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Restraint on free transfer of shares is illegal: HC

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Topics: **Agreements** **High Court** **Shares** **private equity** **investors** **promoters** **transfer** **Corporate India**

MUMBAI: Corporate India is closely tracking a court tussle, whose outcome will determine the nature of future agreements between promoters and JV partners/financial investors like private equity players.

The Bombay High Court recently ruled that any restriction on free transfer of shares is illegal — a directive, which could challenge the 'right of first refusal' that strategic stakeholders like PEs give to promoter groups.

Under such an agreement, a large shareholder planning to exit the company is obliged to give the promoters an opportunity to buy the shares before those can be sold to a third party. Several corporates, listed as well as unlisted, have such agreements with strategic investors.

If the Supreme Court upholds the Bombay High Court's ruling, many corporates will have to rework the pre-agreed arrangements with their investors. Also, there could be other conditions in the shareholder agreements that could come up for scrutiny. Many private equity players are said to be going back to the drawing table, as this could change the dynamics of some of the agreements these investors have already entered into.

"This could be contested legally (by the promoter). We need more clarity on this issue," said the head of PE firm, who is currently grappling with the fallout of this ruling.

Speaking on this issue, Nitin Potdar, partner, J Sagar Associates, said previously, directors of listed companies enjoyed discretionary power to refuse transfer of shares. "Rights of a shareholder and shares are per se two different things. It was never intended that Section 111A should take away the 'right of disposition' of the shareholder. Any shareholder, including promoters, collaborators or select financial investors may self impose certain restrictions on himself for his own commercial reasons," he told ET.

"Post-liberalisation of 1991, every foreign collaboration or investment agreement contains ROFR (right of first refusal), Tag along & Drag along rights. Even today several such agreements are either being executed or are under negotiations. We cannot afford to have any uncertainty over such a crucial issue," he added.

This decision is also expected to inhibit pledging of shares by a shareholder to raise capital. "One significant ramification of this decision could be that a shareholder is inhibited from pledging his shareholding in a public limited company for the purpose of raising a loan, as the pledge would contain covenants that restrict transferability," said Kartik Ganapathy, partner, Nishith Desai Associates.

Given the surplus of paper expected to hit the market this year, corporates are also rattled as to the fallout of such a decision on pre-issue capital of a company, which goes in for an IPO. The Sebi ICDR regulations provide for a one-year lock in on all pre-issue capital, upon an IPO of the company.

"If one were to interpret what the court is saying, does it mean that the pre-issue capital of a company cannot be locked up, and would be freely transferable, post an IPO?" asks Mr. Ganapathy.

The issue gained centre stage following the case of Western Maharashtra Development (WMDC) vs Bajaj Auto where the court has ruled against rights of pre-emption in favour of shareholders of a listed company, as violating Section 111A of the Companies Act.

The agreement in contention was entered into between WMDC and Bajaj Auto, which together held a 51% equity in Maharashtra Scooters (MSL). It provided that if either party intended to part with or transfer its shareholding in MSL, then such party should give the other party the first option to purchase such shares. The issue under the scanner involves MSL's 24% stake held by BAL in Bajaj Holding.

The latter was created two years ago, post the demerger process, as the apex holding company of the auto major.

People familiar with the development told ET that Bajaj Auto is likely to appeal against the court ruling.

When contacted Sanjiv Bajaj, MD, Bajaj Finserve refused to comment on the issue. “We don’t have any further information at this stage, but should know more in 10 days,” he added.