

# Deal Destination

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## Transfer Restrictions – Would They Hold Up in Court?

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## Transfer Restrictions – Would They Hold Up in Court?

Restrictions on a shareholder's ability to sell his stake in a company usually find its way through most Shareholders Agreements. Be it through a right of first refusal, tag along or restrictions of a more absolute nature such as a lock-in or ban on selling shares to any competitor etc. As regards the enforceability of such restrictions, the position has been settled in the case of private companies by the Supreme Court of the land ("**SC Case**")<sup>1</sup> holding that such restrictions and all others imposed under a Shareholders Agreement are to be incorporated into the charter documents of a company (i.e., Memorandum and Articles of Association) for them to be enforceable. However, the law is not as clearly established in the case of public companies.

*What makes public companies so different?*

In essence, private companies possess certain characteristics, significant of which is the unfettered right to restrict share transfers. On the other hand, an essential characteristic of a public company (defined to mean any company that is not a private company) is the freely transferrable nature of its shares. Such a characteristic is not brought out by inference alone. The Companies Act, 1956 ("**Act**"), the principal legislation regulating all companies in India, specifically provides that the shares of a public company are freely transferable.<sup>2</sup>

*Transfer Restrictions vis-à-vis Public Companies*

The law on the subject has supposedly been settled by a few High Courts of India and the Company Law Board ("**CLB**"), an independent quasi-judicial body in India. In an earlier case of 1999 ("**Case 1**")<sup>3</sup>, pre-emptive rights over share transfers of a public company were not incorporated in the Articles and subsequently sought to be enforced. However, the High Court while relying on earlier precedents, including the SC Case held that such restrictions cannot be enforced as they were not incorporated in the Articles.

So would that mean such restrictions (even in case of a public company) can be enforced if incorporated in the Articles? This question was considered more recently in 2005 by another High Court<sup>4</sup> ("**Case 2**"). In this case, four sisters had set up a hotel company and contractually agreed to offer their stake in the hotel to each other before selling their stake to any third party. While this family arrangement was recorded in writing and acknowledged by the board of the company, the said arrangement was not recorded in the Articles of the company. Three of the sisters eventually sold their stake to a third person (albeit after offering their shares internally). The sister retaining her stake in the hotel could not purchase the shares offered to her as she required more time to arrange for funds and thus initiated legal proceedings challenging the transfer. The High Court while noting the absence of such pre-emptive rights in the Articles simply held that even if such rights were included in the Articles, it would have been in breach of the provisions of the Act, as no company can provide in the Articles any matter which offends

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<sup>1</sup> *V.B. Rangaraj v. V.B. Gopalakrishnan*, AIR 1992 SC 453; [See also *Shanti Prasad Jain v. Kalinga Tubes Ltd.*, AIR 1965 SC 1535; *Canbank Financial Services Ltd., v. The Custodian and Ors.*, AIR 2004 SC 5123]

<sup>2</sup> Section 111A (2) of the Act

<sup>3</sup> *Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd. and Ors.* [1999]97CompCas301(Guj)

<sup>4</sup> *Pushpa Katoch v. Manu Maharani Hotels Ltd. and Ors.*, 121(2005)DLT333

the specific provision of an act (in this case, the specific provision being the freely transferable nature of the shares of a public company).

A similar view was also taken by the CLB<sup>5</sup> holding that any fetters on the right of a shareholder to sell its shares in a public company are inappropriate. In this case, the Articles required a selling shareholder to notify the board of directors before selling shares and to give the board the discretion to determine the terms of the sale with the intending purchaser (i.e., sale price etc). The CLB has held that even conferring the board with the discretion to finalize the sale is a restriction on a shareholder's right to transfer shares and thus such provisions in the Articles are not enforceable.

*Are there any exceptions to the freely transferable nature of a public company's shares?*

In a way, yes. The Act provides that if a company refuses to register the transfer of shares "without sufficient cause", an appeal may be made to the CLB, to direct the company to so register the transfer of shares. At the first instance, this is primarily an intending purchaser's right to compel a company to give effect to the purchase (i.e., to register the transfer of shares in his favour). However, this can also be seen as an implied right of a public company to refuse registering the transfer of its shares so long as it is justified in doing so, i.e., if it has 'sufficient cause'. It may thus be possible to interpret that the shares of a public company are not freely transferable in absolute terms as the transferability of its shares may be restricted with sufficient cause.

It doesn't stop there. The Act further entitles certain persons to undo any transfer that has been recorded by the company by making an application to rectify the records of the company. Unfortunately, the grounds on which such an application can be made have been limited to situations where the transfer has been made in contravention of any law.

*What constitutes 'sufficient cause'?*

Mysteriously, the term 'sufficient cause' has not been defined anywhere in the Act leaving it open to interpretation. Would it then be possible to construe contractual arrangements restricting transferability as reflected in the Articles as sufficient cause? The best way to find out is to look at some of the precedents on this issue to understand how the courts in India have come to regard 'sufficient cause'.

And this is where it gets interesting because the diverging views taken by the courts become apparent.

*Meaning of "sufficient cause"- What do the courts have to say?*

In an earlier case of 1999,<sup>6</sup> the CLB had narrowed the scope of "sufficient cause" by reading it with reference to the grounds under which a transfer can be undone. In this case, the CLB held that only when a company refuses to register the transfer of shares on the grounds that the

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<sup>5</sup> *Arjun S Kalro v. Shree Madhu Industrial Estates Ltd.*, [1997] 24 CLA 63 (CLB)

<sup>6</sup> *Estate Investment Company Private Limited and Anr., v. Siltap Chemicals Limited*, [1999]96CompCas217 (CLB)

transfer is in violation of any law, such refusal could be considered to be with “sufficient cause”. The CLB has also gone on to categorically state that “*refusal on any other ground in respect of a public company cannot be considered to be sufficient cause for such refusal*”.

To the contrary, in 2001, a High Court of India <sup>7</sup> (“**Case 4**”) has observed that the expression “sufficient cause” takes within its sweep not only those contingencies contemplated to undo a transfer but there can also be other circumstances and reasons which might require the company to refuse to register the transfer of shares. As a perfect example, the court observed that if the transfer of shares in favour of a person is likely to create, or, would ultimately place the company itself, in a situation to make a breach of certain existing contractual obligations of the company, thereby exposing the company to action in law, the company would be justified in refusing to register such transfer of shares. The court ultimately held that while there could be various reasons which could constitute ‘sufficient cause’, it would not be possible to enumerate all of them and should instead be decided on the facts of each case.

In 2005, the CLB<sup>8</sup> (“**Case 5**”) while considering the scope of the term “sufficient cause” has referred to the above High Court decision.

Strangely, Cases 4 and 5 are in a league of their own and do not consider or refer to Cases 1, 2 & 3 (and vice versa).

*What about the contractual rights vis-à-vis the shareholders?*

Given that a company is bound by its charter documents, it is only reasonable that any contractual arrangement finalized between shareholders be incorporated in the Articles in order for them to be enforceable against the company. This is the judicial position adopted by most countries, including the United Kingdom where the House of Lords,<sup>9</sup> has held that a company cannot bind itself through such shareholders agreements and agree not to exercise certain powers as conferred by statute. But what is important is that the House of Lords also held that though an agreement by or amongst shareholders cannot bind the company, it can certainly bind the shareholders.

Given that a majority of India’s established laws trace their origins to the laws of UK, it is fairly common for Indian courts to refer and sometimes rely on precedents set by UK courts. But in a significant deviation from this decision, Indian courts have ruled that a restriction which is not specified in the Articles, is not binding either on the company or on the shareholders!

Ideally, shareholders should be entitled to create personal obligations against themselves regarding their interests in the company, the enforceability of which should not be dependent on being included in the company’s charter documents. The same has also been argued in Case 1<sup>10</sup>, where the absurdity in preventing shareholders from assuming such contractual obligations have been highlighted by illustrating implications of such a position. However, being bound by

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<sup>7</sup> *Karamsad Investments Ltd., and others v. Nile Limited & Others* [2002]46CLA23(AP)

<sup>8</sup> *eFirst Technologies Private Ltd. and Ors. v. Hiperworld Cybertech Limited and Ors.*, [2005]126CompCas306(CLB)

<sup>9</sup> *Russel v. Northern Bank Development Corporation Ltd.* [1993] 3 Comp LJ 45 (HL)

<sup>10</sup> *Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd. and Ors.* [1999]97CompCas301(Guj)

the legal precedent set in the SC Case, the High Court has rejected such arguments holding that “only a court of co-ordinate jurisdiction” can consider whether the SC Case is bad in law.

*Conclusion – Can share transfers be restricted in a public company?*

On the basis of the diverging precedents, a conclusive view may be difficult to take. Even so, what is comforting to know is that restrictions on share transfers may be enforceable (even in the case of public companies) when incorporated in the Articles if the court accepts that such restrictions constitute ‘sufficient cause’ based on the facts of the case.

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