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VINOD KOTHARI & COMPANY

Legality of a Shareholders' Agreement-

Can shareholders agree outside the Articles?

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Shareholders' agreements are quite common in business, and more so today as variety of strategic, institutional investors make investments in companies. There are numerous situations where such agreements are entered into – family companies, JV companies, venture capital investments, private equity investments, strategic alliances, and so on[1]. In addition, there may be put options, buy back agreements and so on. Questions commonly arise about their enforceability, particularly as against the companies. There may not be a doubt as to their enforceability as between shareholders inter se (except for violation of specific laws, for example, Securities Contracts (Regulation) Act), but issues arise as to whether such an agreement can govern the rights of shareholders of the company generally.

Essentially, Articles of Association constitute an agreement between the company and its members as well as members inter se and is binding on all the members whether he was a member originally or becomes later on. Section 36(1) of the Companies Act states that the registered Memorandum and Articles of Association of a company binds the company and the members to the same extent as if they respectively had been signed by the company and each member and 'member' as defined in section 41 includes any person who has subscribed to the Memorandum of a company and any person holding equity shares of the company whose name has been entered in the register of members or in depository's records. However, quite often, sections of shareholders have private agreements among themselves generalising, shareholders' agreement (SHA). SHA is a contractual arrangement between the shareholders of a company describing how the company should be operated and the defining inter-se shareholders' rights and obligations. SHAs are the result of mutual understanding among the shareholders of a company to which, the company generally becomes a consenting party. Such agreements are specifically drafted to provide specific rights, impose definite restrictions over and above those provided by the Companies Act. They are seen as problematic as they can be instruments for groups of shareholders to circumvent the normal scheme of the

[1]For more on these agreements see http://www.india-financing.com/Private%20equity%20investment-significant%20aspects%20of%20corporate%20laws-in%20template.pdf

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company's legislation or the company's constitution in its Articles of Association. An SHA creates personal obligation between the members signing such agreement however, such agreements do not become a regulation of the company in the way the provisions of Articles are.

An agreement outside the Articles between shareholders as to how they are to exercise their voting rights on a resolution to alter the Articles would not necessarily be invalid. This opens up for agreements that changes, or even distorts, the system of the Articles, and this is one of the questions that we will be discussing in this article.

Enforceability of SHAs in India

It would be trite to state that the enforceability of any contract (which is not perceived as violative of any law) is taken for granted. This may not however, always hold good (especially in India). Enforceability of SHA is one such instance. These kinds of agreements have, sometimes, clauses that go against the company legislation like

- drag-along rights,
- tag-along rights,
- right of first refusal (ROFR),
- composition of board of directors,
- maintaining a particular structure for the company
- conferring on shareholders which would not otherwise be enforceable if not contained in Articles of the company
- specific provision as to quorum requirement for board and general meetings,
- veto or supermajority rights available to certain shareholders at board or shareholder level
- providing private arbitration of disputes

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Though these rights are present in many investment and joint venture agreements, this is the topic of much discussion as the Indian courts generally have not favoured such complete freedom in these agreements. Courts have either refused to recognize clauses in shareholders agreements or, even when consistent with company legislation, enforced such clauses only if they have been incorporated in the articles of association of the company. There is a series of rulings in the respect in case of any conflict between the Articles and the SHA, the former will always prevail. Some of these are:

- *V.B. Rangaraj v. V.B. Gopalakrishnan* (AIR 1992 SC 453)
- *Shanti Prasad Jain v. Kalinga Tubes Ltd*., (35 Com. Cas. 351 SC)
- *Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd* (97 Comp Cas 301 Guj),
- *Pushpa Katoch v. Manu Maharani Hotels Limited* ([2006] 131 Comp Cas 42 (Delhi)]

In *Western Maharashtra Development Corporation Ltd. Vs. Bajaj Auto Ltd* [(2010) 154 Company Cases 593 (Bom)], it was held that such clauses are to hamper the free transferability of shares and in violation of section 111A of the Companies Act, 1956 and hence, are not enforceable. However, the Supreme Court in 2003 in its decision in *M.S. Madhusoodhanan v. Kerala Kaumudi Pvt. Ltd*. (2003 117 CompCas 19 SC) not disagreeing with the decision in *V.B Rangaraj* (Supra) 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.

Recently also, the Division Bench of Bombay High Court in *Messer Holdings Limited v Shyam Madanmohan Ruia and Ors* [(2010) 98 CLA 325] overruling its own previous decision in *Western Maharashtra Development Corporation Ltd* (Supra) held that any private arrangement in relation to shares are not in violation of

section 111A of the Act. The Bench, analyzing inter-alia the validity of ROFR, giving liberal meaning to the term 'transferability', held that 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 Bombay High Court in *IL & FS Trust Co. Ltd v. Birla Perucchini Ltd* [(2003) 47 SCL 426] has held that the provisions in an agreement, cannot be given effect to insofar as the management of the affairs of the company is concerned, unless those provisions have been incorporated in the Articles of a company. The fact that a company is a party to the subscription agreement (as in the case it was) makes no difference to this position because the same is well-settled in law.

The provision of a shareholders' agreement curtailing the rights of directors declared unenforceable if not included in Articles by Bombay High Court in *Rolta India Ltd. & Another vs Venire Industries Ltd. & Others* (2000 100 CompCas 19 Bom). It was held that the shareholders cannot infringe upon the Directors' fiduciary rights and duties. Even Directors cannot enter into an agreement, thereby agreeing not to increase the number of Directors when there is no such restriction in the Articles of Association. The shareholders cannot dictate the terms to the Directors, except by amendment of Articles of Association or by removal of Directors.

Enforceability of SHAs in International context

There are different views on shareholder agreements ranging from a highly critical view to a supportive 'liberty of contract' view. The libertarian view has developed following the decision in *Russell v Northern Bank Development Corporation Ltd* [1992] BCC 578; [1992] 1 WLR 588] where the House of Lords

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found that though a company cannot deprive itself of its power to alter its constitution, the members of the company could agree in a shareholders' agreement as to how they will exercise their voting rights on a resolution to alter the articles/constitution. It was held that such an agreement, although incapable of fettering the statutory entitlement of a company to increase its share capital, could place curbs on the manner in which members exercised their voting rights within the company when exercising a vote on a capital increase. Lord Jauncey stated:

> *"While a provision in company's articles which restricts its statutory power to alter those articles is invalid an agreement dehors the articles between shareholders as to how they shall exercise their voting rights on a resolution to alter the articles is not necessarily so."*

Thus, in this case, an agreement by the company not to use its statutory powers was invalid, but an agreement by shareholders as to how they would exercise their voting powers was valid. The judge dismissed the application on the ground that the agreement was unenforceable because it fettered the company's statutory power infringing the principles established in *Gambotto v WCP Ltd* (1995) 13 ACLC 342.

The interpretation of a shareholders' agreement was at the fore of the litigation in *Euro Brokers Holdings Ltd v Monecor (London) Ltd* [2003] BCC 573; [2003] EWCA Civ 105. This case concerned the enforceability of a provision in a shareholders' agreement, made in the context of a joint venture company, requiring a member to sell its shares to the other member in defined circumstances. That question turned on whether the triggering event (a purported board decision) was valid or whether it could be regarded as valid by applying the *Duomatic Principle* (Re Duomatic Ltd [1969] 2 Ch 365) of informal shareholder assent. Both the judge at first instance (Leslie Kosmin QC) and the Court of Appeal (Pill,

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Waller and Mummery L.JJ.) agreed that this pragmatic common law principle could operate in the context of a shareholder agreement.

In *Minnesota Invco of RSA #7, Inc. v. Midwest Wireless Holdings LLC*, [2006 WL 1596675], the Court of Chancery upheld Drag Along Rights. The court held that the minority owners had lost their rights to block the sale of the holding company by virtue of the reorganization agreements executed when the holding company was formed. Further, the Court held that the minority investors could be "dragged along" to sell their interests in the LLC over their objections because the reorganization agreements superseded their rights as minority owners. The lesson is that a party needs to be careful to protect its existing contract rights when entering into any new agreement that may affect those rights in a less than clear manner.

ROFRs, if reasonable, have been held as valid and enforceable under the Delaware and New York Laws (*Martin v. Graybar Elec. Co.*, 285 F.2d 619, 625).

In *Puddephatt v Leith* ([1916] 1 Ch 200) the court compelled a shareholder to vote as was agreed in a shareholders' agreement.

The US Courts have long accepted shareholder agreements as allowing a small group of investors to 'adopt the decision making procedures of a partnership, avoid the consequences of majority rule (the standard operating procedure for corporations) and still enjoy the tax advantages and limited liability of a corporation'. This principle got approval of Apex Court of California in Blount v Taft [246 S.E.2d 763 at 769 (1978)]

Dealing with the enforceability of voting rights as per the shareholders and pooling agreements, it is stated in the leading UK journal *Law Quarterly Review* (Vol. 84 p. 561):

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> *"In a pooling agreement, each shareholder retains sole ownership of shares binding himself only to vote for a specific person or in a certain way. These agreements are enforceable because the right to vote is a proprietary right- The right to vote may be aided and effectuated by a contract. Generally, pooling agreements are thought of in relation to control of private companies and smaller public companies."*

Given this background, a useful discussion on the enforceability of shareholders' agreements in general is contained in a recent report on *"The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions"* prepared by the Corporation Law Committee of the Association of the Bar of the City of New York and published in the August 2010 issue of The Business Lawyer. Along with listing of the types of clauses included in a shareholders' agreement, the Report also contains a discussion on the legal principles embedded in the laws of the states of Delaware and New York.

The Supreme Court of Canada in *Ringuet v. Bergeron,* [1960(24) D.L.R. 449(2-d)], dealing with shareholders entering into agreement to vote unanimously and observing such agreements not to be illegal, at the same time held that the fiduciary relationship occupied by Directors requires the exercise of these entire duties and attention to the best interest of the company and its shareholders. It was accordingly held that the discretion of the Directors to act in the administration of the affairs of the company cannot be fettered by agreement and, therefore, such agreement was invalid.

It is uncontroversial in every one of these different perspectives that individual shareholders' agreements, whether made by all or some only of the shareholders, create personal obligations between themselves only. They do not become a regulation of the company (in the way that the provisions of the Articles are). Neither do they become binding on the transferees of the parties to it or upon new or non-assenting shareholders. It is also uncontroversial that a provision in a

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company's Articles of Association which restricts the company's statutory power to alter the Articles or a formal undertaking by the company to that effect, would be invalid.

Company's position when it's a party to SHAs

Most of the time, the company is made a consenting party to such agreements and the enforceability of these agreements on the companies is under question.

As noted above, the House of Lords judgment in Russell v Northern Bank goes far in accepting shareholders' agreements. A company cannot itself be a party to an agreement which would restrict its powers as they are required by companies legislation. But this does not bar shareholders' agreements with the same effect from being enforceable by the courts.

As to the question of whether the company should properly be a party following the Northern Bank decision, *Eilis Ferran his article in 53 Cambridge Law Journal 344 1994* in the UK has commented that though the decision does not mean that companies must now not be party to such agreements 'considerable caution is required if they are: any covenants whereby a company promises not to exercise a statutory power will be invalid as against the company and, unless severance is possible, as against the other parties; if severance is not possible the whole agreement may be at risk.

In *Walker v London Tramways Co* (1879) 12 Ch D 705, the ruling authority while discussing the powers and rights of the company to alter its constitutional documents held that:

> *"….the company is empowered by the statute to alter the regulations contained in its articles from time to time by special resolutions (Sections 50 and 51 [of the*

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> *Companies Act 1862]); and any regulation or article purporting to deprive the company of this power is invalid on the ground that it is contrary to the statute".*

In *Welton v Saffery*, Lord Davey had said that an agreement between shareholders as to how they would vote was valid as a personal obligation 'and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders'.

The judgment in *Hickman v. Kent Marsh Shipbreakers Association* (1915(1) Ch D. 881) lays down that an agreement between shareholders cannot be construed to be a contract binding on the company even if the company has taken note of the pooling agreement or even if the company has acted thereon and, on this basis, the English Courts have denied specific performance of such agreements.

Conclusion

In Indian Context, while there does exist one landmark decision of the Supreme Court in V.B. Rangaraj (supra), often cited in the context of shareholders' agreements, most other decisions have been rendered by the High Courts in various states. The High Court decisions are limited in their applicability as they are susceptible to disagreements by other High Courts, thereby conferring limited precedential value. It is difficult to come to clear and crisp answers as to enforceability of SHAs; however, ideally SHAs should be incorporated either by insertion or incorporation by reference. Reference may also be made to provisions of sec. 192(4)(e) of the Companies Act which permits filing of certain agreements that are intended to be binding on members of a class. In order to impact infallible enforceability to SHAs, it may be a good thought to register these agreements in terms of sec. 192.