

How "free" is the free share transferability concept?

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Introduction

The Bombay High Court recently in Bajaj Auto Limited (“**Bajaj**”) v. Western Maharashtra Development Corporation Limited (“**WMDCL**”) [[LSI-479-HC-2015-\(BOM\)](#)] has upheld the validity of a pre-emption clause between the shareholders of a public company. It has been held that the shareholder of a public company has a right to arrive at a consensual

arrangement with a third party or another shareholder to deal with its own shares.

This article analyses the aforesaid principle laid down by the division bench of the Bombay High Court.

Background and Factual Matrix

By virtue of a protocol agreement entered into on October 2, 1974, Bajaj and WMDCL incorporated Maharashtra Scooters Limited (“**MSL**”), a public listed company and a wholly owned undertaking of the State of Maharashtra. Bajaj and WMDCL respectively held 24% and 27% shares in MSL respectively, while the remaining 49% of the equity shareholding was held by the public. Clause 7 of the Protocol Agreement provided for a right of pre-emption to Bajaj and WMDCL.^[1] In 2003, WMDCL considered selling and transferring its 27% shareholding to Bajaj at a price of INR 232.20 per share. Bajaj confirmed its interest in buying WMDCL’s shareholding in MSL, but did not find the price offered per share as acceptable and therefore, requested a meeting by High Level Committee to reach a settlement. After failure of several communications between the Parties to come to consensus as regards rate at which the shares of WMDCL would be sold, a joint reference was made to the Arbitrator on December 29, 2003. The Arbitrator passed an award wherein it was held that the equity shares of WMDCL in MCL are to be sold at a price of INR 151.63 per share to Bajaj (“**Award**”).

WMDCL challenged the Award of the Arbitrator under Section 34 of the Arbitration and Conciliation Act, 1996 before the Bombay High Court. The Single Judge of the Bombay High Court negated all the contentions made by WMDCL except the one challenging the legality of Clause 7 of the said Protocol Agreement. The Single Judge of the Bombay High Court upheld WMDCL’s contention regarding Clause 7 being invalid and held this to be the sole ground to set aside the Award.

The order of the Single Judge of the Bombay High Court was challenged before the division bench of the Bombay High Court by Bajaj.

Issue

1) Whether clause 7 of the Protocol Agreement impinged on the free transferability of shares of a public company as contemplated under Section 111 A of the Companies Act, 1956 or the erstwhile Section 22 A (2) of the Securities Contracts (Regulation) Act, 1956?

Judgment and judicial reasoning

The reasoning of the division bench of the Bombay High Court speaking through B.P. Colabawalla J. is stated as follows:

1) The wordings of erstwhile Section 22A of Securities Contracts (Regulation) Act, 1956^[2] (“**SCRA**”) as well as the statement of objects and reasons behind its introduction make it clear that it was introduced to ensure

that the Board of Directors of public companies exercising powers under Section 111 of the Companies Act, 1956 (“**the Act**”), do not place an undue burden on small investors by refusing to transfer shares without assigning any reason. The legislature felt that unrestricted transferability was necessary for securities of public companies which are listed on the stock exchanges. Hence, Section 22 A of the SCRA was introduced to ensure free transferability of securities of public companies whose securities were listed on stock exchange. Therefore, Section 22 A cannot be read to state that it prohibits two individual shareholders to enter into a consensual arrangement to deal with their shares in a particular manner.

2) Shares of a company are movable property and the right of the shareholder to deal with his shares or enter into contracts in relation thereto and have a pre-emption clause is nothing but a shareholder exercising his property rights. Hence, pre-emption clauses in public company cannot be construed as a restriction on free transferability under Section 22A of the SCRA.

3) Section 111 A of the Act^[3] is similar to that of Section 22 A of the SCRA which states that the shares or debentures and any interest therein of a company shall be freely transferable subject to the other provisions of Section 111 A of the Act. Hence, it reinforces that Section 111 A is intended to regulate the powers of the Board of Directors of public companies regarding transfer of shares in a public company. The proviso to Section 111 A (2) of the Act makes it clear that the “*Board of Directors of a public company can refuse transfer of shares only if sufficient cause is made out.*” Hence, it is not a provision to curtail the rights of the shareholders to enter into a consensual arrangement with a purchaser in relation to their specific shares.

4) Further, if the legislature intended to take away the right of shareholders to enter into consensual arrangement with the purchaser in relation to their specific shares, it could have made an express provision in that regard. The fact that the shares of a public company can be subscribed to by the public, unlike a private company, does not in any way whittle down the right of a shareholder of a public company to arrive at a consensual arrangement with a third party or another shareholder which is in conformity with the Act.

5) Clause 7 of the Protocol Agreement which is incorporated in the Articles of Association of MSL sets out the relationship between Bajaj and WMDCL. It is not a blanket pre-emption clause which binds all the shareholders of MSL to sell their shares only to other members of MSL, which is found in a private company. Clause 7 does not in any way whittle down the rights/ liabilities of other members of MSL.

6) In today’s globalized world, joint ventures are common and clauses similar to Section 7 are necessary to ensure that a joint promoter of a public company does not sell his shareholding to a competitor who then would turn would get control of his rival.

Hence, clause 7 of the Protocol Agreement was held to be valid and not impinge upon the principle of free transferability of shares as contemplated under Section 111 A of the Act.

Analysis

The division bench of the Bombay High Court in *Messer Holding Limited v. SM Ruia and Others*^[4] while dealing with a similar clause in a public company had held Section 111 A of the Act is placed in the Act under heading “*transfer of shares and debentures*” and cannot be stated to be a statutory provision intended towards curtailing the rights of shareholders to enter into consensual arrangement with the purchaser of their specific shares.

Further, it was stated that the concept of free transferability of shares in a public company is not affected in any manner if the shareholder expresses his willingness to sell the shares held by him to another party with right of first refusal at the prevailing market price at the relevant time. It was made clear that the shareholder has freedom to transfer his shares on terms defined by him such as right of first refusal. The division bench of the Bombay High Court has followed the reasoning laid down by the Division Bench in *Messer Holding Limited*.

The Companies Act, 2013 has expressly recognized private consensual arrangements and pre-emption clauses in a public company. The proviso to Section 58 (2) of the Companies Act, 2013 states that “*any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable*

as a contract.” The 57th report of the Parliamentary Standing Committee on the Companies Bill, 2011 in its report has stated that the proviso to Section 58 (2) seeks to codify the pronouncements made by the various courts holding that contracts relating to transferability of shares of a company entered into by one or more shareholders of a public company shall be enforceable under law.

The Securities and Exchange Board of India (“SEBI”) has issued a notification dated October 3, 2013^[5] which clarifies that no permission of SEBI is required to enter into any contracts for pre-emption including right of first refusal, or tag-along or drag-along rights contained in shareholder agreements.

^[1] Clause 7 of the Protocol Agreement: “If either party desires to part with or transfer its shareholding or any part thereof in the equity share capital of Maharashtra Scooters Ltd., such party shall give first option to the other party for the purchase of such shares at such rates as may be agreed to between the parties or decided upon by arbitration.”

^[2] Section 22-A (2) of SCRA states that, “*Subject to the provisions of this section, securities of companies shall be freely transferable*”

^[3] Section 111 A (2) of the Companies Act, 1956 states that, “*Subject to the provisions of this section, the shares or debentures and any interest therein of a company shall be freely transferable*”

^[4] 2010 (59) Company Cases 29 (Bom)

^[5] Notification No. LAD-NRO/GN/2013-14/26/6667