

Dispute Resolution Hotline

March 10, 2010

RESTRAINT ON FREE TRANSFER OF SHARES - ILLEGAL?

In our last edition of [Deal Destination](#), we analyzed the enforceability of restrictions on share transfers. As an update, we analyze the recent ruling of the Bombay High Court in the matter of *Western Maharashtra Development Corporation Ltd. Vs. Bajaj Auto Ltd*¹, where the court has set aside an arbitral award which allowed pre-emptive rights over shares in a public company holding it as being a fetter on the transferability of such shares and therefore “patently illegal”.

BACKGROUND AND FACTS

The Protocol Agreement in contention was entered into between Western Maharashtra Development Corporation Limited (“**Petitioner**”) and Bajaj Auto Limited (“**Respondent**”) with respect to their shareholding in a listed company, Maharashtra Scooters Limited (“**Company**”). As per the Protocol Agreement if either party intended to part with its shareholding in the Company, then such party was required to give the other party the first option to purchase such shares at a price mutually agreed or decided by an arbitrator. These rights were adequately captured in the articles of association of the Company (“**Articles**”). The price at which these shares were to be sold by the Petitioner to the Respondent was disputed which lead to the matter being referred jointly to arbitration. During the arbitral proceedings, the Petitioner filed an application for questioning inter-alia the jurisdiction of the arbitrator and the validity of the agreement on the grounds that it amounted to a restriction on the transferability of shares in violation of Section 111A reading with Section 9 of the Companies Act, 1956 (“**Act**”). The arbitrator rejected the application of the Petitioner on the following grounds:

(i) The Protocol Agreement was a private agreement, only binding on two shareholders in a specified contingency and therefore, in reliance on the ruling of the Hon’ble Supreme Court in *Madhusoodhanan v. Kerala Kaumudi Private Limited*² and Section 111A which did not prohibit shareholders from entering into agreement regarding specific shares, the pre-emptive rights under the Protocol Agreement were valid and binding on the parties;

(ii) The principle established by the Supreme Court in *V.B. Rangaraj v. V.B. Gopalkrishnan*³ namely that that an agreement imposing restriction contrary to provisions of articles would not be binding on the shareholders and the company, has no implication on the case at hand since the pre-emptive rights were incorporated in the Articles.

The aforementioned reasons were referred to in the arbitral award pronounced by the arbitrator which also determined a valuation for which the Petitioner was required to sell the shares of the Company to the Respondent.

The Petitioner challenged this award under Section 34 of the Arbitration and Conciliation Act, 1996 before the Bombay High Court.

ISSUE

The award in totality was challenged before the Bombay High Court. Various aspects including those as to whether the arbitrator exceeded his jurisdiction and the incorrect determination of the valuation arrived at by the arbitrator were discussed at length. However, at the crux of the appeal filed by the Petitioner lay the issue as to whether the pre-emptive rights granted under the Protocol Agreement incorporated in the Articles were valid in light of Section 111A read along with Section 9 of the Act.

HIGH COURT ORDER

The Bombay High Court set aside the arbitral award on the grounds that the arbitrator erred in his decision concerning the validity of the pre-emptive rights. The Bombay High Court further stated that the decision of the arbitrator in this aspect was completely contrary to the provisions of law and was patently illegal and the illegality went to the root of the arbitral award and consequently was subject to be set aside, it being contrary to public policy.

The reasons relied on by the Bombay High Court in arriving at the aforementioned decision, are as follows:

(i) Section 111A of the Act states that the shares or debentures and any interest therein of a public company shall be freely transferable. Unlike in case of a private limited company, the Company being a public company, its shares could not be subject to a restriction on transfer and any such restriction is patently illegal.

(ii) The word “transferable” is of the widest possible import and includes every means by which the property may be passed from one person to another. The use of the expression “freely transferable” has reinforced the legislative intent of allowing transfers of shares of public companies in a free and efficient domain.

(iii) Section 9 of the Act has an overriding effect in that the provisions of the Act prevails over the provisions of the memorandum and the articles of association of a company and consequently, the provisions of the Protocol Agreement incorporated in the Articles, since in violation of the Section 9 of the Act, would to that extent be void.

(iv) The Bombay High Court concurred with the decision of the Delhi High Court in *Pushpa Katoch v. Manu Maharani*

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*Hotels Limited*⁴, wherein the Delhi High Court stated 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

(v) The decision passed by the Delhi High Court in *Madhusoondhanan v. Kerala Kaumudi Private Limited*⁵, in which the Delhi High Court upheld an agreement between particular shareholders relating to the transfer of specified shares, was limited to shares in a private limited company and this principle did not hold for a public company.

ANALYSIS

Of importance is the rationale behind the High Court's ruling. According to the Bombay High Court, the principle of free transferability is founded on the principle that "every member of the public must have the freedom to purchase and *every shareholder the freedom to transfer*". Based on this principle laid out by the Bombay High Court, ideally every shareholder should be given the discretion to enjoy the said freedom to transfer per his discretion. Consequently, should a shareholder elect to limit this freedom by contractually agreeing to preemptive rights over share transfers for monetary or other forms of consideration, he should not subsequently be allowed to breach such contractual obligations on the grounds of 'free transferability'. However, the Bombay High Court appears to have upheld the free transferability of shares in absolute terms by negating the inter se rights of shareholders to transfer shares per their discretion. The principle being that where an interest is "freely transferable" under law, it cannot be restricted by the will of parties.

It must be noted however, that new legislation, like the Depositories Act, 1996⁶, which is more applicable to public (listed) companies than any other type of company, recognize the ability of a shareholder to create a pledge. This being a form of a restriction on transfer may, by virtue of this judgment, be questionable. Other regulations pronounced by the Securities and Exchange Board of India also contemplate a 'lock-in' of shares of a public listed company, which again might be deemed a contradiction to principle of law laid down by the Bombay High Court.

The legality of transfer restrictions in a private company that is a subsidiary of a public company would also require further analysis in light of the Bombay High Court's recent ruling.

As the provisions of the companies act are primarily to administer the affairs of the company, the issue yet to be more closely examined is as to whether Section 111A is to ensure that a company does not impose any post facto restriction on transferability by refusing to record a transfer after its shareholders have agreed to transfer shares in a particular manner or can be extended to even restrict its shareholders from dealing with the shares in a particular manner and nullify such a valid agreement executed amongst shareholders in this regard.

In conclusion, comfort may be drawn from the fact that the Supreme Court has not yet settled this position of law. A balance must be drawn between a shareholders right to create obligations on himself with respect to his shares in a public company and the intent of Section 111A of the Act.

We have analysed in depth the validity of transfer restrictions on shares in our Deal Destination as the law stood prior to the case at hand. To read more, please click [here](#).

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1 MANU/MH/0109/2010

2 (2003) 117 Comp Cas 19

3 (1992) 1 SCC 160

4 AIR 1992 SC 453

5 Supra at 2

6 Section 12 of the Depositories Act, 1996

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