

**RIGHT OF FIRST REFUSAL AND FREE TRANSFERABILITY OF
SHARES IN PUBLIC COMPANIES - A CONUNDRUM*****R.KIRUBAKAR¹****CHAPTER – I****SHAREHOLDER’S AGREEMENT AND RIGHT OF FIRST REFUSAL CLAUSE****1.1. SHAREHOLDER’S AGREEMENT**

Essentially, Articles of Association constitute an agreement between the company and its member as well as members inter se and is binding on all the members. According to *section 10* of the Companies Act 2013, registered Memorandum and Articles of Association of a company binds the company and the members.²

“Section 10 - Effect of memorandum and articles. — (1) Subject to the provisions of this Act, the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed by the company and by each member, and contained covenants on its and his part to observe all the provisions of the memorandum and of the articles.”

However, sections of shareholders have private agreements among themselves called “Shareholders’ agreement”³ (SHA). SHA is contractual arrangement between the shareholders of a company describing how the company should be operated and defining inter-se shareholders rights and obligations. Shareholder agreement regulates the relationship between shareholders in connection with the company’s business these agreements also contains clauses which impose restrictions on transfer of shares.⁴

The agreements signed amongst the shareholders may include some provisions, which broadly include the following:⁵

- ***Right of first look or Right of first offer***, giving the preferred party (non-selling shareholder) the opportunity to offer terms, including as to the purchase price to buy the seller’s shares. If the seller rejects that offer, it will not be permitted to sell those

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² Companies Act, 2013, available at <http://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>

³ According to *Black’s law dictionary*, Shareholders’ Agreement means “The contract between owners of a company that defines mutual obligations, protections, privileges and rights and will comprise articles of association and bylaws

⁴ Enforceability of Contractual Restrictions on the Transfer of Shares, <http://www.supremecourtcases.com>

⁵ Kieren Parker, “Pre-emption Rights and Rights of first refusal – First mover Disadvantage ?”, available at <http://www.addisonslawyers.com.au/knowledge/assetdoc/1baad3f9bbe4b954/Pre-emption%20rights%20and%20rights%20of%20first%20refusal-first%20mover%20disadvantage.pdf>

- shares to a third party at a price less than the offer price or on other terms more favorable to the third party than the terms of the rejected offer;
- **Right of first refusal**, being similar to a right of first look. This is an agreement between the existing shareholders whereby the shareholder wishing to sell to a third party must first offer the shares to the holder of the first refusal right. If the holders of the right of first refusal do not buy the shares, the shareholder can normally sell freely to a third party. and
 - **Right of last refusal**, giving the preferred party the opportunity to accept or reject terms conditionally agreed between the seller and a third party for the sale of the shares.
 - **Drag-Along Right**, right that enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller.
 - **Tag-Along Right**, if a majority shareholder sells his or her stake, then the minority shareholder has the right to join the transaction and sell his or her minority stake in the company.

A *right of first look* is the most favourable to the grantor, as it does not have to show its hand, letting the preferred party make the first move instead. A *right of last refusal* is the most favourable to the preferred party, as the grantor must not only test the market, but must bring to the preferred party a negotiated deal.⁶

1.2. RIGHT OF FIRST REFUSAL CLAUSE

Shareholders agreements often include a right of first refusal as a means to ensure that the company and/or other shareholders will have an opportunity to purchase any shares that any shareholders desire to sell.⁷

⁶ Babri, "Real Property", Lexis Nexis (2008), available at http://www.lexisnexis.com/documents/pdf/20150722022528_large.pdf

⁷ Corporation Law Committee of the Association of the Bar of the City of New York, "The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions", The Business Lawyer, Volume 65, August 2010, available at [http://www.nycbar.org/pdf/report/uploads/20071830-](http://www.nycbar.org/pdf/report/uploads/20071830-TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf)

[TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf](http://www.nycbar.org/pdf/report/uploads/20071830-TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf), accessed on 1 September 2017

PARTIES TO ROFR

Typically in the Right of first refusal (ROFR), at least three parties are implicated

1. The existing shareholder who wishes to sell his shares
2. The existing shareholder(s) who is the right first refusal holder
3. Third party to whom the shares are to be sold if refused by the ROFR holding shareholder.

The ROFR is commonly employed in a variety of contractual settings. It is found, among others, in real estate sale, lease contracts, personal property, a screenplay, in agreements among shareholders of a closely held company or in an interest in a business. For instance, in the entertainment industry, a right of first refusal on a concept or a screenplay would give the holder the right, assumingly, to make that movie first. Only if the holder turns it down may the owner then sell it around to other parties. Taking the above into consideration, it may be noted that the aforementioned right is framed so as to enforce the interests of the investors and the promoters/ current shareholders in a particular venture.

For Example: - Assume that 'A' holds right of first refusal against 'B'. If 'B' wants to sell his shares than 'B' must offer the selling shares to 'A' with the same terms as that of offered to 'C'. If 'A' did not exercise her right of first refusal then only 'B' can sell his shares to 'c'.

A ROFR Clause is generally intended to⁸:

- enable the shareholders who wish to remain in the company to acquire by preference the shares of the selling shareholder and therefore avoid that a third, unknown party, becomes a shareholder of the company
- enable a specific shareholder (or a group of shareholders) to increase their shareholding participation by priority to the remaining shareholders (first-rank pre-emption right).

However, the ROFR clause has some hurdles especially with regard to the free transferability of shares in public companies which will be dealt in the forthcoming discussion.

⁸ Marco Ventrizzo, "Issuing New Shares and Preemptive Rights: A Comparative Analysis", *Richmond Journal of Global Law & Business*, 2013, available at <http://elibrary.law.psu.edu>, accessed on 1st September 2017

RIGHT OF FIRST REFUSAL CLAUSE – INTERNATIONAL PERSPECTIVE

FRANCE

Under French law, the restrictions on the transferability of shares are valid as long as such restrictions are not preventing totally the transfer of shares. The purpose of these clauses is to ensure the stability of the shareholding structure.⁹

Right of first refusal clause (*clause de préemption*): the shareholder wishing to sell his shares to a third party must first offer the shares to the other shareholders benefiting from a right of first refusal. If the shareholders benefiting of the right of first refusal do not purchase the shares, the shareholder can normally sell his share to a third party.¹⁰ The French Bylaws also have a *prior approval clause* (“*clause d’agrément*”). It is a clause which subjects the transfer of shares by a shareholder to the prior approval of the shareholders’ assembly or another corporate body. The purpose of a prior approval clause, which must be included in the bylaws of the company, is to enable interested parties to control the composition of the shareholders of the company. The prior approval clause may apply in the event of sale of shares to third parties, as well as in the event of sale of shares between shareholders.¹¹

USA¹²

In USA, the transfer restrictions must be in Writing.¹³ Both Delaware and New York law permit many types of restrictions on transfers of shares, but in Delaware the restrictions must be in writing, either in the corporation’s certificate of incorporation, its bylaws, or in an agreement among shareholders or among shareholders and the corporation.¹⁴ While New York does not explicitly require that transfer restrictions be in writing.¹⁵

⁹ <https://www.legifrance.gouv.fr>, accessed on 1st September 2017, Also See <https://www.ibanet.org>, accessed on 1st August 2017

¹⁰ <http://www.french-business-law.com/pre-emption-right-article9.html>, accessed on 1st September 2017

¹¹ <http://www.french-business-law.com/bylaws-of-a-french-company-prior-approval-clause-article24.html>, accessed on 1st September 2017

¹² <https://corpgov.law.harvard.edu/2010/12/30/enforceability-and-effectiveness-of-typical-shareholders-agreement-provisions/>, accessed on 2nd September 2017

¹³ Corporation Law Committee of the Association of the Bar of the City of New York, “*The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*”, *The Business Lawyer*, Volume 65, August 2010, available at

[http://www.nycbar.org/pdf/report/uploads/20071830-](http://www.nycbar.org/pdf/report/uploads/20071830-TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf)

[TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf](http://www.nycbar.org/pdf/report/uploads/20071830-TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf), accessed on 1 September 2017

¹⁴ Delaware Code, Title 8, <http://delcode.delaware.gov/title8/title8.pdf>, accessed on 1st September 2017

¹⁵ *Rafe v. Hindin*, 288 N.Y.S.2d 662, 663–64

Permissible Types of Transfer Restrictions - Delaware General Corporation Law, section 202(c)¹⁶ specifically identifies five categories of permitted transfer restrictions: one of such permitted transfer restrictions is “*Provisions that obligate a shareholder to offer to the corporation, other shareholders, or any other person a prior opportunity, to be exercised within a reasonable time, to acquire the shares* (for example, rights of first refusal, rights of first offer, or tag-along rights). Whereas New York does not have a statute that recognizes specified types of transfer restrictions.

¹⁶ Section 202, Delaware General Corporation Law, (a) A written restriction or restrictions on the transfer or registration of transfer of a security of a corporation, or on the amount of the corporation's securities that may be owned by any person or group of persons, if permitted by this section and noted conspicuously on the certificate or certificates representing the security or securities so restricted or, in the case of uncertificated shares, contained in the notice or notices sent pursuant to § 151(f) of this title, may be enforced against the holder of the restricted security or securities or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder. Unless noted conspicuously on the certificate or certificates representing the security or securities so restricted or, in the case of uncertificated shares, contained in the notice or notices sent pursuant to § 151(f) of this title, a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.

(b) A restriction on the transfer or registration of transfer of securities of a corporation, or on the amount of a corporation's securities that may be owned by any person or group of persons, may be imposed by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation. No restrictions so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

(c) A restriction on the transfer or registration of transfer of securities of a corporation or on the amount of such securities that may be owned by any person or group of persons is permitted by this section if it:

(1) ***Obligates the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities; or***

(2) Obligates the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities; or

(3) Requires the corporation or the holders of any class or series of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities, or to approve the amount of securities of the corporation that may be owned by any person or group of persons; or

(4) Obligates the holder of the restricted securities to sell or transfer an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, or causes or results in the automatic sale or transfer of an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing; or

(5) Prohibits or restricts the transfer of the restricted securities to, or the ownership of restricted securities by, designated persons or classes of persons or groups of persons, and such designation is not manifestly unreasonable.

(d) Any restriction on the transfer or the registration of transfer of the securities of a corporation, or on the amount of securities of a corporation that may be owned by a person or group of persons, for any of the following purposes shall be conclusively presumed to be for a reasonable purpose:

(1) Maintaining any local, state, federal or foreign tax advantage to the corporation or its stockholders, including without limitation:

a. Maintaining the corporation's status as an electing small business corporation under subchapter S of the United States Internal Revenue Code [26 U.S.C. § 1371 et seq.], or

b. Maintaining or preserving any tax attribute (including without limitation net operating losses), or

c. Qualifying or maintaining the qualification of the corporation as a real estate investment trust pursuant to the United States Internal Revenue Code or regulations adopted pursuant to the United States Internal Revenue Code, or

(2) Maintaining any statutory or regulatory advantage or complying with any statutory or regulatory requirements under applicable local, state, federal or foreign law.

(e) Any other lawful restriction on transfer or registration of transfer of securities, or on the amount of securities that may be owned by any person or group of persons, is permitted by this section.

*Restrictions on Transfer Must Serve a “Reasonable” Purpose*¹⁷ - In considering the enforceability of transfer restrictions, the Delaware and New York courts seek to balance the concern that “an important incident of the ownership of property is its transferability”. So, a general restraint upon alienation is invalid because contrary to public policy, with a recognition that transfer restrictions may be used to further reasonable corporate purposes.¹⁸ Under Delaware common law, restrictions on transfer are generally valid if they are “reasonably necessary to advance the corporation’s welfare or attain the objectives set forth in the corporation’s charter.”¹⁹ Similarly, under New York law, a restriction on transfer of corporate shares is enforceable if it “effectuates a lawful purpose, is reasonable, and is in accord with public policy.”²⁰

*Both Delaware and New York courts have held that ROFR are enforceable if not unreasonable.*²¹

GREECE

Greece law also provides some indicative forms of restrictions to the transfer of (registered) shares that may be inserted in the articles of association, such as:

- a. the prohibition of the transfer if the shares have not been previously offered to the rest or to some of the shareholders;
- b. The indication by the company, of a shareholder or a third party who will acquire the shares in case a shareholder wishes to transfer its shares.
- c. The articles of association must define the procedure, the terms and the term in which the company approves the transfer or indicates the buyer. The law expressly defines that the restriction on the transfer should not render the transfer impossible.²²

¹⁷ Robert L. Reed, *Section 202 of the Delaware Corporation Law—Per Se Rules for Stock Transfer Restrictions*, Volume Boston College Law Review. 405 (1968), available at <http://lawdigitalcommons.bc.edu/bclr/vol9/iss2/6>, accessed on 2nd September 2017

¹⁸ *Tracey v. Franklin*, 67 A.2d 56, 58 (Del. 1949).

¹⁹ *Grynberg v. Burke*, 378 A.2d 139, 143 (Del. Ch. 1977) which held that restraint on the free transferability of shares is permissible if it “bears some reasonably necessary relation to the best interests of the corporation”.

²⁰ *Benson v. RMJ Sec. Corp.*, 683 F. Supp. 359, 371 (S.D.N.Y. 1988)

²¹ *Martin v. Graybar Elec. Co.*, 285 F.2d 619, 625 (7th Cir. 1961)

²² IBA Guide on Shareholders’ Agreements, Greece

CHINA

Article 72²³ of the People's Republic of China Company Law provides that "Where a shareholder transfers its shares to a person other than a shareholder, the consent of more than half of all other shareholders shall be required. Where the shareholders consent to the share transfer, other shareholders shall have the preemptive right to purchase the shares to be transferred on equal terms and conditions. Where the articles of association stipulate otherwise, such stipulations shall apply". Therefore, unless otherwise provided in the articles of association, the exercise of the preemptive right consists of the following issues:

- a) consent of more than half of all other shareholders;
- b) the article literally refers to half of other shareholders and not refers to the shareholders with more than 50%;
- c) transferring shareholder and non-shareholder purchaser have reached agreement on the terms and conditions of such transfer; and d) the existing shareholder chooses to exercise its preemptive right based on equal terms and conditions.

CHAPTER – II

CONCEPT OF FREE TRANSFERABILITY OF SHARES IN PUBLIC COMPANIES

Some of the important focal sections which would be dealt with this chapter are:-

1. *Section 2(84) of the Companies Act, 2013* which defines Shares as share capital of a company which includes stock.
2. *Section 2(71) of the Companies Act, 2013* states "Public Company" as a company which is not a private company and which has a minimum paid-up share capital as may be prescribed. A private company, which is a subsidiary of a public company, is deemed to be a public company under the 2013 Act.²⁴

²³ Article 72: When a people's court transfers the equity interests of a shareholder pursuant to the enforcement procedures stipulated in law, it shall notify the company and all shareholders, and the other shareholders shall have the priority purchase right under equal conditions. Where the other shareholders fail to exercise the priority purchase right within 20 days of the date of notice of the people's court, they shall be deemed to waive their priority purchase right, available at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html#_Toc381707449, accessed on 2nd September 2017

²⁴ Hillcrest Realty Sdn. Bhd Vs. Hotel Queen Road Pvt. Ltd. and Ors., [2006] 71 SCL 41 (CLB)

3. **Section 44 of the Companies Act, 2013** (Corresponding to section 82 of Companies Act, 1956) states that shares are movable property and are transferable in nature as provided by the articles of the company
4. **Section 58(2)²⁵ of the Companies Act, 2013** which provides that the shares or debentures and any interest therein of a public company **shall be freely transferable**.

WHAT IS “FREELY TRANFERABLE”

Transferability is an important feature of a share in a company registered under the Companies Act, 2013. Upon incorporation, a company acquires its own independent legal personality and legal entity.²⁶ Section 44 of the Companies Act, 2013 states that the share shall be a movable property and transferable in a manner provided by the articles of the company.²⁷

It is also important to analyze the expression '*freely transferable*', which has not been defined under Companies Act 2013. The expression '*freely transferable*' is a mandate against the board of directors to register the transfer of the specified shares and such expression should be

²⁵ Section 58 - Refusal of Registration and Appeal against Refusal

- (1) If a private company limited by shares refuses, whether in pursuance of any power of the company under its articles or otherwise, to register the transfer of, or the transmission by operation of law of the right to, any securities or interest of a member in the company, it shall within a period of thirty days from the date on which the instrument of transfer, or the intimation of such transmission, as the case may be, was delivered to the company, send notice of the refusal to the transferor and the transferee or to the person giving intimation of such transmission, as the case may be, giving reasons for such refusal.
- (2) Without prejudice to sub-section (1), the securities or other interest of any member in a public company shall be **freely transferable**
Provided that any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract.
- (3) The transferee may appeal to the Tribunal against the refusal within a period of thirty days from the date of receipt of the notice or in case no notice has been sent by the company, within a period of sixty days from the date on which the instrument of transfer or the intimation of transmission, as the case may be, was delivered to the company.
- (4) If a public company without sufficient cause refuses to register the transfer of securities within a period of thirty days from the date on which the instrument of transfer or the intimation of transmission, as the case may be, is delivered to the company, the transferee may, within a period of sixty days of such refusal or where no intimation has been received from the company, within ninety days of the delivery of the instrument of transfer or intimation of transmission, appeal to the Tribunal.
- (5) The Tribunal, while dealing with an appeal made under sub-section (3) or sub-section (4), may, after hearing the parties, either dismiss the appeal, or by order—
 - (a) direct that the transfer or transmission shall be registered by the company and the company shall comply with such order within a period of ten days of the receipt of the order; or
 - (b) direct rectification of the register and also direct the company to pay damages, if any, sustained by any party aggrieved.
- (6) If a person contravenes the order of the Tribunal under this section, he shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

²⁶ *Salomon v A Salomon and Co Ltd* [1897] AC 22

²⁷ Companies Act, 2013, available at <http://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>

given wider interpretation.²⁸ However, such expression does not in any way restrict the power of the board of directors of a public company to refuse the registration of transfer of such shares on 'sufficient cause' which is provided under Section 58(4) of the Companies Act, 2013²⁹. The board of directors must prudently use their right to refuse to register the transfer of shares and this discretion must not be in any malafide or fraudulent intention³⁰. This discretion can be put into test known as the "test of discretion" by the courts. In the case of *Bajaj Auto Limited v N.K.Firodia*³¹, the interpreted the expression 'discretion' in the following words:-

"Discretion does not mean a bare affirmation or negation of a proposal. Discretion implies just and proper consideration of the proposal in the facts and circumstances of the case. In the exercise of that discretion the Directors will act for the paramount interest of the company and for the general interest of the share-holders because the directors are in a fiduciary position both towards the company and towards every share-holder. The Directors are therefore required to act bona fide and not arbitrarily and not for any collateral motive".

In *Estate Investments Company P. Ltd. v. Siltap Chemicals Ltd*³², the Company Law Board laid down the scope of the words "sufficient cause". The opinion of the CLB was that only those grounds would constitute a sufficient cause on which the CLB can order rectification of the Register of Member of Company under S. 111A(3) of Companies Act, 2013. ***The grounds of refusal as laid down under S. 111A(3) are***³³:

1. Contravention of the provisions of the SEBI Act, 1992 or Regulations made under that Act. Where the acquisition of shares exceeded 10% and the procedure as to public announcement of such acquisition as prescribed by the Takeover Regulations was not followed, that was held to be a "sufficient cause" within the meaning of section 111A for the Company not to register the transfer.³⁴
2. Violation of Sick Industrial Companies (Special Provisions) Act, 1985.
3. Contravention of any other law for the time being in force.

²⁸ A RAMAIYA GUIDE TO THE COMPANIES ACT, , LEXIS NEXIS, NEW DELHI, (18th ed. 2015)

²⁹ Section 58(4) of the Companies Act, 2013 - If a public company without sufficient cause refuses to register the transfer of securities within a period of thirty days from the date on which the instrument of transfer or the intimation of transmission, as the case may be, is delivered to the company, the transferee may, within a period of sixty days of such refusal or where no intimation has been received from the company, within ninety days of the delivery of the instrument of transfer or intimation of transmission, appeal to the Tribunal

³⁰ *Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd.*, (2010) 154 Company Cases 593 (Bom)

³¹ *Bajaj Auto Limited v N.K.Firodia*, 1970 SCC (2) 550 (Supreme Court of India)

³² *Estate Investments Company P. Ltd. v. Siltap Chemicals Ltd.*, 1999 96 CompCas 217 CLB

³³ *Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd.*, (2010) 154 Company Cases 593 (Bom)

³⁴ *Bakhtawar Construction Co. O. Ltd. Vs. Blossom Industries Ltd.*, 2000 99 CompCas 44 CLB

Legislative History of Section 111A(2) of Companies Act, 1956 (Corresponding to Section 58(2) of Companies Act, 2013)

Section 111A of the Companies Act, 1956 states that “*Subject to the provisions of this section, the shares or debentures and any interest therein of a company shall be freely transferable.*”

The section speaks about free transferability of the shares and debentures of the Public Limited Company.³⁵ The original text of Section 111-A and the principle of ‘free transferability’ was imported in the Companies Act in September 1995 from Section 22-A of Securities Contract Regulation Act, 1956³⁶ which now stands deleted. “Section 22-A. Free transferability and registration of transfers of listed securities of companies – (2) **Subject to the provisions of this section, securities of companies shall be freely transferable.**” The statement and objects of the Section stated that the introduction of this section was by taking into consideration which prevailed in that time. This Provision was inserted in backdrop of arbitrary powers of directors in refusing to register shares In order to provide relief to small investors who were aggrieved by refusal of the Board of Directors from registering the transfer of securities and in order to promote free marketability of listed securities, the legislature inserted Section 22A SCRA Act, 1956 to ensure free transferability of securities of public companies.³⁷ The expression “freely transferable”, thus mandates that shares are freely transferable and directors need to register transfer of shares and no refusal without sufficient cause. By the Depositories Act, 1996, the provision of Section 22A SCRA was deleted and simultaneously, Section 111A of the 1956 Act was inserted, the effect which was similar to Section 22A SCRA.³⁸ It is also now pertinent to note that the said Section 111-A was inserted in the Companies Act by The Depositories Act, 1996³⁹ which primarily regulates depositories in securities, shares held in Dematerialized form and matters incidental thereto. Therefore, one could argue that enactment of Section 111-A was not to emphasize on free transferability of shares of public limited companies but to provide an impetus to transfer shares in dematerialized form and a mechanism to check misuse of power by board of directors of the company.⁴⁰

³⁵ A RAMAIYA GUIDE TO THE COMPANIES ACT, , LEXIS NEXIS, NEW DELHI, (18th ed. 2015)

³⁶ *Securities Contracts (Regulation) Act, 1956*, <http://www.sebi.gov.in/acts/contractact.pdf>

³⁷ *Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd.*, (2010) 154 Company Cases 593 (Bom)

³⁸ PRACHI MANERKA, “INSIGHT INTO THE NEW COMPANY LAW”, , LEXIS NEXIS, NEW DELHI, 136 (1st ed. 2015)

³⁹ *Depositories Act, 1996*, <http://www.sebi.gov.in/acts/act03a.pdf>

⁴⁰ Rajesh Begur, “Right of First Refusal : Legal right and enforceability”, available at <http://www.business-standard.com/article/companies/right-of-first-refusal-legal-right-and-enforceability-1101110001111.html>, accessed on 1st September 2017

CHAPTER - III

JUDICIAL TRENDS WITH REGARD TO ROFR CLAUSE AND ITS ENFORCEABILITY

A ROFR clause is a clause which restricts the freedom of shareholders to sell their shares.⁴¹ Because of this restrictive character, ROFR clause is given strict interpretation by court.⁴² Thus, this chapter would bring out the judicial trend with regard to enforceability of ROFR clauses on restrictions of shares in public companies in the past 25 years (1991-2016).

The discussion on this subject began in the year 1992 when the Supreme Court in the case of *V.B.Rangaraj v. V.B.Gopalakrishnan*⁴³. The issue in this case was whether the shareholders can among themselves enter into an agreement which is contrary to or inconsistent with the Articles of Association of the company. The Supreme Court held that in case of a private limited company transfer restrictions, if any, agreed by the shareholders unless embodied into the articles of association would not be valid and binding. This is only the Supreme Court ruling with regard to the above discussion for the past 24 years.

The next case where the enforceability of ROFR clause was discussed was *Mafatlal Industries Ltd v Gujarat co.Ltd*,⁴⁴ In this case a shareholder disposes the 3.87% share holding in the open market in violation of the agreed terms. The plaintiff was ROFR holder and thus contended that selling of shares in contravention to the agreement was violative. The Gujarat High court in this case held that “In view of the concept of free transferability of shares as embodied in sections 82 and 111A(2) of the Companies Act and expounded by the Supreme Court in V. B. Rangaraj’s case, the alleged agreement for pre-emption is not binding on any of the defendants.” Further , Judge Mr. Shah pointed out that “*ratio laid down in the case of V B Rangarajan by the Apex Court is having much greater force and can be applied to public company also*”.

The court in the above mentioned case took the help of V.B.Rangaraj case to pronounce his judgement but it is to be noted that the facts and circumstances of both the cases where

⁴¹ David I. Walker, “ *Rethinking Rights of First Refusal*”, Harvard Law School, Stanford Journal of Law, Business & Finance, available at http://www.law.harvard.edu/programs/corp_gov/papers/No261.99.Walker.pdf

⁴² Vyapak Desai, “Right of First Refusal : Is it valid in law ?”, Indian Law Journal, available at http://www.indialawjournal.org/archives/volume3/issue_4/article_by_Vyapak.html

⁴³ *V B Rangaraj v. V B Gopalakrishnan*, AIR 1992 SC 453 (Supreme Court of India)

⁴⁴ *Mafatlal Industries Ltd v Gujarat co.Ltd* ,(1998) 2 GLR 1436 (Gujarat High Court)

different having different subject matter i.e., V.B.Ranagraj was related to Private companies whereas the case in Gujarat High court was related to Public company. So, it would be argued that the case was wrongly decided. In the year 2006, the Delhi High court expressed his views on the enforceability of ROFR clause through the case of *Pushpa Katoch v Manu Maharani Hotels Ltd and ors*,⁴⁵ The Delhi High Court in this case held that there could not be any fetters on the right of a shareholder to transfer his/her shares in a public company. It was specifically held that pre-emptive rights are unenforceable even if incorporated in the articles of association, since such rights would be ultra vires to Section 111-A. The next important case which dealt in detail about the enforceability of the ROFR clause was *Bajaj Auto Ltd. v. Western Maharashtra Development Corporation Ltd*⁴⁶. The brief facts of this case are that Bajaj Auto Ltd. and Western Maharashtra Development Corporation Ltd. (“WMDC”) had set up a joint venture in the form of Maharashtra Scooters Ltd., in which Bajaj Auto held 24%, WMDC 27% and the public 49%. The dispute arose out of a share transfer restriction contained in clause 7 of a Protocol Agreement between Bajaj Auto and WMDC, which is in the nature of a right of first refusal. The High court of Bombay held that the Agreement and provision in Articles of Association restricting the transfer shares is violative of section 111A read with section 9 of the Companies Act, 1956 and therefore it is void. This was appealed the division bench of Supreme Court, which overturned the single judge decision. This decision further adds some robustness to the enforceability of share transfer restrictions in shareholders agreements. The court went into explaining the historical origin of section 111A that substituted section 22A of the Securities Contracts (Regulation) Act, 1956 (SCRA). Section 22A (2) of SCRA clearly stated that securities of public companies shall be freely transferrable. But this not taken away the rights of shareholders to enter into an contractual agreement inter se. So the court concluded that even through the terms of the Protocol Agreement were incorporated into the articles of association of the company that would not alter the enforceability of the agreement inter se between the parties. The most important judicial interpretation with regard to the ROFR clause in the recent time is the *Messer Holdings Limited v. Shyam Madanmohan Ruia*⁴⁷, the case was first decided by the Bombay High court. This case upheld the validity of such pre-emptive rights including ROFR and opined that such rights do not violate the provisions of Section 111-A of Companies Act,

⁴⁵ *Pushpa Katoch v Manu Maharani Hotels Ltd and ors* , 2006 131 CompCas 42 Delhi (Delhi High Court)

⁴⁶ *Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd.*, (2010) 154 Company Cases 593 (Bom)

⁴⁷ *Messer Holdings Ltd. v. Shyam Madanmohan Ruia*, [2010] 98 CLA 325

1956. It also observed that a shareholder has freedom to transfer his shares on terms defined by him, including ROFR and subject to compliance with existing laws, such arrangements do not restrict free transferability of shares. It was also held by the Hon'ble Court that pre-emptive rights arise out of a private contract between shareholders with a third party and these need not be embodied in the articles of association of the company since the company is not a party to such arrangements. This case went on appeal to the Supreme Court⁴⁸ on 2016 but since there was outside court settlement between the parties, the court refused to comment upon the enforceability of the ROFR clauses in the shareholder agreements. It is respectfully submitted that the Messer Holding Judgment is contrary to the law of the land pronounced by the Supreme Court in *V B Rangaraj v. V B Gopalakrishnan*⁴⁹ stating that shareholders arrangements not stated in the articles of association are not binding either on the shareholders or on the company. Further, this judgment also contradicts with the principles laid down by *Pushpa Katoch vs. Manu Maharani Hotels Ltd. and Ors*,⁵⁰ wherein it was specifically held that pre-emptive rights are unenforceable even if incorporated in the articles of association, since such rights would be ultra vires to Section 111A.

THE RIGHT OF FIRST REFUSAL STILL REMAINS A SIGNIFICANT UNRESOLVED CONTROVERSY

It would be stated that the Messer Holding case was one of the significant cases in the discussion of ROFR clauses in shareholder agreement. But the Supreme Court in the appeal from the Messer holding case refused to look into the matter of enforceability of ROFR clauses and its validity. So the Supreme Court would not pronounce an judgment with regard to the enforceability of ROFR clause which would have become the Law of Land diminishing the precedential values of V.B.Rengaraj case which is used as a reference in the cases of ROFR, since it is the only case which is from the supreme court. But however, the Bombay high court judgment in Baja Auto case in 2015 which reiterated the Messer holding ratio would be hold good one till the Supreme Court gives its judgment on the enforceability of the ROFR clause in shareholder agreements.

⁴⁸ *Messer Holdings Limited v. Shyam Madanmohan Ruia*, Special Leave Petition (Civil) Nos. 33429-33434 of 2010 (Supreme Court of India)

⁴⁹ *V B Rangaraj v. V B Gopalakrishnan*, AIR 1992 SC 453

⁵⁰ *Pushpa Katoch vs. Manu Maharani Hotels Ltd. and Ors*, 2006, 131 Comp Case 42 (Delhi)

Moreover, adding supported to the discussion, on the October 3, 2013, a Notification⁵¹ was issued by SEBI (Securities Exchange Board of India), which said that Right of First Refusal was legally allowed and valid in the Shareholders Agreement. It also allowed tag along and drag along rights. Through this, SEBI has rescinded its previous notification of March 1, 2000 that prohibited contracts other than spot delivery contracts or those entered into through the stock exchange mechanism. Accordingly, SEBI now permits various types of pre-emption rights and put and call options, but subject to certain conditions.⁵² The Notification states that no person shall enter into any contract without the permission of SEBI for the sale or purchase of securities other than a contract that falls under one or more of the following:

- **contracts for pre-emption [including *right of first refusal*, or tag-along or drag-along rights contained in shareholders agreements or articles of association of companies or other body corporate .**

The Notification permits Indian companies (listed as well as unlisted public companies) to execute contracts containing exit options in the nature of put and call options and other restrictive covenants including right of first refusal, or tag-along or drag-along rights etc. and such provisions are now capable of being enforced without concerns on their validity under SCRA. The notification is a boost to the present discussion and making ROFR clause in Shareholder Agreements enforceable.

CONCLUSION

It can be concluded that in general parlance, the usage of right of first refusal is used by the shareholders who are actively involved in the management of the company and accordingly, unwilling to transfer the shares of existing shareholders to third party enter into shareholder agreement for restrictions on the transfer of shares by shareholders, both inter vivo and upon the death of a shareholder. But the issue of conflicting provisions in a shareholder's agreement and the articles of association of a company is a never ending debate. It is settled law that articles of association prevail over shareholder's agreement. However, in the absence of an expressed

⁵¹ The Gazette of India Extraordinary, Part III, SEBI Notification (Mumbai), 3rd October, 2013, available at http://www.sebi.gov.in/sebi_data/attachdocs/1380791858733.pdf, accessed on 1st September 2017

⁵² Enforcement of Pre – Emption Rights made easier, <http://www.manupatrafast.in/NewsletterArchives/listing/India%20Juris/2013/Oct/Enforcement%20of%20Pre-Emption%20Rights%20made%20easier.pdf>, accessed on 1st September, 2017

provision in articles, the issue remains unsolved as to whether a clause in shareholder's agreement (like ROFR) is enforceable or not. The author would conclude that the Proviso to Section 58(2) and the notification of SEBI on October 2013 has uphold the validity of the ROFR clause and thus as now the position is that shareholder agreements containing restrictions on transferability of shares is enforceable and valid and thus not against the free transferability rule of Section 58(2) of the Companies Act, 2013. In light of the revised definitions under Companies Act, 2013 and the recent judgments, the legal position with respect to validity of restrictions on transfer of shares of a public company can be summarized as under:

- An agreement between shareholders restricting the transfer of shares in a public company does not violate the legal mandate of free transferability of shares of a public company;
- Restrictions on transfer of shares as aforesaid, must not be in violation of the articles of association of the public company or the governing law;
- Such agreement restricting transfer of shares, can be enforced as a contract amongst and against the shareholders who are party thereto;
- However, such contractual restrictions on transfer of shares of a public company are not enforceable against the company, in case the company is not a party to the agreement containing such restrictions.
- ROFR clause in shareholder agreement is not against the free transferability rule of public companies.

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. However ideally, the SHA agreement should be registered as mentioned in Section 117(2)(d) of companies Act, 2013 which permits filing of certain agreements that are intended to be binding on members of a class. So, in order to impact an effective enforceability of SHAs such as right of first refusal etc., it may be a good thought to register these agreements in terms of Section 117(2)(d) of companies Act, 2013. I would conclude by quoting the excerpts from the Bajaj Auto case, *"in today's global scenario, joint ventures are extremely common and ROFR clauses have become necessary to ensure that a joint promoter of a company does not sell his shareholding to a competitor who can then take control of the company."* Thus, ROFR clauses are enforceable and valid under the Law in India between the shareholders in a company.