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Shareholder's Agreement and Articles of Association: A Power Struggle

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ABSTRACT

The cooperation between Articles of Association and Shareholder's Agreement forms the basis of an investors' engagement with a corporate entity. While the Articles lay down what the company can and cannot do, the Shareholder's Agreement binds the company to the investor and assigns the various rights and duties it has with respect to each other. When engaging with the company, the investor hopes to be a part of the management of the company and also be able to freely transfer the shares it has been allotted. While it may sound so simple, it isn't. Several of the key rights that the investors wants are incorporated in SHA, but it is common observance that the Articles may not have specific provisions for granting the same. Further, with advent in contractual terms and nature of deals, SHAs also tend to contain provisions that are not addressed in the Companies Act itself. Therefore, the enforceability of SHA is put under question.

Keywords: *Shareholders Agreement, Corporate Law, Articles of Association, Companies Act.*

I. INTRODUCTION

A company is governed essentially by three major sets of documents: (i) National and/or regional legislation (in case of India, the Companies Act, 2013), (ii) Memorandum of Association (MoA) and Articles of Association (AoA), and (iii) Agreements and Contracts. While MoA formally establishes the existence of the company, AoA deals with the day to day affairs of the company and is, in a way, the Constitution of the company and its members. Third category of documents that govern the discharge of duties of a company include its agreements with various shareholders. When an investor engages with a company to buy its equity shares, it generally enters into several agreements which include Term Sheet, Shareholders Agreement and Share Transfer/Purchase Agreement. The relationship between the company and its investors are majorly governed by two instruments, firstly, the clauses, powers and obligations mentioned in the Articles and, secondly, the Shareholder's Agreement (SHA) entered into

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between the investor and the company. This paper aims to discuss the enforceability of such instruments and the jurisdictional conflict that arises in situations where applicability of SHA is questioned.

Further, the discussion also attempts to test the extent of the enforceability of the rights and obligations that form the contents of an SHA. Reference to stands taken by Indian courts, including the many High Courts, Company Boards, Tribunals and the Supreme Court, shall be made in order to reach to the closest possible conclusion to the issue in this paper.

II. OVERVIEW OF GOVERNING DOCUMENTS

(A) Companies Law

Indian Corporate scene began with the implementation of the Joint Stock Companies Act introduced during the colonial rule and thereafter, for the longest time by the Companies Act 1956 (hereinafter referred to as 'Act of 1956' or '1956 Act'). Most of the companies that are currently flourishing in the country came into existence under the Act of 1956, which survived, with multiple amendments, for over half a century. Rapid digitalisation and globalisation made the need for a new legislation more pertinent and hence the Companies Act 2013 (hereinafter referred to as 'Companies Act', 'Act', '2013 Act' or 'Act of 2013') came into existence after careful and lengthy deliberation by the leaders of the India corporate sector under the leadership of Mr. Uday Kotak.

While the Act supersedes the earlier legislation, it also imbibes provisions for overriding other documents. Section 6 of the Companies Act declare that provisions contained in the memorandum, articles, agreement or resolution that are repugnant to the provisions of the Act are to be void. Further, this particular section gives the Act overriding powers in respect of any document or resolution or decision made by the company or its Board of Directors.

(B) Articles

Memorandum and Articles are the two important governing documents of a company. Along with other policy papers, these form important components of the Corporate Governance of an entity.

Articles fundamentally serve and structure the governance of the company, including day-to-day management and control of the corporate entity.[2] All the important functions and powers of the company and its directors are mentioned in the Articles. It contains byelaws and regulations for management of the company.[3] It is often termed as heart and soul of corporate

[2] Companies Act, 2013, Sec. 5(1) "The articles of a company shall contain the regulations for management of the company."

[3] Section 5, Companies Act 2013.

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governance as it contains procedures and process that effect both day to day operation of company's dealings, and its internal management. Articles also empowers the company to do or not to do something. Where the Articles prohibit the company from entering into a market without shareholder approval, doing the contrary would be seen as a clear violation of the bye-laws of the company. Client entities and investment companies often begin their due-diligence by thoroughly going through the Articles to verify whether the company has power for the purposes of entering into the proposed contract. Therefore, Articles hold utmost significance with respect to a company's governance and conduct.

The Act prescribes that the content of the Articles must provide for the following[4]:

- Share capital and variation of rights
- Calls on shares and
- Transfer and transmission of shares
- Forfeiture of shares
- Alteration of capital
- Capitalisation of profits
- Buy-back of shares
- General meetings, proceedings at meetings and adjournment
- Voting rights and proxy
- Board of Directors and their proceedings
- CEO, Manager, CS, and CFO
- Seal of Company
- Dividends, Reserves and Accounts
- Winding up of company
- Indemnity

The Articles of a company bind the company to its members, and vice-versa and binds the members to each other, they constitute a contract amongst themselves. A member may sue the company and vice-versa to enforce and restrain breach of the articles of the company.

(C) Shareholder's Agreement

Shareholder agreement is a document that binds the company and the investor(s) with respect to their rights and obligations towards each other. It is an agreement to define rights and liabilities of shareholders with respect to the operations of the company. For the protection of the investor's shares in the company and their control (and/or influence) over the Board

[4] Tables F to G of Schedule I of Companies Act 2013.

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decisions, several clauses are embedded in the SHA which are a result of rigorous negotiation rounds and meetings.

Some of the important clauses in the SHA, the enforcement of which will be a part of the discussion in this paper, can be divided into two categories: transfer of shares and management of the company.

i. Transfer of shares

a. Anti-dilution clause: This clause provides investors protection from dilution of their share percentage upon new issue of shares. Upon activation of this clause, the existing investor is given the opportunity to buy subsequent shares in the new round at a price per share which is lower than the set price.[5] To grant such protection, Companies Act makes 'further issue of shares' subject to special resolution passed at general meeting. It must also be offered to existing shareholders at a discounted price before it is offered to the public, either as rights issue or bonus issue.[6]

b. Call and Put Options: In investment terms, 'option' refers to the right or entitlement of a person to buy or sell an asset, which in the present context comprises shares of a company. A put option is the right of a shareholder of a company to sell its shares at a later date to another person at a pre-determined price.[7] The antithesis of a put option is a 'call option' which grants the right to a person to acquire shares in a company from an existing shareholder at a pre-determined price.[8] These are rights and must not be confused with obligations.

c. Tag/Drag Along: Drag along rights give the party selling its shares to a third party, a right to compel the other shareholders to sell with them upon the same terms. Tag along rights gives the shareholders a right to tag their shares to any permitted third party sale upon the same terms. While drag rights seeks to protect the controlling shareholder/promotors, tag along is a protection mechanism for the minority shareholders.

d. ROFO/ROFR: Right of first offer (ROFO) and right of first refusal (ROFR) are contractual terms used in the context of exit by a party, that is, sale of shares by a shareholder in the company. ROFO ensures that if a shareholder entity wishes to sell its shares from the company, it must first offer it to the other shareholder (in whose favour a ROFO is granted), who in turn may offer a price for the shares being sold. The selling shareholder may then sell

[5] *See* Paul Albert & Ashwin Bhat, Anti-Dilution Protection In Shareholders Agreement, MONDAQ (Nov. 2018) http://www.mondaq.com/india/x/750920/Shareholders/AntiDilution+Protection+In+Shareholders+Agreement+Implementation+Under+Indian+Laws.

[6] Companies Act, 2013, Sec. 62.

[7] Umakanth Varottil, *Investment Agreements In India: Is There An "Option"?* Nujs Law Review 467-493, vol 4 (2011).

[8] *Id.*

the shares to the shareholder holding ROFO rights if he is unable to obtain a higher price from a third party. In ROFR arrangement, on the other hand, the selling shareholder has to present the offer by a third party to the shareholder having ROFR rights for giving that shareholder an opportunity to match the offer being offered. If accepted, the selling shareholder has to sell it to the shareholder having ROFR rights. If the offer is not matched or is rejected, the selling shareholder has to sell it to the third party which originally offered the price.

ii. Management of the Company

a. **Veto rights:** Veto is an official right or power to refuse to allow something to happen.[9] The corporate veto is generally of three types: absolute, qualified and suspensive.[10] These require affirmation by a certain investor or class of investors for an assigned topic and is usually arrived at in pursuance of a contractual agreement between the investor and the company. Veto rights could generally be split into core corporate concerns (changes to company's constitution/articles or winding up of the company) and operational concerns (entering into material contracts or capital expenditure, making material acquisitions or disposals of assets, appointing senior employees or directors).[11]

b. **Quorum Rights:** Quorum right literally translates into 'mandatory presence'. By enforcing quorum rights, an investor can prohibit certain issues to be dealt with in a meeting in case a specified member/director or class of members are not present in that meeting. This right would make the meeting fail even when statutorily stipulated quorum is present if the specified person is not in presence. A private equity investor would usually advocate for presence of their representative/nominee in shareholder meetings, even in board meetings, and it would be considered improper quorum in case of absence of such representative/nominee.[12]

III. ANALYSING THE JUDICIAL STAND ON SHA-ARTICLES-ACT

Agreement negotiation forms a significant part of all major equity investment deals, especially when investment firms are aiming to be minority shareholders in a company. These firms move to secure their rights in the agreements, and often, in the Articles. The clauses and provisions mentioned in the above section are sacrosanct to SHA if the investor is looking to secure its rights in the investment deal. It, therefore, needs to be understood whether such an arrangement is enforceable or not in the eyes of the courts of the country and governing corporate law.

Section 6 of the Companies Act make provisions contained in the memorandum, articles,

[9] *See* Definition of veto, https://dictionary.cambridge.org/dictionary/english/veto.
[10] Black's law dictionary (2nd ed. 1910).
[11] *Id.*
[12] GEOFF YATES & MIKE HINCHLIFFE, A PRACTICAL GUIDE TO PRIVATE EQUITY TRANSACTIONS 162-3, Cambridge University Press (2010).

agreement or resolution void that are repugnant to the provisions of the Act. This particular section gives the Act overriding powers in respect of any document or resolution or decision made by the company or its directors. Many hold the view that Articles are stronger than SHA and the provisions of the agreement should be mandatorily included in the Articles for better legal enforcement.[13]

Here, we deal with two issues:

(i) Whether clauses in the SHA or Articles that are not in consonance of the Companies Act would be enforceable; and

(ii) Whether protections mentioned in SHA could be enforceable if the same is not included in the Articles.

(A) Supremacy of Companies Act

The enforcement of an agreement in the context of corporate matters was dealt with in the case of *Feroz Bhasania vs. United Breweries*[14] where Calcutta High Court declared a shareholder's agreement to be void as it restricted the right to change the name of the company. The court said that a company may change its name via a special resolution as prescribed in the Act [Companies Act 1956] and this cannot be restricted via a 'mere agreement'. Relatedly, the Company Law Board in the case of *In Re Jindal Vijayanagar Steel*[15] held the special provisions in the Articles relating to change of official address of the company violative of the Act. Similarly, in the case of *Mazda Theatres Pvt Ltd vs. New Bank of India Ltd*[16], the articles of the company provided that the resolutions may be passed without the requirement of circulation of the draft resolution to the Directors. The resolution was struck down as being repugnant to section 289 of the old Act[17]. It may be, therefore, seen that the courts have abided by the word of law strictly and deviation from the same is termed violative.

Contrary to the above judicial opinions, the Punjab and Haryana High Court at Chandigarh in the case of *Amrit Kaur Puri vs. Kapurthala Flour, Oil and General Mills Co. P. Ltd*[18] allowed the shareholders to have minimum quorum members to be more than what is prescribed in the Act as the 1956 Act was silent on the matter. Silence, thus, was not considered to be an opposition to a provision introducing a positive modification.

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[13] *See* Laxmi Joshi & Aditi Rana, *AoA over SHA: Overriding Powers!*, MONDAQ (Aug. 2017), https://www.mondaq.com/india/shareholders/624970/aoa-over-sha-overriding-powers.

[14] (1971) ILR 1 (Cal.) 367 (India).

[15] 2006 129 CompCas 952 CLB

[16] ILR (1975) 1 DEL 1.

[17] Companies Act, 1956, Sec. 289 – "Passing of resolutions by circulation. No resolution shall be deemed to have been duly passed by the Board or by a committee thereof by circulation, unless the resolution has been circulated in draft, together with the necessary papers, if any, to all the directors, or to all the members of the committee,…"

[18] 1984 56 CompCas 194 P H.

Coming to the side of Articles being mute on certain matters, the Company Law Board in *Akshya Ispat Udyog Pvt. Ltd. and Ors. Vs. Ishwardas Rasiwasia Agrawal*[19], opined that since the articles of the company was not amended to incorporate the arbitration clause as the preferred method of dispute resolution between the parties, the arbitration could not be availed by the parties as the Article was silent on this aspect.

(B) Articles vis-à-vis SHA

The Supreme Court's position on SHA and AoA can be seen in the judgment delivered by the court in the case of *VB Rangaraj vs. VB Gopalkrishnan*[20]. Apex court held that the provisions of the SHA that are in contravention of the Articles of the company are not binding on the parties.

On similar lines, in the case of *IL& FS Trust Co. Ltd. vs. Birla Perucchini Ltd*[21] Bombay High Court held that the decision in VB Rangaraj case would be applicable with respect to any conflicts between SHA and Articles and not only to conflicts relating to transfer of shares. Further, in case of contradiction between the SHA and the Articles of the Company, the latter (i.e. AOA) will prevail. The Delhi High Court also relied upon the *VB Rangaraj* dictum in its judgment in *World Phone India (P.) Ltd. vs. WPI Group Inc., USA*[22] and held that where the articles of a company are silent on the existence of an affirmative vote, it would not be possible to hold that a clause in an agreement between the shareholders would be binding without being incorporated in the articles. The controversial point, however, in the World Phone judgment is that it stated that a clause in the SHA which is not mentioned in the Articles but is also not repugnant to the Act will be unenforceable.

Apex court further clarified its stance on the matter in its observations made in the case of *Vodafone International Holdings BV vs. Union of India*[23], where it stated that the restrictions imposed under SHA provisions, though in compliance with the applicable laws, are best enforceable when incorporated in the Articles of the company. In the judgment, Supreme Court held that shareholders and company could enter into any arrangement in the best interests of the Company as long as the provisions are not contrary to the Indian Contract Act[24]. In this sense, the court's opinion implied that SHA clauses that are not embedded in the Articles and are also not provided for in the Companies Act, may be enforceable as long as it not a violation of Contract law. Further, it was noted that in the event of breach of terms of SHA (which were

[19] C.A. No. 328 of 2013 in O.P. No. 117 of 2013.
[20] AIR 1992 SC 453.
[21] [2004] 121 Comp Cas 335.
[22] [2013] 178 Comp Case 173 (Del).
[23] (2012) 6 SCC 613; MANU/SC/0051/2012.
[24] Indian Contract Act, 1872, Sec. 23.

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not breach of terms of AoA), the aggrieved shareholder could pursue legal actions as per the law of the land.

The binding value of Vodafone case can be questionable as it was in the obiter dicta part of the judgment. It must also be noted that World Phone judgment did not follow the Vodafone judgment even though it came later in timeline.

(C) Options in SHA

Recent trends show that courts are honouring agreements availing exit rights to investors.[25] In the case of *Cruz City 1 Mauritius Holdings vs. Unitech Limited*[26], the Shareholder's Agreement provided for a put option hat could be exercised if the real-estate project does not commence within the prescribed time-period. Due to delay on the part of the company in completing the project, the investor exercised its put option mentioned in the SHA which required Unitech's subsidiaries to purchase its shares on a pre-set price. Unitech claimed that the put option was against public policy in India and therefore the arbitral award could not be enforced but the Delhi High Court rejected the claim of the opposing party and held that the put option was enforceable as it was based on breach of contractual terms.

Similarly, in *NTT Docomo Inc vs. Tata Sons Limited*[27], the transaction documents entered between parties gave the investor an option to exit the company if the targets agreed mutually between the parties were not achieved within the stipulated timeframe. The price at which such exit were to be made would be not less than fair market value of the shares of the company or half of the amount invested by investor, whichever is higher. On investor's exit, the company claimed that the exit clause violates the extant exchange control laws of India. Thereafter, the parties invoked the arbitration clause and the London Court of International Arbitration ruled in favour of the investor. When the award was to be enforced in India, the Delhi High Court ruled that the award was not violative of any provisions of the Indian law and allowed the award to be enforced in India on the grounds that the award to the investor were damages for breach of the transaction documents and not the assured return on the purchase price of the shares.

Both in Cruz City (*supra*) and NTT (*supra*), the validity of options contract was under scrutiny. While the courts did not per se determine the validity of options with respect to applicable laws and whether there must be mention of the option powers in Articles, the enforceability of the same was held to be valid. The Shareholder's Agreement mentioned mentione options right

[25] *See* Sudish Sharma & Anantha Desikan S, *How strong are investor rights in Indian private equity*, FINANCIAL EXPRESS (July 2019), https://www.financialexpress.com/market/how-strong-are-investor-rights-in-indian-private-equity-all-you-need-to-know/1640281/.

[26] 239(2017)DLT649; MANU/DE/0965/2017.

[27] 241(2017)DLT65; MANU/DE/1164/2017.

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between the investor and the company and it was ruled to be binding upon the parties. SHA's value, hence, is significant and important.

IV. CONCLUSION

It is, hence, less clear whether enforceability of shareholder's agreement is absolute or not. The applicability of *VB Rangaraj* judgment still stands clear but we can see that courts have at times not stuck literally to the dictum. Nevertheless, it appears that the courts have been sceptical of giving SHA priority over Articles. What investors must then do is push the company to incorporate the important clauses of SHA into the Articles of the company. By doing that, investors could make the agreed terms and demands to be enforceable and actionable in case of any breach.

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