Right of First Refusal: is it valid in law?

The freedom to contract has been the topic of much discussion especially in cases where the subject matter involves transfer of shares of a public company. Does the concept of free transferability in a public company referred to in Section 111A of the Companies Act, 1956 (Act) curtail a shareholders right to enter into a private arrangement in relation to its shares?. The Division Bench of the Bombay High Court (Court) has analysed this premise in its recent judgment of *Messer Holdings Limited v Shyam Madanmohan Ruia and Ors* where inter-alia the validity of a right of first refusal in a share purchase agreement between shareholders was called to question write *Vyapak Desai, Alap Yadav* and *Simone Reis.*

The Division Bench in this decision held that such a private arrangement would not violate Section 111A of the Act for reasons discussed below. This pronouncement overrules the judgment by the Single Bench of the Court in the matter of ***Western Maharashtra Development Corporation Ltd***. Vs. ***Bajaj Auto Ltd*** wherein pre-emptive rights over shares of a public company were held to be patently illegal.

Judicial Precedents

A synopsis of the law as it stood prior to the decision of the Division Bench on Messrs Holdings:

- The Supreme Court in 1992 in its decision in ***V.B. Rangaraj v. V.B. Gopalakrishnan***; held that a restriction on the transfer of shares contrary to the articles of association of a private company was not binding on the private company or its shareholders.
- The Gujarat High Court in 1998 in its decision in ***Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd*** relying on the Supreme Courts decision in ***V.B Rangaraj***, did not enforce the pre-emptive rights of the shareholders of a public company as the same were not incorporated Articles of association of the said public company.
- The Supreme Court in 2003 in its decision in ***M.S. Madhusoodhanan v. Kerala Kaumudi Pvt. Ltd.*** not disagreeing with the decision in ***V.B Rangaraj*** but distinguishing itself from the facts in that judgment, held that a restriction in relation to identified members on identified shares of a private company did not amount to restriction of transferability of shares per se.
- The Delhi High Court in 2005 in its decision in ***Pushpa Katoch v. Manu Maharani Hotels Limited*** held that as per the provisions of Section 111A of the Act, there could not be any fetters on the right of a shareholder to transfer his/her shares in a public company and observed that a right of pre-emption, even if found in the articles of association, would be ultra vires the provisions of the Act
- The Single Bench of the Court in 2010 in its recent decision in ***Western Maharashtra Development Corporation Ltd. Vs. Bajaj Auto Ltd*** , in relying on the decision of the Delhi High Court in ***Pushpa Katoch*** held that pre-emptive rights over shares in a public company are a fetter on the transferability of such shares and therefore patently illegal.

Background and Facts

Vide a Share Purchase Agreement (SPA) dated June 23, 1997 the controlling shareholders of Bombay Oxygen Ltd (Company), a public listed company agreed to divest a majority of their shareholding to Messer Griesheim Gmbh (MGG) pursuant to which the controlling shareholders agreed to divest a majority of their shareholding in the Company to MGG. As per Clause 6.1 of the SPA , in the event either party intended to sell the entire or any part of the shares in the Company, the transferring party was required to first offer the shares being transferred to the other party. Although this case dealt with various other issues, in this Hotline we analyze the issue pertaining to the legality of Clause 6.1 of the SPA and whether the same is violative of free transferability of shares in a public company provided by Section 111 A of the Act. MGG relied on inter-alia the decision of the Single Bench in ***Bajaj Auto Ltd*** where this Court held that pre-emptive rights on shares of a public company are contrary to the provisions of Section 111A of the Act which requires that the shares of a public company should be freely transferable. The Division Bench however, over ruling the aforesaid judgment, held that such private arrangements are not in violation of Section 111A of the Act in reliance of the following:

- Given the historical background of the deletion of Section 22A of the Securities Contracts (Regulations) Act, 1956 (SCRA) by the Depositories Act, 1996 and the introduction of Section 111A in the Act, it can be inferred that the provisions of Section 111 A was meant to regulate the powers of the board of directors of a company qua the transfer of shares or debentures of a company and any interest therein. The board of directors cannot refuse to register a transfer of shares unless there is sufficient cause to do so.

- Section 111A of the Act is not a law dealing with the right of the shareholders and does not expressly restrict or take away the right of shareholders to enter into consensual arrangement/agreement by way of pledge, preemption/sale or otherwise. The expression freely transferable in Section 111A of the Act does not mean that the shareholder cannot enter into consensual arrangements/agreement with the third party (proposed transferee) in relation to his specific shares.

- The concept of free transferability of shares of 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 purchase (pre- emption) at the prevailing market price at the relevant time. So long as the member agrees to pay such prevailing market price and abides by other stipulations in the Act, Rules and Articles of Association there can be no violation. For the sake of free transferability both the seller and purchaser must agree to the terms of sale. Freedom to purchase cannot mean an obligation on the shareholder to

sell his shares.

- The decision in ***Madhusoodhanan's*** case is an authority on the proposition that consensual agreements between particular shareholders relating to their specific shares do not impose restriction on the transferability of shares. Further, such consensual agreements between particular shareholders relating to their shares can be enforced like any other agreements. It is not required to be embodied in the Articles of Association. The Division Bench also relied on the distinction drawn by the Supreme Court in ***Madhuoodhanan*** from the proposition laid down in ***V.B Rangaraj*** in that the judgment arrived at by the Supreme Court in ***V.B Rangaraj*** was on account of the restriction being a blanket restriction on all the shareholders present and future and could not be imported to a private agreement between particular shareholders.

Analysis

(1) Freely transferable

The interpretation by the Division Bench of the term freely transferable appears to be a complete contradiction to the interpretation arrived at by the Single Bench in ***Bajaj Auto*** in a matter of few months. Although the Division Bench appears to have given the term transferability a liberal meaning, it is important to decipher as to whether all forms of private arrangements can take refuge of this judgment and be upheld as legal. Although the Division Bench has in this judgment given a broad dimension to the term freely transferable as set out in Section 111A of the Act, the Division Bench has also stated that ***the concept of free transferability of shares of a public company is not affected in any manner if the shareholder expresses his willingness to sell the shares to another party with right of first purchase at the prevailing market price. Freedom to purchase cannot mean obligation on the shareholder to sell his shares***.

Given the aforesaid rationale, it may still be questionable as to whether exit rights such as put option agreements and call option agreements where shareholders are obligated to buy or purchase shares (as the case may be) at a price other than the prevailing market price would fall within the framework of freely transferable as analyzed by the Division Bench in this judgment.

(2) Amending articles of association – Rangaraj overruled?

The Division Bench in ***Messrs Holdings*** has also questioned the necessity of amending the articles of association of a public company to include such transfer restrictions. In fact the Division Bench has specifically stated that such consensual agreements between particular shareholders relating to their shares can be enforced like any other agreements and it is not required for such arrangement to be embodied in the Articles of Association. Further, the Division Bench in relying on the Supreme Courts decision in ***S.P. Jain v. Kalinga Tubes*** has also commented on the non-necessity of a company being party to such private arrangements between shareholders.

In light of the aforesaid, it is questionable as to whether the principles enumerated in the Supreme Courts decision in ***V.B Rangaraj,*** namely for a company to be bound by a restriction on transfer of shares the same would have to form part of the articles of association of a company, have been negated by the decision of the Division Bench in the Messers Holdings judgment. In our opinion this may not be the case. It may be noted that the principles laid down by the Supreme Court in ***V.B Rangaraj*** were further analysed by the Supreme Court in ***Madhusoodhan*** which concluded that the judgment arrived at by the Supreme Court in ***V.B Rangaraj*** was on account of the restriction being a blanket restriction on all the shareholders present and future and could not be imported to a private agreement between particular shareholders.

The Division Bench in this case of Messers Holdings has agreed with the interpretation of the ***Rangaraj*** decision by the Supreme Court in ***Madhusoodhan*** and in the spirit of free transferability has extended this concept to private arrangements between shareholders in a public company. However, should certain provisions be required to enforced against a company, the rationale relied on by the Division Bench for not incorporating such transfer restrictions in the articles of association of the company or making the company a party to such arrangements, may not necessarily hold well. Consequently, the rationale behind ***V.B Rangaraj*** may come into play which means that principles laid down in ***V.B Rangaraj*** still hold good.

(3) Liberalization of investor rights

In the event the Messer Holdings judgment ends up being good law it could result in liberalization of transfer of shares and bring about commercial viability amongst investors. Further, the said judgment may provide relief to the private equity investors regarding enforceability of their rights culminating from the private arrangements entered into by them. However, since this decision is that of a High Court, the relief granted by this judgment may only be temporary as it is still subject to the affirmation of the Supreme Court.

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