

Legal Updates

Vinod Kothari & Company

***Shares of public
companies cannot be
subjected to any kind of
restriction – says
Mumbai High Court***

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The Mumbai High Court in recent judgement in *Western Maharashtra Development Corporation Limited vs Bajaj Auto Limited*¹ has indeed given a very broad dimension to “**the principle of free transferability of shares**” in case of public companies which questions the very right of members to lay down provisions in the Articles governing the company. The HC in this case has ruled against the rights of pre-emption in favour of shareholders of a listed company, as violating section 111A of the Companies Act.

It is settled law that the Articles of Association constitute a contract between the members and the company, and the members inter se. A company, whether private or public is an association of persons and members may, by provisions of the Articles, bind themselves in such manner as they may deem fit. Section 9 of the Companies Act, 1956 provides that the provisions of the law shall override the MoA and AoA, and the provisions of the MoA shall override those of the AoA. This implies that unless a provision of the articles is contrary to a law, or the Companies Act, or the MoA, such provision validly binds all members, present and future.

Section 82 allows members to lay down the manner in which shares of a company shall be transferable. Sec 82 itself is not exhaustive as regards transferability of shares – it is perfectly possible for the company to lay down in the articles not just the manner of transfer but the terms and conditions pertaining to the same.

Interestingly, the Mumbai HC without even considering the provisions of sec. 82 has put a seal of rejection on articles contemplating the restrictions as to transferability of shares in public companies.

Facts of the case

A Protocol Agreement was entered into between Western Maharashtra Development Corporation Limited (hereinafter referred to as “WMDCL” being the Petitioner) and Bajaj Auto Limited (hereinafter referred to as “BAL” being the Respondent) pursuant to which Maharashtra Scooters Ltd. (hereinafter referred to as “MSL”) was incorporated under the provisions of the Companies Act, 1956. MSL is a Public Company listed on the

¹ [MANU/MH/0109/2010](#)

BSE and the NSE. In accordance with the terms of the Protocol Agreement, WMDCL holds 27% of shareholding of MSL while the BAL holds 24%, the balance of 49% being held by the public.

Clause 7 of the Protocol Agreement created a right of pre-emption between WMDCL and BAL in the event that either of them seeks to part with or transfer its shareholding in MSL, the party desirous to transfer its shareholding is obligated to furnish a first option to the other for the purchase of the shares at such rate, as may be agreed to between the parties or decided upon by arbitration. The Protocol was incorporated in the Articles of Association of MSL to make it binding on the shareholders.

Decision of the Mumbai High Court:

The Mumbai High Court citing the provisions of Section 111A and Section 9 of the Companies Act, 1956 thus held that

“The provision contained in the law for the free transferability of shares in a public Company is founded on the principle that members of the public must have the freedom to purchase and, every shareholder, the freedom to transfer. The incorporation of a Company in the public, as distinguished from the private, realm leads to specific consequences and the imposition of obligations envisaged in law..... The principle of free transferability must be given a broad dimension in order to fulfill the object of the law. Imposing restrictions on the principle of free transferability is a legislative function, simply because the postulate of free transferability was enunciated as a matter of legislative policy when Parliament introduced Section 111A into the Companies’ Act, 1956....

The effect of a clause of preemption is to impose a restriction on the free transferability of the shares by subjecting the norms of transferability laid down in Section 111A to a pre-emptive right created by the agreement between the parties. This is impermissible. Section 9 of the Companies’ Act, 1956 gives overriding force and effect to the provisions of the Act, notwithstanding anything to the contrary contained in the Memorandum or Articles of a Company or in any agreement executed by it or for that matter in any resolution of the Company in general meeting or of its Board of Directors. A provision contained in the Memorandum, Articles, Agreement or Resolution is to the extent to which it is repugnant to the provisions of the Act, regarded as void.”

Precedents on the issue and how applied

The Mumbai High Court in its present judgement has relied upon the decision given by the Delhi High Court in *Smt. Pushpa Katoch vs. Manu Maharani Hotels Ltd*². The Delhi High Court in an appeal arising out of the judgment of the CLB relied upon the judgment of the Supreme Court in *V.B.Rangaraj vs. Gopalkrishnan*³ to hold that a restriction which is not specified in the Articles, would not bind either the Company or its shareholders. It is pertinent to note here that in *Pushpa Katoch*' case (supra), the right of pre-emption was contained in a family settlement agreement and not in the Articles of Association. Furthermore, the Delhi High Court while deciding the issue did not consider the provisions of section 82 of the Act which clearly enshrines a right on the members to lay down restrictions in the Articles of Association of a company with regard to transferability of their interest in the company.

The Supreme Court in Rangaraj's case has observed that whether under the Companies Act or the Transfer of Property Act, the shares are transferable like any other movable property. Restrictions on transferability are valid only if contained in the company's articles. A private agreement between some shareholders which contains additional restrictions on transferability is not binding either on the company or on its shareholders. Therefore, the Apex Court of the Country has accepted the restrictions contemplated in the Articles of Association in case of public companies.

The Supreme Court in the above-referred case referred with approval to the relevant passages from the well-known Works on Company Law by Gore Borwne, Palmer and Pennington as also to Halsbury which stated that a shareholder has the right to transfer his shares when and to whom he pleases, that any restriction in that right must be contained in the company's articles, and that such restrictions must be construed strictly.

The decision in *MS.Madhusoodhanan vs. Kerala Kaumudi Pvt. Ltd*⁴ case was held to be of no relevance in the present case since the same dealt with restriction on transferability in case of private companies.

² 121(2005) DLT 333

³ 18(1992) 73 Comp Cases 201

⁴ 13(2003) 117 Com.Cases 19

Conclusion

This decision of the Mumbai High Court categorically laid down that a pre-emptive right would impose a fetter on transferability of shares which the law permits only for private companies and in fact prohibited for public companies. It has been declared as clear transgression from the scheme of the Act and therefore “patently illegal”. It is *ultra vires* the Act and the company is not bound to take any cognizance thereof post this judgment. The question now arises as to whether imposing restrictions in the Articles of Association of the company following the power given to the members by virtue of Section 82 of the Act and which has been upheld by the Courts in a number of cases is void?

On many occasions, even the government has formed and registered its joint venture with private parties as public limited companies. The ratio of this decision applied to such joint venture companies would radically question their very constitution and impact the enforceability of shareholder agreements and joint venture agreements governing public limited companies wherein the transfer restriction clauses like rights of first refusal, tag along and drag along rights forms the backbone of structural of companies incorporated pursuant to such agreements