

INTERNATIONAL JOURNAL OF LAW
MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 4 | Issue 3

2021

© 2021 *International Journal of Law Management & Humanities*

Follow this and additional works at: <https://www.ijlmh.com/>

Under the aegis of VidhiAagaz – Inking Your Brain (<https://www.vidhiaagaz.com>)

This Article is brought to you for “free” and “open access” by the International Journal of Law Management & Humanities at VidhiAagaz. It has been accepted for inclusion in International Journal of Law Management & Humanities after due review.

In case of **any suggestion or complaint**, please contact Gyan@vidhiaagaz.com.

To submit your Manuscript for Publication at **International Journal of Law Management & Humanities**, kindly email your Manuscript at submission@ijlmh.com.

What Overpowers the Other: Shareholder Agreement or Article of Association: The Indian Position

KRATEE AGGARWAL¹

ABSTRACT

A company is governed by its Article of Association. Article of Association is a document governed by the Companies Act, 2013, containing provisions for internal regulation which are to be adhered to by the Shareholders, directors and members of the company. Whereas a Shareholder Agreement is a type of contract bound by the Indian Contract Act, 1872 laying down certain duties, right and obligations of the shareholders.

Quite often the provisions of the Article of Association and Shareholder Agreement are conflicting which makes it difficult to decide whether to rely on the Article of Association or the Shareholder Agreement. It was the V.B. Rangaraj v. V.B. Gopalakrishnan and others² case that clarified the position in cases of conflict between a company's Shareholder agreement and Articles of Association concerning limitation on shares transferability

Keywords: *Article of association, Shareholder agreement, Companies Act, 2013.*

I. DISCUSSION AND ANALYSIS

In the Rangaraj case, there was a Private limited company which was owned by Defendant No. 3, with a total number of shareholding equal to 50. Initially, the shareholder split of the company was such that the majority shares i.e. 37 shares were held by outsiders and the minority shares i.e. 13 were held by the Naidu joint family which comprised of two brothers Baluswamy Naidu and Guruviah Naidu. Later, the family came to acquire the 37 shares as well and became the sole shareholder of Defendant no.3's Private Company. Then they contracted a Shareholder agreement which was made orally by them in 1951. The agreement stated that Baluswamy and Guruviah's branch will carry on to hold an equal number of shares in the company i.e 25 shares each and if a member wants to sell his part of the share, he will have to give the first option of purchase to the members of his branch and only if the other member of

¹ Author is a student at O.P Jindal Global University, India.

² AIR 1992 SC 453.

the same branch does not wish to buy, the shares would be eligible to be sold to others³. As a result of the oral agreement between the two brothers Baluswamy and Guruviah, they both came to hold equal shares for their own branches in the Private Company i.e. 25 each. Further, Baluswamy had three sons, defendant no.1 and 2 and Selvaraj and Guruviah also had three sons, namely Defendant no. 4 to 6. Soon after, in 1963 on 5th February Baluswamy died and a few years later on 10 January, 1970 Guruviah died. As per the agreement which was made orally, after the death of both the brother, equal shares were to be held by both the branches of the family and the sons could only sell their part of the share to others after giving a chance to members of his branch.

Defendant no.1 who was the son of Baluswamy went contrary to the oral agreement and hence sold the shares to Guruviah's son's defendant no.4 to 6 without offering the shares to his two brothers. When Defendant no. 1 sold shares to Defendant no. 4 to 6, Baluswamy's other two sons or the brothers of defendant number 1 (the second one was pro forma defendant) moved an application to the trial court who were the original Plaintiffs and contended on the grounds that, firstly the sale of shares to defendant no. 4 to 6 should be declared void because as per the oral agreement defendant no.1 could not have sold the shares without taking consent from his brothers who are the plaintiffs here. Secondly, they prayed an order should be passed directing Guruviah's sons (defendant no. 4-6) for transferring shares to the plaintiff and second defendant. Thirdly, they prayed for an order of permanent injunction to restrain defendant no. 4-6 to apply for registration of the transferred shares in their names. The original appeal was filed by Baluswamy's two sons.

The court relied on Section 3 (iii), Section 26, Section 28, Section 36, Section 39, Section 82 of the Companies Act,2013, and Oral agreement between Guruswamy and Baluswamy and Articles of Association. The Article of Association stated: If a member dies, his heirs or nominee are to be declared as members but if they are not willing to become member, then the deceased member's share is to be divided among the members equally or can be transferred to a new member if he is admitted with consent of the majority of the members⁴.

Initially, the matter stood in front of the trial court, where the court held that transfer of share was invalid as it was contrary to the shareholder agreement. The Court held in favour of Plaintiffs thereby directing Defendant No. 4-6 to transfer back shares to plaintiffs (defendant no 2 and & pro forma defendant- Selvaraj) indicating the supremacy of Shareholder agreement over the Article of Association and also passed an order for permanent injunction as was

³ *Ibid* 2.

⁴ *Ibid* 16.

prayed. Unhappy with the decision of the trial court, defendant no 1 along with defendant no. 4 to 6 appealed to the Madras High Court where their appeal was dismissed. After the dismissal, they made a second appeal in which the Madras High court entertained the matter in dispute and decided in consonance with what the trial court had ordered. The high court held firstly, that the transfer of share from Defendant no 1 to Defendant no 4 to 6 was invalid and that the other two sons of Baluswamy inherently qualified to purchase them. Secondly, Company was bound by shareholder agreement thereby preferring it over the Article of Associations and thirdly it ordered that the shares were to be registered under the original plaintiffs' name (defendant no 2 and Selvraj).

Appellants were dissatisfied by the position denoted by the High Court on 8th February 1980, thus two civil appeals were filed against the Madras High Court decision, one by defendant no. 1 (Civil Appeal No. 1946 of 1980) and Civil Appeal No. 1947 of 1980 by defendant no 4 to 6 (Guruviah's sons) in the Supreme Court of India. The Supreme Court took a different approach to deal with the matter. The Apex court referred to the oral agreement/ the shareholder agreement and Article 13 of Article of Association of Defendant no. 3's Private Company along with few precedents. Both the sides were heard, the contentions put forth by Shri Parasaran the counsel for defendant no 4-6 in the appeal, was that the shareholder agreement had put an additional restriction on the right to shares transferability which the Article of Association did not mention anywhere and hence the oral agreement should not be binding on the transferor (defendant no. 1) and the transferee (defendant no. 4 to 6). Therefore, the position denoted by the High court was not right in declaring the sale of shares invalid and also by directing the transfer of shares to the original Plaintiff. Further, in the appeal made by defendant no. 1 Shri Bhatt, the counsel appearing for him said that even if we consider the High court order about declaring the sale of share invalid, the court did not have inherent power to further force defendant no 4-6 to surrender those shares to the original plaintiffs (the other two sons of Baluswamy).

To these arguments by the appellants, the contrary contentions were made by Shri Krishnamurthy the counsel for respondents which were first; oral agreement of 1951 had a binding effect on shareholders. Secondly, the agreement's motive was to benefit the Naidu family and ensure that there was an equal distribution of shares between both branches. Thirdly, the Article of Association of the company contained nothing which prohibited this agreement by shareholders and fourthly the high court was not wrong in enforcing the shareholder agreement as the family was party to it.

After hearing the counsel for both sides, the Supreme Court looked into the applicable sections

of the Companies Act, 1953(hereinafter “Act”). The Apex court emphasized on Section 3 (iii) of the Act which articulates, a company is a private company if the company’s article prohibits the public for the subscription of its shares, limit shareholding to 50 and further restricts the right of shareholders to transfer its shares⁵. So, from this section, it can be concluded that Defendant no. 3’s company is a private company. Further, Section 26 furnishes, if a private company is limited by shares, it is a Memorandum of Association and Article of Association that contain the company’s regulations and thus they need to be signed by the subscriber⁶. This section clarifies that, in all cases, it is the Memorandum and the Article of Association that contain the company’s regulation and not any other Agreement entered into by the shareholders. Furthermore, Section 28 of the Act provides that in a company that is limited by shares, its Articles can incorporate the regulations provided in Table A in Schedule I of the Act⁷. Further, under Section 36, registered Memorandum and Articles of Association govern the company and its members.⁸ By Section 39 duplicate copy of the Articles of Association and Memorandum are to be supplied to every member⁹. These two provisions explain that the Naidu family was obligated to Defendant no.3 company Articles and they were supposed to be given copies of Article of the Association. Further, Section 82 sets out that shares are movable property and thus can be transferred by the method set in the company’s Articles of Association.¹⁰ This section clarifies the transferable nature of share.

Along with the statutory provisions the court referred to certain precedents to clarify that the Article of Association is the regulations that bind the functions of the company. In *Shanti Prasad Jain v Kalinga Tubes Ltd* the court concluded, the provision about share issuance by the company contained in the shareholder agreement is not binding on Company until the same is put forth in the company’s articles¹¹. In another leading case of 1968, *Re Swaledale Cleaners*¹² it was held that a share is a movable property of a company and is freely alienable unless the Articles expressly state restrictions with respect to their alienation. Furthermore, it has been clarified that unless the law inflicts restriction or the articles of the company expressly state the restriction or the restriction arises by necessary implication, there is no way a shareholder can be restricted to transfer his shares to whomsoever he wants.¹³

⁵ Companies Act 2013,(Act no. 18 of 2013), s.3(iii)

⁶ *Supra* note 5, s.26.

⁷ *Supra* note 5, s.28.

⁸ *Supra* note 5, s.36.

⁹ *Supra* note 5, s.39.

¹⁰ *Supra* note 5, s.82.

¹¹ *S.P Jain v Kalinga Tubes Ltd*, AIR 1965 SC 1535.

¹² (1968) 1 WLR 1710.

¹³ Anthony James Boyle, *Gore-Browne on Companies* (Jordan Publishing, U.K, 43rd edn., 2004).

The court further referred to another book dealing with 'transfer of shares', which clarifies that a shareholders' right to transfer his shares is an unrestricted one unless the articles of the company state otherwise.¹⁴ The author of *Halsbury's* book states that just like any other transferable personal property, shares are also the personal estate of the shareholders. They can transfer them in the mode prescribed by the company's articles and do not need to be transferred in the nature of the real estate¹⁵. Furthermore, in *Pennington's* book,¹⁶ it is explicitly stated that a presumption is always made that shares are freely transferable and if there are any restrictions on their alienation they have to be put forth in the articles of association of the company. The court concluded from these precedents that just like any other movable property shares are also transferable under the Act. The Act does not place any restriction on shares transferability to any person. Since the company's Articles state the regulations and bind its members, it is only the Articles which are empowered to impose conditions or restriction on alienation of shares. If Articles do not place any limitation on the right of a shareholder to transfer shares, then the Shareholders can alienate their shares freely.

Further, Supreme Court analyzed Company's Article 13 and read it in three parts. Firstly, the majority's consent was needed to admit a new member. Secondly, in case a member dies, his legal heirs should be admitted as the members and thirdly, if the heir is unwilling to be admitted as a member, the deceased members' share should be divided equally amongst all the existing members or be transferred to a new member provided the majority consents to his admission. Further, a 'nominee' is an outside person who is given the power to succeed the person who nominates him to be a member¹⁷. The Article of the Company lays down only one condition with respect to the admission of a new member that is, the requirement of consent of the majority of the member for his approval to be a member. The Article does not state any restriction on the transfer of shares by the shareholder to other existing shareholders.

From the article, it is evident and conclusive that if the transfer is made to an existing member, there is no need for taking consent of other members but it provides if a new member is to be transferred shares then this transfer is supposed to be approved by the majority. Here is the conflict of the Shareholder agreement with that of Article of the company whereby the Shareholder agreement restricted the right of the member with respect to share transferability to any person except to a member of his own branch (consisting of his brothers) though nothing

¹⁴ Sir Francis Beaufort Palmer and Geoffrey Morse, *Palmer's Company law* 608-9 (Stevens & Sons Ltd Publishing, U.K., 24th edn., 1987).

¹⁵ Lord Mackay of Clashfern, *Halsbury's laws of England* para 359 (LexisNexis Publishing, U.K., 4th edn., 2006).

¹⁶ R. Pennington, *Pennington's Company Law* 753 (Butterworths Publishing, U.K., 6th edn., 1990).

¹⁷ Article 13 of the Article of Association of Defendant No.3's Private Company.

like this was mentioned in the article. The Shareholder Agreement restricts the transferability of shares to other existing members and also provides for the succession of shares within the same branch of the family. The requirement of this oral agreement could be binding only if the same was incorporated in the Article of Association because a company is controlled and regulated by its Memorandum and Article of Association. It is these Articles that bind all the members regarding the affairs of the company and any other agreements binding the members on affairs of the company are not enforceable. It was held by the Apex Court that the position denoted by High Court was invalid and that the Articles of the company prevailed over the Shareholder's Agreements.

The *Rangaraj case*, in a nutshell, had laid down that any restriction imposed by the Shareholder agreement which was consistent with the Companies Act, could not be imposed on the Members of the company because the same was not included in the Article of the company. The courts have expanded this understanding and hence in the *Vodafone International Holdings vs. Union of India*¹⁸, The Apex Court denoted a flexible position stating that shareholders agreement can contain a provision in the best interest of the company and can be enforceable but only if the provisions are not going contrary to the Article of Association.

II. CONCLUSION

It remains to be decided if the shareholder agreement overpowers the Article of association or vice versa. The courts have denoted contrasting views and have not yet adopted a strict position while deciding if the provisions of shareholder agreement are invalid if not incorporated in the Articles of Associations. To overcome any discrepancy, it is always better to include the provisions of shareholder agreement in the clauses of the article of association to adopt an enforceable nature of the shareholder agreement and avoid any ambiguity.

¹⁸ (2012) 6 SCC 613.