

LEGAL ISSUES AND CHALLENGES IN RELATION TO SHARE TRANSFER RESTRICTIONS: AN OVERVIEW OF THE CONTEMPORARY DISPUTES

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ABSTRACT

Restrictions on share transfer are often used by businesses to maintain control over their ownership structure and limit unwanted ownership changes. However, such restrictions can also present various issues and challenges. One of the main issues is the potential for disputes over the valuation of shares. When shareholders wish to sell their shares but are subject to transfer restrictions, disagreements over the value of the shares can arise, especially in closely held companies where there may be limited marketability of the shares. Compliance issues are another potential challenge. If the company fails to properly implement the transfer restrictions or if shareholders attempt to circumvent them, legal issues can arise. Finally, legal challenges can arise if the transfer restrictions are deemed unreasonable or contrary to public policy. In such cases, the restrictions may be subject to legal challenge, and the company may need to justify their use in court. Overall, while restrictions on share transfer can serve a valid business purpose, it is essential for companies to carefully consider the potential benefits and drawbacks of such restrictions and ensure that they are drafted in a clear and enforceable manner. Seeking the advice of legal professionals can also help companies navigate these issues and challenges.

Keywords: Restrictions on share transfer, Ownership structure, Valuation disputes, Compliance issues, Legal challenges.

INTRODUCTION

When a proposition of law becomes deeply rooted, it is not surprising to see that difficult situations have arisen regarding its interpretation. The present condition of the legislation in India on the enforceability of limits on the share's sale is typical of the phenomenon. It is suggested in this segment to explain how the legislation has evolved and demonstrate that it is not up to the mark in at least few ways, and to suggest a most suitable response.

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Every dispute associated with this issue starts with the ruling of the Supreme Court in VB Rangaraj v. VB Gopalakrishnan.¹ In that judgment, the Hon'ble Supreme Court adopted the proposition of law that an arrangement between owners of a private corporation, under which limits are placed on their right to move their shares, is entirely defunct or non-effective till its inclusion in one of the charter documents of the company, i.e., the AOA of the entity or the company.² The proposition of the "incorporation rule", implied that there was no space for shareholders in their agreements to contractually establish rights and duties regarding the transfer of their securities, except those demanding for damages that are not remote in cause, unless those were incorporated in the AOA of the company or an entity. The incorporation law completely neglects the contractual limitations that are not present in the articles of the company. Although the documents from which the incorporation law was drawn are discussed at length subsequently, it is required to notice that a share which is a form of security in a business is a "movable property",³ and section 82 of CA, 1956 mirror to section 44 of CA, 2013, which stipulates that share or the securities are only transferable as per the prescribed process stated in the Articles of Association. The incorporation law was later extended to public⁴ and corporate companies⁵ as well.

Sec. 111A of the CA 1956, Sec. 58 of the CA 2013, and Sec. 22A of the Securities Contract (Regulation) Act, 1956 (hereafter referred to as "SCRA 1956") formed the foundation for the second ban. Companies' securities and debts can be freely transferred under Section 111A(2) of the CA Act, 2013, which is also specified in Section 58(2) of the Act. On the surface, this regulation appears to be similar to the limits in the articles of incorporation and the restrictions outlined in private shareholder agreements⁶. However, private businesses are exempt from the need of unrestricted transferability due to the fact that their articles of association allow by definition for transferability constraints to apply.⁷

There were three instances where the scope of section 111A(2) may have been established based on the inclusion clause since contractual constraints were not included in the documents in these circumstances. In one instance, it was claimed before the Hon'ble Gujarat

¹ (1992) 1 SCC 160.

² Vyapak Desai, Alap Yadav & Simone Reis, "Right of First Refusal: is it valid in Law?", India Law Journal, available at: https://www.indialawjournal.org/archives/volume3/issue_4/article_by_Vyapak.html (last visited on 24-05-2022).

³ VB Rangaraj v. VB Gopalakrishnan, (1992) 1 SCC 160.

⁴ Mafatlal Industries Ltd. v. Gujarat Gas, [1999] 97 Comp Cas 301 (Guj).

⁵ Crompton Greaves v. Sky Cell, [2003] 115 Comp Cas 832 (Mad).

⁶ Id. at 13.

⁷ Supra note 10, s. 3(1)(iii)(a).

High court, a single judge bench, that section 111A(2) has no relation to a restriction set by a shareholder on itself, and so the pre-emptive privileges through contractual interpretations fall beyond its reach. Because it ran counter to federal integration legislation, Shah J. turned down this argument.⁸ With respect to this, it is quite unclear if the proposition, to which we may apply as the “free transferability law”, that a constraint is not effective in spite of its incorporation will really proceed from the rule of incorporation. As well as, in the year 2005, the Hon’ble High Court of Delhi pronounced a similar decision and held that a limitation not found in the papers is not effective by a mere incorporation clause that has been put up and is void with the application of the free transferability rule.⁹ In 2011, division bench, Hon’ble High Court of Bombay in the case of Messer Holdings v Shyam Madanmohan Ruia¹⁰ dismissed this argument and found that section 111A had no effect on the legitimacy of a pre-emptive provision, since it was meant to refer only to the right of the board comprising of the directors to deny a registration of a sale, and not relating to the contractual limitations that run qua shareholders. However, the Hon’ble Court also depended to come to the conclusion on one exception to the incorporation rule as laid down, leaving the statute on the connection between these two origins of an infirmity in a condition of certain doubt. Furthermore, as in not one of these three instances was the pre-emptive provision included in the papers, the findings in Mafatlal¹¹ and Pushpa Katoch¹² that it will be, in any event has been unsuccessful w.r.t. section 111A may therefore at best be considered the obiter.¹³

Whether the free transferability of shares provision invalidates a pre-emptive/pre-emption provision that is incorporated in the AOA was specifically in question in 2 judgments of the Hon’ble High Court of Bombay in the year 2009 and 2011 – Western Maharashtra v. Bajaj Auto¹⁴ and Jer Rutton Kavasmaneck v. Gharda Chemicals.¹⁵

In the Bajaj Auto case, a single judge bench held that a provision in the articles of association is contradictory to section 111A.¹⁶ This decision has been overruled in the Messer Holdings

⁸ Mafatlal Industries Ltd. v. Gujarat Gas, [1999] 97 Comp Cas 301 (Guj).

⁹ Pushpa Katoch v. Manu Maharani Hotel Limited, (2006) 131 Comp Cas 42 (Del).

¹⁰ (2010) 5 Bom CR 589.

¹¹ Mafatlal Industries Ltd. v. Gujarat Gas Co, Ltd., (1998) 2 GLR 1436.

¹² Pushpa Katoch v. Manu Maharani Hotel Limited, (2006) 131 CompCas 42 (Del).

¹³ Aditya Kumar, “Legal Matrix – Transferability of Shares”, LinkedIn (19 May, 2017), available at

https://www.linkedin.com/pulse/legal-matrix-transferability-shares-aditya-yadav/?trk=related_article_Legal%20Matrix%20%E2%80%93%20Transferability%20of%20Shares_article-card_title (last visited on 23-05-2022).

¹⁴ (2010) 154 Comp Cas 593 (Bom).

¹⁵ MANU/MH/0800/2011.

¹⁶ Western Maharashtra v. Bajaj Auto, (2010) 154 Comp Cas 593 (Bom).

case, particularly if the resolution in that situation has not been included into the charter documents of the company. In *JR Kavasmaneck*, a single judge bench focused on this discrepancy between the facts as there in *Messer Holdings* and also those in *JR Kavasmaneck* to conclude that a provision in the AOA containing a pre-emptive provision was contrary to section 111A.

In brief, there are 2 prohibitions acting on a pre-emptive provision or various other statutory constraints on transfer: the incorporation law applied around the board of directors, and the rule of free transferability thereby applicable to public corporations.

These developments show that the statute is not satisfactory in at least few ways. Second, it emerges from a judgment of the Supreme Court in 2002¹⁷ that the incorporation provision would not refer to an arrangement between some particular shareholders related to the sale of certain specified shares. If the free transferability clause still would not extend is not an issue the Supreme Court was able to decide, since the arrangement between the parties in that case applied to the stock of a private corporation. But, in two subsequent cases involving public corporations, a single judge bench of the Hon'ble High Court of Delhi¹⁸ and the Bombay High Court in *Messer Holdings*¹⁹ placed their reliance on the case of *Kerala Kaumudi* to have come to the conclusion that any arrangement between two shareholders that does not connect "future" shareholders in an agreement with respect to the "specific" securities owned by them and thus not contradictory to either the incorporation law of the company or the free transferability rule. If this is right, it is impossible to pinpoint any arrangement between shareholders which is not specific, and the incorporation law and the free transferability rule relating to shares would, as a stated by the Hon'ble justice (in) famous ruling, have been "reduced to the level of a holy cow to which a ceremonial obeisance must first be rendered and which can then be ignored."²⁰ However, as in neither situation was the arrangement stated in the AOA, the High Court was able to escape addressing the query whether an agreement in the articles is ever worthy of being considered as "specific" in this context. That in turn allowed the single judge bench in the *JR Kavasmaneck* case²¹ to maintain that an arrangement that is included in the AOA of a public company is invalid. Curiously, this suggests, as far as public corporations are involved, that an arrangement that is not included

¹⁷ *MS Madhusoodhanan v. Kerala Kaumudi Pvt. Ltd.*, 2003 (117) Comp. Cases 19 (SC).

¹⁸ *MS Madhusoodhanan v. Kerala Kaumudi Pvt. Ltd.*, 2003 (117) Comp. Cases 19 (SC).

¹⁹ *Messer Holdings v Shyam Madanmohan Ruia*, (2010) 5 Bom CR 589

²⁰ *Furniss v Dawson*, [1984] AC 474.

²¹ *Jer Rutton Kavasmaneck v. Gharda Chemicals*, MANU/MH/0800/2011.

in the AOA is more likely to be followed than one which is, it also suggests, more broadly, that the legitimacy of a pre-emption provision continues today to turn on considerations that do not, at the first instance, seem important to what the legislature intended to achieve by adding sections 82 and 111A(2) in the CA 1956.

It's also unclear what the legislature intends to do in sections 82 and 111A(2) or, more generally, what this area of law is about, despite the numerous decisions on this topic. For example, the Board of Directors' power to refuse to register a transfer and its validity has not been clearly explained.²²

Third, judges may refuse to extend the incorporation legislation if the situation is regarded to differ even significantly in character from a pre-emption clause simpliciter, for example, if there is just a limited limitation on the right to pass. The incorporation clause, as the name indicates, asks only one question: was the arrangement incorporated into the articles of association? It is difficult to understand how this applies to the application of this section.

A fourth example is when a corporation has been formed without any restrictions on the selling of stock. When it comes to things like a board member's ability to step down while a shareholder's agreement is still pending, the incorporation legislation has the last say. That is ²³ V Shyam Kishor, "How Free is 'Free Transferability of Shares' in Liberalized India – An Analysis of the Judicial Response", 1 KIIT Journal of Law and Society 103 (2011).

to say, until the company is officially formed, no agreement relating to "management of the company's affairs" may go into force. The incorporation code makes it difficult to determine whether this is an accurate interpretation of Indian law or not, as the origins of that provision may be traced back to concerns about restrictions on the selling of securities.

A RESTATEMENT OF THE RULE OF ENFORCEABILITY OF RESTRICTIONS IN CONTRACTS

The integration law and the free transferability rule are two legal institutions that exist in support of pre-emption clauses and other statutory limits. Section 111A(2) and 111A(1) are to be analysed in this section, and we intend to show that the Rangaraj case was incorrectly decided because it did not adequately take into account the legislative history of section

²² Ibid.

²³ VB Rangaraj v. VB Gopalakrishnan, (1992) 1 SCC 160.

111A(2) or the principles of English law on which it relied; I the legislative history of what's presently section 111A(2) shows that it's very significant; and (ii) we intend to show that the Rangaraj case³⁶ was incorrectly decided because it did not adequately take into account English law (2). Laws in India have emerged as a consequence of two flawed assumptions: that laws regulate the capacity of the board to reject registration of a move owing to contractual limits; and that what's valid of the incorporation rule should also be true for free transferability.

RESTRICTIONS ON SHARE TRANSFER: ISSUES AND CHALLENGES

Restrictions on share transfer refer to the provisions in the Articles of Association of a company that limit or regulate the transfer of shares by its members. Such restrictions may take various forms, including pre-emption clauses, lock-in periods, or outright prohibitions on transfer. While these restrictions may serve various legitimate purposes, such as protecting the company's interests or ensuring a stable ownership structure, they also pose legal and practical challenges.

One key issue is the potential conflict between share transfer restrictions and the fundamental right to freely transfer property, including shares. Under Article 300A of the Indian Constitution, "no person shall be deprived of his property save by authority of law." This implies that any restrictions on share transfer must be lawful and reasonable, and must not amount to a total deprivation of the shareholder's property rights. In the case of *Madhav Rao Jivaji Rao Scindia v. Union of India*, the Supreme Court of India held that the right to transfer shares is an integral part of property rights and cannot be restricted except for reasonable cause, such as protecting the company's interests.

Another issue is the enforceability of share transfer restrictions, especially in the case of private companies. While such restrictions are valid as between the parties, they may not be enforceable against third parties, such as buyers of shares or creditors. In addition, restrictions on share transfer may not be effective in preventing hostile takeovers or shareholder activism, as they can be circumvented through alternative means, such as share swaps or derivative instruments.

Furthermore, share transfer restrictions may create liquidity issues for shareholders, as they limit the marketability and value of their shares. This may discourage potential investors from buying shares in the company, and may reduce the company's ability to raise capital.

Additionally, share transfer restrictions may limit the shareholder's ability to exit the company, which may be problematic in case of disputes or changes in the shareholder's circumstances.

In light of these challenges, it is important for companies to carefully consider the purpose and scope of share transfer restrictions, and to ensure that they are consistent with applicable laws and regulations. Companies should also consider alternative mechanisms, such as shareholders' agreements or buyback provisions, to address the risks and challenges associated with share transfer restrictions.

CONCLUSION

In conclusion, while restrictions on share transfer can serve a valid business purpose, they can also present challenges and issues. Valuation disputes, compliance issues, and legal challenges can arise if the restrictions are not properly implemented or if shareholders attempt to circumvent them. It is important for companies to carefully consider the potential benefits and drawbacks of such restrictions before implementing them, and to ensure that they are drafted in a clear and enforceable manner. Seeking the advice of legal professionals can also help companies navigate these issues and challenges.

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