority over the earlier forms of organisation.

11. Extensive borrowing capacity.—A company can raise capital through public issuing debentures. Further, public finance institutions lend their resources more willingly to companies than to other forms of business organisation. The facility of borrowing and giving security by way of a floating charge is also an exclusive privilege of companies.

12. Economics of large scale operations.—The availability of large capital enables the company to undertake business operations on large scale. It can buy expensive heavy machinery and appoint expert staff for management of business. It can buy materials at concessional rate on large scale. It can undertake research to improve methods of product which reduce costs. In short, a company can reap the economies of large scale production and distribution.

13. Economic development.—The results of scientific and technological research would not have seen the light of the day but for the company form of

organisation. It is only through joint stock company system that industries, commerce, transport, communication, banking and insurance have developed all over the world.

14. **Social benefits.**—Companies have conferred a number of benefits on society. Through large scale production, they have made available to the community goods of better quality at lower prices. They have provided employment opportunities to millions of persons. They are an important source of revenue to the Government. They make a significant contribution to the national income. They have improved the living standards of the people all over the world. The society is supplied with enough quantity of goods.

15. **Ability to cope with changing business environment.**—Joint stock companies can afford to invest on research to cope with the changing economic environment and changes in technology.

★ Disadvantages of a Company

1. **Lifting the corporate veil.**—When some individuals start using the veil of corporate personality for fraud or improper conduct, then the Courts lift the veil and look at the persons behind the company who are the real beneficiaries and then some of the advantages of corporate personality disappear. The separate entity of the company is disregarded and the schemes and intentions of the persons behind are exposed to full view.

2. **Liability of directors and members.**—The Companies Act also imposes personal liability on the directors or members of a company in certain cases. Though the independent existence of the company is maintained, the company may also be liable. But, apart from the liability of the company, those cloaked behind it are also made liable.

3. **Formality and expensive.**—Another disadvantage of incorporation of a company is its expense and formality. A number of legal formalities have to be complied with, a lot of expenditure has to be incurred on preliminaries and a number of people have to be approached for raising capital, before a company can start functioning.

4. **Company is not citizen.**—A company, though a legal person, is not a citizen. It can have the benefit of only such fundamental rights as are guaranteed to every "person" whether a citizen or not. Neither the provisions of the Constitution, Part II, nor of the Citizenship Act, either confer the right of citizenship on, or recognise as citizen, any person other than a natural person.

A company incorporated in a particular country has the nationality of that country, though, unlike a national person, it cannot change its nationality.

5. **Oligarchic management.**—Company management is democratic in theory only. In actual practice, it is a case of oligarchy. Company management is a management of a few, by a few and for a few. The vast majority of shareholders do nothing and get nothing. Practically they have no voice in the management of the company. Often they are misled by directors by wrong or ambiguous reports. Once elected, the directors stick on to their positions throughout their life through manipulation of voting power. The divorce between ownership and management has brought about economic dictatorship.

6. **Bureaucracy and redtapism.**—Company management is highly complex. It is a series of wheels within wheels. Every matter has to pass through several hands in a systematic manner. As a result decisions are delayed. Quick decisions and prompt action which are so vital to take advantage of the changing market conditions are conspicuously absent in company form organisation.

7. **Lack of personal interest and initiative.**—Companies are managed by directors and paid officials. Directors do not have as much personal interest and initiative as the proprietors would have. The paid officials hesitate to take initiative and bear responsibility and business risk.

8. **Unscrupulous management.**—Company organisation has given opportunity to unscrupulous persons to float fraudulent companies and cheat innocent public. A number of companies have been formed in the past by fraudulent promoters to misuse or misappropriate the capital collected from the public.

9. **Speculation in shares.**—The joint stock companies facilitate speculation in the shares at stock exchange. The speculators try to fluctuate the prices of shares according to their suitability. As a result, the interests of genuine shareholders are affected.

10. **Lack of secrecy.**—Everything is discussed in the meetings of Board of Directors and General Body Meetings. The secrets cannot be maintained.

11. **delay in decision-making.**—It cannot take quick decisions. All important decisions are taken by the Board of Directors and General Body Decision taking process is time consuming.

12. **Nepotism and favouritism.**—The directors usually show favouritism and nepotism in the appointment of staff and officers. They appoint their friends and relatives as officers of the company ignoring the considerations of the ability, experience and qualifications. Hence, the management of companies tends to be inefficient.

13. **Excessive state regulations.**—A large number of rules and regulations are framed for the working of the companies. The Government tries to regulate the working of the companies because large public money is involved. The companies could not obtain their objectives for which they have been formed.

14. **Concentration of economic power.**—The company form of organisation has helped concentration of economic power in a few big business houses. It has encouraged the formation of combinations, resulting in monopoly.

15. **Evils of factory system.**—The evils of factory system like insanitation, environmental pollution, congestion of cities are attributed to joint stock companies.

16. **Interfering in Government decisions.**—In many countries, companies have grown so powerful that they can influence the policies and programmes of the Government. They give donations to political parties and create pockets of influence in Government circles. Thus they buy political power with economic power.

Forming a Corporation

Corporations are often formed in the state in which the business operates, but it doesn't have to be. Some corporations are formed in states thought to be pro-business, such as Delaware or Nevada, although that creates extra paperwork. You then need to register the corporation as a foreign entity in the state in which you are doing business, and pay taxes to that state.

The next step is creating Articles of Incorporation, which are filed with the state in which you have registered the corporation. These include :

- The name and physical address of the business.
- A description of the business and its goods and services.
- The name and address of the registered agent, or the person authorized to receive official notices.
- A count of the number of shares issued and to whom.

And then create by-laws, which are the rules of the corporation. They include, at a minimum:—

- How often the Board of Directors meets, and when.
- Whether the business operates on a calendar or fiscal year.
- How long board members can serve.
- Rules for changing by-laws.

By-laws can be amended as needed once the corporation is formed.

A corporation is a legal entity that is separate and distinct from its owners. Corporations enjoy most of the rights and responsibilities that individuals possess : they can enter contracts, loan and borrow money, sue and be sued, hire employees, own assets, and pay taxes. Some refer to it as a "legal person".

- A corporation is a legal entity that is separate and distinct from its owners. Corporations enjoy most of the rights and responsibilities that individuals possess.
- An important element of a corporation is limited liability, which means that shareholders may take part in the profits through dividends and stock appreciation but are not personally liable for the company's debts.
- Corporations are not always for profit.

✓ The Creation of a Corporation

A corporation is created when it is incorporated by a group of shareholders who have ownership of the corporation, represented by their holding of common stock, to pursue a common goal. A corporation's goals can be for-profit or not, as with charities. However, the vast majority of corporations aim to provide a return for its shareholders. Shareholders, as owners of a percentage of the corporation, are only responsible for the payment of their shares to the company's treasury upon issuance.

A corporation can have a single shareholder or several. With publicly traded corporations, there are often thousands of shareholders. Corporations are created and regulated under corporate laws in their jurisdictions of residence.

Becoming a Corporation

The process for forming a corporation varies according to the state you do business in and the state you live in. For the most part, you'll need to file articles of incorporation with the state and then issue stock to the company's shareholders. The shareholders will elect the Board of Directors in an annual meeting.

The Day-to-Day Operations of a Corporation

The shareholders, which generally receive one vote per share, annually elect a Board of Directors that appoints and oversees the management of the corporation's day-to-day activities. The Board of Directors executes the corporation's business plan and must take all the means to do so. Although the members of the board are not generally responsible for the corporation's debts, they owe a duty of care to the corporation and can incur personal liabilities if they neglect this duty. Some tax statutes also provide for the personal liabilities of the Board of Directors.

Special Considerations : The Liquidation of a Corporation

When the corporation has reached its objectives, its legal life can be terminated using a process called liquidation or winding up. Essentially, a company appoints a liquidator who sells the corporation's assets, then the company pays any creditors and gives any remaining assets to the shareholders.

The liquidation process can be voluntary or involuntary. If it is involuntary, the creditors of an insolvent corporation usually trigger it, and this may lead to the bankruptcy of the corporation.

Corporations come in many different types but are usually divided by the law of the jurisdiction where they are chartered based on two aspects: by whether they can issue stock, or by whether they are formed to make a profit. Corporations can be divided by the number of owners: corporation aggregate or corporation sole. The subject of this article is a corporation aggregate. A corporation sole is a legal entity consisting of a single ("sole") incorporated office, occupied by a single ("sole") natural person.

Where local law distinguishes corporations by the ability to issue stock, corporations allowed to do so are referred to as "stock corporations", ownership of the corporation is through stock, and owners of stock are referred to as "stockholders" or "shareholders". Corporations not allowed to issue stock are referred to as "non-stock" corporations; those who are considered the owners of a non-stock corporation are persons (or other entities) who have obtained membership in the corporation and are referred to as a "member" of the corporation.

Corporations chartered in regions where they are distinguished by whether they are allowed to be for-profit are referred to as "for-profit" and "not-for-profit" corporations, respectively.

There is some overlap between stock/non-stock and for-profit/not-for-profit in that not-for-profit corporations are always non-stock as well. A for-profit corporation is almost always a stock corporation, but some for-profit corporations may choose to be not-stock. To simplify the explanation, whenever

"stockholder" or "shareholder" is used in the rest of this chapter to refer to a stock corporation, it is presumed to mean the same as "member" for a non-profit corporation or for a profit, non-stock corporation.

Registered corporations have legal personality and their shares are owned by shareholders whose liability is generally limited to their investment. Shareholders do not typically actively manage a corporation; shareholders instead elect or appoint a Board of Directors to control the corporation in a fiduciary capacity. In most circumstances, a shareholder may also serve as a director or officer of a corporation.

In American English, the word *corporation* is most often used to describe large business corporations. In British English and in the Commonwealth countries, the term *company* is more widely used to describe the same sort of entity while the word *corporation* encompasses all incorporated entities. In American English, the word *company* can include entities such as partnerships that would not be referred to as companies in British English as they are not a separate legal entity.

Later in the 19th century, a new form of the company having the limited liability protections of a corporation, and the more favourable tax treatment of either a sole proprietorship or partnership was developed. While not a corporation, this new type of entity became very attractive as an alternative for corporations not needing to issue stock.

As contrasted with the other two major forms of business ownership, the sole proprietorship and the partnership, the corporation is distinguished by a number of characteristics that make it a more-flexible instrument for large-scale economic activity, particularly for the purpose of raising large sums of capital for investment. Chief among these features are : (1) limited liability, meaning that capital suppliers are not subject to losses greater than the amount of their investment; (2) transferability of shares, whereby voting and other rights in the enterprise may be transferred readily from one investor to another without reconstituting the organization under law; (3) juridical personality, meaning that the corporation itself as a fictive "person" has legal standing and may thus sue and be sued, may make contracts, and may hold property in a common name; and (4) indefinite duration, whereby the life of the corporation may extend beyond the participation of any of its incorporators. The owners of the corporation in a legal sense are the shareholders, who purchase with their investment of capital a share in the proceeds of the enterprise and who are nominally entitled to a measure of control over the financial management of the corporation.

The form of the modern business corporation originated in a fusion of the type of commercial association known as the joint-stock company, which was in fact a partnership, and the traditional legal form of the corporation as it had been developed for medieval guilds, municipalities, monasteries, and universities. Although business corporations were formed in England as early as the 16th century, these enterprises were monopolies chartered by the crown for the pursuit of strict mercantilist policies and were thus closer, in some respects, to the form of the modern public corporation than to that of the private business corporation.

The fusion of the two forms took place incrementally over the first two-thirds of the 19th century in Great Britain, the United States, France, and Germany with the passage of general incorporation laws, which gradually made incorporation a more or less routine matter for business enterprises. Particularly influential for this development in the United States was the fact that powers of incorporation were largely restricted to the individual states under the Constitution, which led in the late 19th century to competition between the states for liberalization of their respective incorporation laws. Given the freedom of inter-state commerce guaranteed under the Constitution, would-be incorporators could choose the state in which they wished to incorporate without compromising their freedom to transact business in any other state.

Strong impetus for this fusion of the two forms arose from, and was intensified by, the spread of new capital-intensive technologies of production and transportation. In particular, the construction of railroads—a matter of pressing national importance for all industrializing nations in the late 19th century—required large sums of capital that could be secured only through the corporate form and, in fact, only with many innovations in the development of financial and debt instruments within the corporate form. Moreover, the railroads made possible, and in some cases made necessary, an enormous expansion of existing industries (notably steel and coal) that the corporate form alone could support. By the final third of the 19th century, the last legal obstacles to the corporate form had been removed, and the ensuing period (c. 1870—1910) saw an unprecedented expansion of industrial production and the concomitant predominance of the corporate form. However, with these developments came new problems. Large industrial corporations such as the Standard Oil Company and the United States Steel Corporation came to exercise monopolistic powers in their respective economic spheres, often apparently at the cost of the public interest. US President Theodore Roosevelt sought to curb this concentration of corporate power in the early 20th century, urging the enactment of antitrust legislation aimed at preserving competition.

As corporations increased in size and geographic scope, control of the enterprise by its nominal owners, the shareholders, became impossible when the number of shareholders for the largest companies grew to the tens of thousands and as the practice of proxy voting (i.e., the voting of shares of absent stockholders by management in the annual shareholders' meetings) was legalized and adopted. Salaried managers came to exercise virtually proprietary discretion over the corporation and its assets, which gave rise to debates that continue today over the nature of ownership and the social responsibility of corporations. Shareholders have nonetheless attempted to influence the actions of corporations through annual proxy proposals.
