Page 1455 - 1463 **DOI:** *https://doij.org/10.10000/IJLMH.114925*

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 6 | Issue 3

2023

Analysing Shareholders Agreement Encompassing Restrictions on Free Transferability of Shares and Their Enforceability with Regards to The Articles of Association

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ABSTRACT

The Shareholders of a Company enter into a consensual agreement through the Shareholders Agreement pertaining to internal management of the Company and transfer of shares. The enforceability of the Shareholders Agreement depends on the charter documents of the company, especially the Articles of Association. While the enforcement of a Shareholders Agreement may seem like an enforcement of any other contractual agreement, such is not the case. It is commonly observed that the SHAs contain provisions that the AoA does not address. Additionally, SHAs represents the mutual understanding of shareholders and detail provisions for share transferability that they AoA may be silent upon. The friction between the AoA and SHAs results is witnessed by the Courts wherein the enforceability of the SHA is disputed. This paper demonstrates the judicial trends pertaining to the conflict in India and suggests the way forward in dealing with such disputes.

Keywords: *Shareholders Agreement, Shares, Articles of Association.*

I. INTRODUCTION

In India, the Companies Act of 2013[2] is the national legislation that governs and regulates the incorporation and functioning of companies. Yet, it renders no definition for a 'Company'. Chief Justice Marshall's definition of a company describes it to be "an artificial being, invisible, intangible, existing only in contemplation of the law. Being a mere creation of law, it possesses only the properties which the Charter of its creation confers upon it, either expressly or as incidental to its very existence."[3] Justice Marshall's definition is enlightening for the purposes of this paper as it implies that an abstract entity such as an incorporation necessarily functions as per the will of its creator, which is embodied in the charter documents, that are the Memorandum of Association ["MoA"] and the Articles of Association ["AoA"]. The MoA

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[2] Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).
[3] Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636–37 (1819)

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defines the scope of operations of the company while the AoA lays foundation to the regulation of internal affairs of the company.[4] The AoA must be within the scope of the MoA as the MoA is considered as the Constitution of the company.[5] The two instruments work harmoniously, without contradicting one another, and can be read together to do away with ambiguity.[6] In addition to the Companies Act and charter documents, investors also enter into private agreements to aid the functioning and management of the company. While AoA regulate the internal working and management of a Company, shareholders may enter into a private agreement, known as the Shareholders Agreement ["SHA"], that ascertains rights and obligations to "make provisions for proper and effective internal management of the company."[7] SHAs that govern the internal management of the company include voting and veto rights, quorum rights, etc. while SHAs that govern transfer of shares usually include clauses such as the Right of first offer and the right of first refusal, tag/drag along, call and put options, anti-dilution clauses and so on.[8] It can be observed that the functioning of the AoA and the SHA is inextricably tied as both address the conduct of investors with respect to their participation in the affairs of the company. For the purposes of this paper, the author focuses the analysis to the SHAs that address transferability of shares and elucidates their enforceability with regards to the Company's AoA.

This paper scrutinizes the functioning of the AoA concurrently with the SHA with the aim of elucidating, **[II.]** the validity of imposing restrictions on share transferability through a Shareholders Agreement, [**III.]** the enforceability of SHA when the AoA is silent on the provisions of the SHA, and lastly, **[IV.]** the way forward with regards to addressing the conflict that arises when the enforceability of the SHA is challenged by parties.

II. LEGAL VALIDITY OF IMPOSING RESTRICTIONS ON SHARE TRANSFERS VIZ-A-VIZ SHAREHOLDERS AGREEMENT

The Charter documents (the MoA and AoA), under Section 399 of the Companies Act of 2013,[9] are deemed public documents that bind all shareholders[10] whereas SHAs are private agreements and are contractual in nature. Therefore, they only bind those who are privy to them and exclude

[4] G. K. KAPOOR & SANJAY DHAMIJA, COMPANY LAW AND PRACTICE A COMPREHENSIVE TEXTBOOK ON COMPANIES ACT 2013 (24th Ed. 2019).
[5] Shyam Chand v. Calcutta Stock Exchange AIR 1947 Cal. 337.
[6] Re, South Durham Brewery Company [1885] 31 Ch. D 261, [Duncan Gilmour & Co. Ltd., Re [1952] All. ER 871.
[7] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.
[8] Prateek Gupta, *Shareholder's Agreement and Articles of Association: A Power Struggle*, 4 Int. J. L. Human. Mgmt. 1239, 1242 (2021).
[9] Companies Act, 2013, § 399, No. 18, Acts of Parliament, 2013 (India).
[10] Companies Act, 2013, § 10, No. 18, Acts of Parliament, 2013 (India).

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those who have not entered into the agreement. This means that even though some shareholders are party to the agreement, the Company and shareholders that have not entered into the agreement are not party to the same and are considered as third parties. Initially, this introduced a challenge in terms of enforceability as the Charter documents of the Company mandatorily applied to all shareholders under Section 10 of the Companies Act of 2013[11] while the SHA was only enforceable against the shareholders who entered into the agreement through a mutual understanding amongst themselves. However, the Indian judiciary has clarified that parties can seek relief under the law of land for breach of SHA, like any other breach of agreement.[12] However, the breach of SHA "is a valid corporate action" and does not constitute a breach of the company's AoA.[13]

Additionally, the dichotomy of the private and public companies is prudent to be kept in mind while addressing the restrictions on the transfer of shares of a company. The Indian legal regime allows private companies to place restrictions on share transfers[14] but mandates free transferability of shares in a public company.[15] In *Bajaj Auto Ltd. v. Western Maharashtra Development Corporation Ltd.,*[16] the Bombay High Court deliberated the validity of free transferability of shares of public company as envisaged in Section 111A of the Companies Act, 1956 (analogous to Section 58 of the Companies Act, 2013). Here the Court opined that shares of a company are movable property of Shareholders and they can exercise their property rights by voluntarily entering into contracts with other shareholder(s) or third parties. Here, it was observed that entering into such contracts was a matter of right to freely "deal with and /or transfer shares."[17] Hence, the Court declared that the right of a shareholder of a public company to enter into consensual agreements with another shareholder or third party (in accordance with the AoA, Companies Act and Rules and other governing laws) does not, in any way, whittle down just because of the fact that "the shares of a public company can be subscribed to by the public, unlike in the case of a private company."[18] The Court also acknowledged that SHAs render greater flexibility that the AoA, envisage how future capital contributions can be made and also contain provisions for dispute resolution between shareholders. The Court concluded that so long as the provisions of SHAs do not contradict the provisions of AoA, the SHAs are

[11] *Id.*
[12] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.
[13] *Id.*
[14] Companies Act, 2013, § 3, No. 18, Acts of Parliament, 2013 (India).
[15] Companies Act, 2013, § 58(2), No. 18, Acts of Parliament, 2013 (India).
[16] 2015 SCC OnLine Bom 2111.
[17] *Id.*
[18] *Id.*

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valid and enforceable. The Court in the *Baja Auto* case[19] had also accepted the judgement of the Division Bench of the Bombay High Court, which was the case of *Messer Holdings Limited v. Shyam Madanmohan Ruia & Ors.*.[20] Here, the Court affirmed that a contractual arrangement regarding share transferability can be enforced as any other contract and does not hinder free transferability of shares. It is important to note that this does not curtail the power of Board of Directors of a public company to deny the registration of shares on grounds of 'sufficient cause'.[21]

Following the *Messer Holdings* judgement[22], a proviso under Section 58(2) was incorporated that allowed shareholders to enter into "any contract or arrangement between two or more persons in respect to transfer of securities" and such an agreement was deemed "enforceable as a contract".[23] Thus, the general position of Indian law allows the inclusion of clauses that impose restrictions on share transferability in the SHA and confers statutory recognition and validity to SHAs so long as the provisions of the SHA do not violate provisions of the Companies Act, 2013. If they do, then the SHA loses its validity and is declared void under Section 6(b) of the Companies Act, 2013.[24] However, the friction between SHAs and AoAs gives rise several disputes and its enforceability with respect to the AoA is a heavily debated discourse that is elucidated in the sections enlisted below.

III. Enforceability of the Shareholders Agreement when the AoA is silent on the provisions of the SHA

The author has demonstrated that the provisions of SHAs that are contrary to the AoA are rendered invalid and unenforceable. However, the enforceability of SHAs is also disputed when the AoA is silent on its provisions. The Indian Judiciary first addressed the enforceability of the SHAs in 1991, when the Companies Act of 1956 was still in force.[25] In the case of *V. B. Rangaraj v. V.B. Gopalkrishnan and Ors.*,[26] the SHA contained a Right of First Refusal ["RoFR"] Clause that imposed a share transfer restriction mandating a shareholder to first offer the shares to the other party before offering it to others. However, the RoFR Clause was absent in the Company's AoA. Here, the Court highlighted the paramountcy of the Company's charter

[19] *Id.*
[20] 2010 159 CompCas 29 (Bom).
[21] Companies Act, 2013, § 58(4), No. 18, Acts of Parliament, 2013 (India); **S. Krishna Sarma v. Kanthimathy Plantations (P) Ltd., (2009) 2 CompLJ 253 (CLB); Mackintosh Burn Limited v. Sarkar and Chowdhury Enterprises Private Limited**, (2018) 5 SCC 575.
[22] Messer Holdings Limited v. Shyam Madanmohan Ruia & Ors., 2010 159 CompCas 29 (Bom).
[23] Companies Act, 2013, § 58(2), No. 18, Acts of Parliament, 2013 (India).
[24] Companies Act, 2013, § 6(b), No. 18, Acts of Parliament, 2013 (India).
[25] Companies Act, 1956, No. 1, Acts of Parliament, 1956 (India).
[26] V. B. Rangaraj v. V.B. Gopalkrishnan and Ors., AIR 1992 SC 453.

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documents [the MoA and AoA] and interpreted Sections 3(iii) and 82 of the Companies Act, 1956, jointly to hold that restrictions on transferability of shares of a private company can only be enlisted in the AoA. The Court observed that the AoA already imposed certain restrictions of transferability of shares and held that additional restrictions, through the SHA, was 'contrary' to the Company's AoA and ultimately, the Companies Act. Hence, the Court did not enforce the SHA. The Court mandated the provisions of the SHA to be incorporated in the AoA lest they be rendered unenforceable. The *IL&Fs Trust Co. Ltd. v. Birla Perucchini Ltd.* case[27] broadened the applicability of the *Rangaraj* dictum and held that its ratio would be applicable to any conflict between the SHAs and the AoAs and not merely to transfer of shares.

This position was then altered through the case of *Premier Hockey Development Private Limited v. Indian Hockey Federation* in 2011.[28] In this case, the Delhi High Court rejected the *Rangaraj* ratio and held that the provisions of the SHA were enforceable despite not being incorporated in the AoA. Additionally, the 2012 case of *Vodafone International Holdings v. Union of India and another*,[29] while deliberating on several issues, also deliberated on SHAs pertaining to restrictions on transfer of shares. Here, the Court yet again deviated from the *Rangaraj* ratio and opined that those provisions of SHA that are in the best interest of the company and are not in violation of the Indian Contract Act[30] were valid and binding. The case implied that as long as there was no violation of the Indian Contract Act, the SHAs would be enforceable even if they were not incorporated in the AoA and not enlisted in the Companies Act.[31] However, it is important to note that the Court opined that SHAs are best enforceable when the AoA has incorporated its provisions. However, the Delhi High Court in 2013, in the case of *HTA Employees Union v. Hindustan Thompson Associates Ltd. and Ors.*,[32] again digressed from the view taken in the *Vodafone* judgement wherein Justice Endlaw opined that it was 'highly doubtful' whether the *Vodafone* judgement could be said to overrule the *Rangaraj* dictum. Here, the Delhi High Court observed that the *Rangaraj* case was not expressly overruled and applied the *Rangaraj* ratio (as the facts of the case were akin to the case of *Rangaraj*). Similarly, the case of *World Phone India Pvt. Ltd & Ors. v. WPI Group Inc. USA*[33] also witnessed a conflict regarding enforceability of an affirmative vote of the chairman under a Shareholders agreement which was not incorporated under the AoA. Although the case did not pertain to restrictions on

[27] IL&Fs Trust Co. Ltd. v. Birla Perucchini Ltd., (2004) 121 CompCas 355 (Bom).
[28] 2011 (2) ArbLR 492 (Delhi).
[29] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.
[30] Indian Contract Act, 1872, No. 09, Acts of Parliament, 1872 (India).
[31] Gupta, *supra* note 7, at 1245.
[32] RFA 247/2004.
[33] (2013) 6 CompLJ 401 (Del).

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share transfers, the Delhi High Court refused to enforce the affirmative vote embedded in the SHA as it was not incorporated in the AoA. The Delhi Court's judgement overruled the initial Company Law Board decision to enforce the provision even though it was not incorporated in the AoA.

Through the judicial trends, it can be observed that the position of law on the conflict between the SHA and the AoA is not yet settled. Hence, a case for enforceability of a provision under the SHA (when the AoA is silent on it) can be argued either way as there is ample of jurisprudence for the same.

IV. THE WAY FORWARD

It is well settled in law that the AoA would override the provisions of the SHA if such provisions contradict or violate the clauses embedded in the AoA. However, the true conflict arises when the provisions of the SHA are not incorporated in the AoA. While the Indian judicial stance on the said conflict is muddled, it can be observed that the confusion stems from the clash between the *Rangaraj*[34] and *Vodafone*[35] ratio. On one hand, the *Rangaraj* ratio centred around the paramountcy of the Charter Documents and only allowed enforceability of SHA clauses (pertaining to restrictions of share transfers) if they were incorporated in the AoA. The judgement explicitly mandated all SHA clauses to be incorporated in the AoA in order to be enforceable. On the other hand, the *Vodafone* ratio allowed the enforcement of all those SHAs clauses that were not incorporated in the AoA as long as they did not contradict the AoA and the Indian Contract Act and were also in the best interest of the Company. The author asserts that the position taken by the *Vodafone* case ought to be followed for the following reasons. The *Rangaraj* ratio was established in 1991 when the Companies Act of 1956 was still in force.[36] Additionally, the judgement was passed when the proviso under Section 58(2)[37] was not in force and private contractual agreements between shareholders did not have explicit statutory recognition. Before the enforcement of the Companies Act, 2013, the 57th Report of the Parliamentary Standing Committee on the Companies Bill[38] stated that the proviso of Section 58 simply sought to "codify the pronouncements made by various Courts holding that contracts relating to transferability of shares of a company entered into by one or more shareholders of a company (which may include promoter or promoter group as a shareholder) shall be enforceable

[34] V. B. Rangaraj v. V.B. Gopalkrishnan and Ors., AIR 1992 SC 453.
[35] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613.
[36] Companies Act, 1956, No. 1, Acts of Parliament, 1956 (India).
[37] Companies Act, 2013, § 58(2), No. 18, Acts of Parliament, 2013 (India).
[38] STANDING COMMITTEE ON FINANCE, Fifteenth Lok Sabha, *Report on the Companies Bill, 2011,* Fifty Seventh Report, 104 (15th June 2012).

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under law."[39] In lieu of the proviso, the Securities and Exchange Board of India (SEBI), on 3rd October 2013, also issued a notification rendering validity to contracts that embedded pre-emption clauses "including right of first refusal, or tag-along or drag-along rights contained in shareholders agreements or articles of association of companies or other body corporate."[40] The said developments were recognized by the Indian judiciary where it acknowledged that what Section 111A of the Companies Act of 1956 implied was now made explicit and codified in Section 58 of the Companies Act of 2013.[41]

It is also important to note that the function and the purpose the SHA intends to serve. The *Vodafone* judgement acknowledged that SHAs make provisions for effective internal management of the company as well as provide for restriction of transfer of shares. The author asserts that the SHAs must be viewed as agreements that complement the AoA as they encompass additional and nuanced provisions for internal administration and share transfers. SHAs indicate a mutual understanding amongst shareholders and ease the facilitation of share transfers and internal management of a company, thereby the overall ease of doing business. The author believes that *Vodafone* ratio puts a reasonable standard for the enforcement of SHAs as it allows such private agreements to be enforced as long as they do not violate the AoA, Companies Act[42] and the Contract Act.[43] Hence, it is asserted that the SHAs ought to be enforceable if they can be read harmoniously with the AoA and are in the best interest of the Company. Nonetheless, Companies ought to incorporate provisions of SHAs in the AoA to avoid the conflict that stems from the friction between the two instruments.

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[39] *Id.*
[40] Securities and Exchange Board of India, No. LAD-NRO/GN/2013-14/26/6667 (Notified on 3rd October. 2013).
[41] Bajaj Auto Ltd. v. Western Maharashtra Development Corporation Ltd., 2015 SCC OnLine Bom 2111.
[42] Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).
[43] Indian Contract Act, 1872, No. 09, Acts of Parliament, 1872 (India).

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19. World Phone India Pvt. Ltd & Ors. v. WPI Group Inc. USA,(2013) 6 CompLJ 401 (Del).

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