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Legal Issues Involved in Share Transfer Restrictions in Case of Private Company

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Abstract

A Shareholders' agreement (SHA) in a company is a private document unlike the Articles of Association (AOA). For the maintenance of confidentiality of terms, the parties are motivated to enter into an SHA. The main advantage of entering into a separate SHA instead of incorporating the terms of agreement in the AOA is maintenance of confidentiality. Shares of a company are considered to be movable property. Shares of the company are also personal property. One of the rights attached to property is the right to transfer the property. Transfer of property Act, 1882 states that if you have a title to the property, you have the right to transfer it or restrict the transfer. The law involved in the landmark judgement of the case of V B Rangraj v Rang raj B Gopalakrishnan is perplexing. Here the court has not allowed the formation of private contracts between the shareholders in private company. Transferability of shares changes the corporate structuring according to the nature and proportion of shares involved in such transfer.

Keywords: Articles of Association, company, contract, Shareholders' agreement, transferability of shares

INTRODUCTION

Shareholders' Agreement (SHA)

Shareholders' agreements are contractual devices to manage tensions among shareholders of a corporation. These agreements have a wide scope related to shareholders' interest.

In simple terms, SHA is a private contract between some or all of the shareholders of the company.

Shareholders' agreements are part of the rules determined by "contracts or other forms of agreements". A SHA is a contract. The object of this contract is to define the scope and extent of the relationship among the shareholders.

Why an SHA is required?

A Shareholders' agreement (SHA) is a private document unlike the Articles of Association (AOA). Therefore, for the confidentiality of terms the parties are motivated to enter into an SHA.

An SHA may cover many aspects that have an effect on the management and governance of the company; it ranges from membership of the board of directors to removal of directors, etc. Some shareholders, such as those in joint venture firms, would ask that some of these elements be respected by the company's management, as their relationship is more akin to that of partners in a partnership firm [7]. Way to achieve this is by entering into an SHA, as these features cannot be

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covered in constitutional documents (Articles of Association and Memorandum of Association) of the company [7].

The purposes that a SHA may want to achieve can be classified into four categories [7]:

1. Conferring rights on an individual shareholder (such as conferring veto power on particular matters, protection to such directors from removal);
2. Governance of the special relationship of the shareholders unconnected to the administration of the company (such as service as a lawyer or an accountant of the company);
3. Protection of the minority shareholders of the company (in order to prevent an ordinary resolution against the interest of a shareholder he must have at least 50% of the voting rights, and in the case of a special resolution at least 25% of voting rights. However, a right conferred by the SHA cannot be overridden by the majority. Even if these clauses are incorporated in the articles, articles can be amended by passing a special resolution. Thus, minority shareholders will be better protected if their rights are incorporated in SHA rather in AOA); and
4. Confidentiality of the terms and conditions.

Main advantage of entering into a separate SHA other than incorporating the terms in the AOA is confidentiality.

The AOA, is a public document, hence, it is not suitable for incorporating matters that the parties want to be confidential. While a SHA cannot be altered without the approval of all parties, a shareholder with less than 25% voting rights cannot be confident in a clause in the AOA because it can be amended by a special resolution. However, provisions in SHA, being a contract, can be enforced under normal contractual principles, and statutory rights can be enforced only upon satisfying the court as to the existence of preconditions the law stipulates; for example, in order to succeed in an action against oppression the shareholder must prove all the necessary elements that would constitute oppression under the law. On the other hand, in the case of SHA only breach of the SHA has to be established.

Position of Share Transfer Restrictions in Private and Public Companies

There are two questions that arise:

1. Firstly, do the share transfer restrictions need to be incorporated in the Company's Articles in order to be enforced?
2. Secondly, even if the share transfer restrictions are included in the AOA, are transfer restrictions on the shares of public company enforceable?

As per section 2(68) of Companies Act, 2013 [3], a private company is a company which restricts the transfer of shares. Hence in a private company restriction on transfer of shares can be incorporated in the SHA. The situation regarding private companies is very clear.

With respect to public companies, section 58(2) of Companies Act, 2013 [2] says that the shares of a public company are freely transferrable. Under section 44 of Companies Act, 2013 [2], shares of a company are considered to be movable property. Shares of the company are also personal property, hence right to transfer and restrict the transfer of shares. Therefore, there should be restrictions allowed in the SHA in public companies. Proviso to section 58(2) says that any contract between two or more persons shall be enforceable as a contract. Does that mean that in case of breach of that contract a person can claim remedies only under the Indian Contract Act? Also, a question arises should the terms of the contract be incorporated in the AOA to claim damages in case of breach of contract?

The *V.B. Rangaraj v. V.B. Gopalkrishna* (1992) Supreme Court confirmed that share transfer restrictions need to be incorporated in the Company's Articles (AOA).

In case of private company, it is not a worry because the definition of private company includes restricting the right to transfer the shares. But for the Public Company under Section 111 A of the Companies Act 1956 [1], it says shares of Public Ltd Company shall be freely transferable. Many courts interpreted it strictly.

But the issue was rectified in *Messer Holding Ltd v. Shyam Madamohan Ruia* (2010) where the court said Section 111 A is with respect to company and company has to recognize the restriction on transfer, nothing prevents two shareholders from having restrictions.

LAW UNDER THE COMPANIES ACT, 1956

Regulation of enforceability of shareholders' agreement is not expressly mentioned in the Companies Act, 1956 ("CA 1956") [1] but transferability of shares is mentioned. The CA 1956 speaks about nature of shares. And it also outlines the free transferability of shares in public companies and the transferability of shares in private companies, subject to the restrictions contained in the articles.

According to Section 82 of CA 1956 [1], shares or debentures or other interest of a member in a company shall be movable property, transferable in the manner provided by the articles of the company. This means that shares are movable property and the AOA of the company provides for the mode by which the shares shall be transferred.

However, the right to transfer the shares cannot be prohibited completely by the articles, as it is a statutory right (Sadashiv Shankar Dandige v Gandhi Seva Samaj Ltd (1958) 28 Comp. Cas. 137 Bom). And if the articles prohibit the right to transfer, it would be void as it is repugnant with the Act-CA 1956 Section 9 [1] states that "the provisions of this act shall have effect notwithstanding anything to the contrary contained in the memorandum or articles of a company, or in any agreement executed by it, or in any resolution passed by the company in general meeting or by its Board of Directors, whether the same be registered, executed or passed, as the case may be before or after the commencement of this Act". Section 111A (2) of the CA 1956 [1] states that shares of a company shall be freely transferable. Section 111A (1) says that company referred to in this section is a private company. That means shares of a private company are not freely transferrable.

HISTORY OF SECTION 111A

Before Section 111A was enacted, there were two remedies available to the aggrieved person (transferor/transferee) in respect of transfer of shares of a public or a private company. The remedies were:

- File an appeal before the Central Government under Section 111, or
- File an appeal to the High Court under Section 155 for rectification of the Register.

Under the Securities Contracts (Regulation) Act (SCRA), a section was inserted-section 22A, which provides that shares of a listed company shall be freely transferable and restricting the arbitrary powers of the Board of Directors by allowing them to refuse transfer of the securities of the company on four provided grounds only.

Later important changes were made to the Companies Act by the Depositories Act, 1996 and Section 111A was inserted to the CA 1956 to provide for free transferability of shares and debentures and to deal with transfers through depositories, with the insertion of Section 111A into the CA 1956, and Section 22A of the SCRA was simultaneously deleted, which indicates that Section 111A takes into its sweep Section 22A of the SCRA.

So, basically, Section 111A was introduced into the Companies Act not by way of an amendment to the act itself but by the Depositories Act. The long title of the Depositories Act mentions that it is an act to provide for the regulation of depositories in securities. Looking at the object and the long title, we do get a hint that the rationale behind the enactment of Section 111A was not of emphasizing free transferability of shares but to facilitate transfer of shares in dematerialized forms and providing for a mechanism to check the misuse of power of the Board of Directors to refuse registration of transfer without sufficient cause.

Section 3 of Companies Act 1956 gives the definition of private company and says private company means a company which "by its articles restricts the right to transfer its shares, if any".

Therefore, the definition governs the transferability of shares of private companies. The condition envisioned by the definition of a private company is that there must be some restriction upon the transferability of the company's shares. However, a restriction which precludes a shareholder altogether from transferring his shares is invalid, as it transgresses the boundary of a restriction and assumes the form of a prohibition [6].

The act provides that the Articles shall specify the manner by which the shares are to be transferred (Section 82 of Companies Act, 1956). The shares of a public company shall be freely transferable. However, the AOA of a private company shall contain a restriction on the transferability of shares- Section 3 of Companies Act, 1956. The enforceability of shareholder agreements in the light of this statutory framework for the transferability of shares may have a stifling effect on the freedom to contract. As a result; the juxtaposition of shareholder agreement conferring pre-emptive rights and the statutory transferability of shares has been subject to vivid judicial debate [6].

INDIAN CASES WITH RESPECT TO SHARE TRANSFER RESTRICTIONS IN CASE OF PRIVATE COMPANY

The first landmark Judgement that expressed its views on the enforceability of SHA was the case of *V B Rangraj v Rang raj B Gopalakrishnan ([1990] A.I.R. S.C. 453)*. This case was decided by the supreme court of India, which was related to a SHA in a private company which imposed restriction on transfer of shares [5]. These restrictions on transfer of shares were not incorporated in the AOA. This agreement was actually entered into between two brothers to ensure parity and consistency in the number of shares held by each branch of the family. To that end, there was a restriction imposed upon a living member to transfer his shares only to the branch of the family to which he belonged [6]. The Supreme Court of India went through the Companies Act, 1956 and held that the restraints on transferability of shares could only be imposed by the AOA [4]. Thus, it held that any agreement between shareholders imposing a restriction on the free transferability of shares must be incorporated in the AOA to be enforceable ([1990] A.I.R. S.C. 453 at).

This, for the sake of simplicity, may be referred to as the test of incorporation.

After the Rangaraj case came another case called the *S.P. Jain v. Kalinga Tubes (SC (14.01.1965))* there was an agreement between two shareholders and an outsider. The agreement said that the shares would be issued to the outsider (Jain) whenever the company would increase its share capital. Company was a private company. In few instances the agreement was acted upon. And some shares were issued to Jain. But company was not part of the agreement and the terms were not incorporated in the AOA. Later the Company was converted into a public company and shares issued were not allotted to Jain. Jain filed a suit. The SC observed that Company was not a party to the agreement, the terms were not incorporated in the Articles and hence the company was not bound by the agreement. And the SC also said that this was not a case of oppression and mismanagement.

This *Rangaraj case* was prospered by the Supreme Court case of *Gujarat Bottling Co v Coca Cola Co ([1995] A.I.R. S.C. 2372)* and the Gujarat HC decision of *Mafatlal Industries Ltd v Gujarat Gas Co Ltd ((1999) 97 Comp. Cas. 301 Guj)*. Both these related to the enforceability of SHA in public companies.

The case of *M S Madhusoodhanan v Kerala Kaumudi Pvt Ltd,* ascended out of a very intricate family dispute in Kerala and out of an agreement which provided that "there would be no change in the existing share structure in the family" of the private limited company. It also provided that the shares of two members would pass to Madhusoodhanan if they die. In this case of *M S Madhusoodhanan v Kerala Kaumudi Pvt Ltd (2004] A.I.R. S.C. 909)* the Supreme Court laid down an alternative proposal relating to the enforceability of an SHA. The court held that in private companies, the AOA impose a restraint on the free transferability of shares. However, in the present case, the agreement was between "particular" shareholders relating to the transfer of "specific" shares, namely those inherited by the four brothers from their parents, and hence does not impose a restriction on the transferability of shares.

The court highlighted the blunt contrast between the issue of new shares by a company, and the transfer of shares already issued by the company. In the former case, it is the company which issues and allots the fresh shares, but the latter transaction involves a private agreement to be specifically enforced between the parties to the transfer, and the company comes into play only for the limited purpose of recognition of the transferee as the new shareholder.

Hence, this case gave the freedom to contract by holding that if there is an agreement between "particular" shareholders relating to transfer of "specific" shares it is not restriction per se.

In the *Vodafone International Holding v Union of India ((2012) 6 SCC 613)* the SC disagreed with the decision of the Rangaraj case and observed: that "in the case of Rangaraj an agreement was entered into between shareholders of a private company wherein a restriction was imposed on a living member of the company to transfer his shares only to a member of his own branch of the family, such restrictions were; however, not envisaged or provided for within the Articles of Association. This Court has taken the view that provisions of the Shareholders' Agreement imposing restrictions even when consistent with Company legislation, are to be authorized only when they are incorporated in the Articles of Association, a view we do not subscribe".

However, the enforceability of SHA regarding transfer of shares was not the direct issue in the Vodafone case, hence the observation made by the SC was just treated as obiter that is not binding.

Significantly, the legislature has also attempted to undo what the Rangaraj case did, by introducing a proviso to s.58(2) of the Companies Act 2013, as far as the transfer of shares in a public company is concerned, by providing that any contract or arrangement in respect of the transfer of securities shall be enforceable as a contract.

In *World Phone India Pvt. Ltd v. WPI Group Inc USA ([2013] 178 Comp Cas 173)* a resolution was passed by the board of directors of the company approving a rights issue in accordance with the Articles of the company, they passed the resolution even though such an action required the affirmative vote of the Appellant in accordance with a SHA entered into between the shareholders of the company. The Company Law Board had held that since the provisions of the SHA were not incorporated in the Articles of the company, the said provision is unenforceable and the board resolution approving the rights issue was valid. On appeal, the Delhi High Court held that, the provisions of the SHA, though silent in the Articles of the company, and not in contradiction with them, will not be enforceable [9].

In the year 2013, the new Companies Act came into force, it repealed the Companies Act, 1956. Under the Companies Act, 2013, Section 58(2) is similar to section 111A of the 1956 Act. And Section 58(2) provides that shares of the public company shall be freely transferable. There is a proviso also to section 58 (2) which state that any contract or arrangement between persons in respect of transfer of securities shall be enforceable as a contract. To enforce the position in *Messer's Holding Limited v. R.M. Ruia & others (2010)* the legislature included the proviso to Section 58(2). It states that the shareholders may enforce the agreement inter se, but the company itself will not be bound (Messer's Holding Limited v. R.M. Ruia & others (2010)).

But, the proviso to Section 58(2) applies only to public companies and there is no statutory recognition of the enforceability of such agreements with respect to private companies [8]. Hence, the *Rangaraj case* is good for the private companies, and not for public companies, but that would be contrary to the general understanding with regard to transferability of shares private companies are allowed to have more restriction. But to eliminate any doubt whatsoever, it has been suggested that it would be more advisable to amend the Companies Act 2013 to explicitly validate shareholder agreements relating to transfer both for public and private companies.

CONCLUSION

There is a lack of uniformity in the judicial approach; this is because the courts have not cherished the fact that a SHA should be governed by the Contract law that is the principles of contract.

In the new companies Act 2013, we have section 58(2) which has tried to solve the problem but it has not offered us a satisfactory solution. The proviso to section 58 (2) states that a SHA conferring pre-emption rights with respect to shares of a public company is valid, it is silent as to a SHA of a private company.

It is imperative that the enforceability of SHAs is secured under the Indian legal system, but both judicial and legislative efforts fall short of bringing certainty in this regard. A clear pronouncement of the law, both judicial and legislative, in this regard is the need of the hour.

A SHA is a very important agreement. A business will require capital no matter in which stage it is, whether at the start-up or during operations.

An SHA can set forth how the corporation will access funds and whether the shareholders are responsible for contributing such funds in accordance with their relative interest in the business. If all the shareholders are not willing to contribute or they are not able to contribute, an SHA can set out preferential interest rates for those shareholders who contribute.

In the UK, the position is clearer; both for public and private companies, the shareholders can enter into a private contract, but it should not fetter with the company legislation and the company law statutes. If the SHA goes against the company legislation and company law statutes then it is void.

But in India, the position about private companies is not clear; it is observed that most of them think the *Rangaraj case* applies to private companies. But it was the old position. In the Companies Act 2013, there is no mention about the private companies entering into private contracts.

Therefore, the requirement of incorporation of the terms of the SHA in AOA must be settled. However, for the sake of clarity and definiteness, it is advisable to incorporate them in AOA.

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