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# Share Transfer Restrictions: Enforceability of the Provisions of a Shareholder Agreement vis-à-vis the Articles of Association

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SUNIDHI AGRAHARI<sup>1</sup>

## ABSTRACT

*The question of enforceability of the provisions of a shareholder agreement (“SHA”) vis-à-vis the Articles of Association (“AoA”) is a perplexing one. The Companies Act, 2013 (“the Act”) provides that an AoA of a company, containing the guidelines of the internal regulations of the company, governs and binds all members of that company, including the directors and the shareholders. On the other hand, an SHA is an agreement entered into by the shareholders of a company in accordance with the Indian Contract Act, 1872, which levies additional rights and obligations (apart from those prescribed in the Act) upon the shareholders that are party to the said agreement. The company itself can be a party to this agreement. Since these agreements have acquired popularity only over the last two decades, the Indian judiciary has not got many opportunities to decide upon the enforceability of the provisions of such agreements if such provisions lie in conflict with the provisions of the AoA. Further, it is an arduous task to draw common strands in the ratios of the few cases that have dealt with this matter to present clarity for parties that enter into such agreements. However, the case of V.B. Rangaraj v. V.B. Gopalakrishnan is a landmark judgement, considered to be the guiding light in the context of this matter. In this paper, the author will explore the developments in jurisprudence pertaining to this matter and elucidate certain extant conundrums in law.*

## I. INTRODUCTION

Indian jurisprudence has acknowledged that the right to transfer shares is an inherent right in the ownership of shares with reasonable restrictions. However, absolute restriction on share transfer rights is not valid nor binding.<sup>2</sup> While deciding the matter of *V.B. Rangaraj v. V.B.*

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<sup>1</sup> Author is a student at Jindal Global Law School, India.

<sup>2</sup> Sidharrth Shankar & Vidur Prabhakar, *Articles of Association v. Shareholders Agreement- The Conundrum*, Mondaq (Nov. 04, 2020), <https://www.mondaq.com/india/shareholders/1001432/articles-of-association-v-shareholders-agreement-the-conundrum>.

*Gopalakrishnan*<sup>3</sup> (“*the Rangaraj case*”), in which the parties had entered a shareholder agreement (“SHA”) and levied upon themselves the obligation of share transfer restriction, to the extent that one party was required to offer his shares to the other party before offering it to an outside party, the apex court held that for the provisions of restricting share transfer in the SHA to be enforceable, it should have been included in the Articles of Association (“AoA”). Since, in this case, the provision had not been incorporated in the AoA, the enforceability of such provision was questioned. This binding restriction has been slightly relaxed via the proviso to Section 58(2)<sup>4</sup> of the Companies Act 2013, which recognises that “*any contract or arrangement between two or more persons in respect to the transfer of securities shall be enforceable as a contract*”.<sup>5</sup> This relaxation was furthered by the Supreme court in 2012, in the case of *Vodafone International Holdings B.V. v. Union of India*<sup>6</sup> (“*the Vodafone case*”).

Even though the rules regarding the Share Transfer Rights seem to be clearly laid out, it has become a controversial topic because of some inconsistencies. In this paper, after tracing the development of the legal holdings regarding the enforceability of the SHA, I will be dealing with two inconsistencies in this law. First, various high courts have ignored the stand of the *Vodafone case* and stuck to the ratio laid down by the *Rangaraj case*, making the interpretation of the current law regarding the enforceability of the SHA somewhat ambiguous. Second, the relaxation prescribed by section 58(2)<sup>7</sup> applies only to public companies and their shareholders, and no such provision has been made for private companies, and this disparity has been closely scrutinised.

## II. PRIOR LEGAL BACKGROUND

In *S. P. Jain vs Kalinga Tubes Ltd.*<sup>8</sup>, two groups of shareholders, holding equal shares in a private company, entered into an agreement with a third party (the appellant) in 1954. Various resolutions were passed by the company to implement the terms of this agreement; however, these resolutions never explicitly referred to the agreement. Further, no changes were made in the AoA to incorporate the terms of the agreement. In 1957, the company converted into a public company and to this cause, appropriate amendments were made in the AoA, but even then, the agreement of 1954 was not incorporated, and when the appellant claimed benefits of the agreement, disputes arose, and a suit was instituted. To finalise the matter, the Apex court

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<sup>3</sup> *V.B. Rangaraj v. V.B. Gopalakrishnan*, AIR 1992 SC 453, [1992] 73 Comp. Cas. 201.

<sup>4</sup> The Companies Act, 2013, Acts of Parliament 2013 (India).

<sup>5</sup> Shankar & Prabhakar, *supra* note 4.

<sup>6</sup> *Vodafone International Holdings BV v. Union of India* (2012) 6 SCC 613.

<sup>7</sup> *supra* note 5.

<sup>8</sup> *S. P. Jain vs Kalinga Tubes Ltd.* 1965 AIR 1535, 1965 SCR (2) 720.

held that the agreement in question was not binding on the private company (as it started) and even less so on the public company (as converted in 1957).<sup>9</sup> The court held that even though some of the provisions of the SHA had been carried out, its terms were never put in the AoA, thence, the company was not bound by the agreement, and it was rendered unenforceable.<sup>10</sup> This court established that the provisions of an SHA had to be incorporated in the AoA to be enforceable.

In *Re Swaledale Cleaners Ltd.*<sup>11</sup>, the court held that a share in a company is an item of property and can be freely alienable in the absence of express restrictions through the AoA. This meant that the transfer of shares could only be restricted by the AoA. Similar views are upheld by *Tett v. Phoenix Property and Investment Co. Ltd. and Ors.*<sup>12</sup>.

Gore-Browne on Companies<sup>13</sup> propounded that a shareholder has the right to transfer his shares when and to whom he pleases, subject to the restrictions imposed on him by law. However, he also emphasised that this right could be further restricted through the provisions of the AoA; however, if such restriction is not expressly set out in the AoA, then all ambiguity is cleared out in favour of the shareholder who wishes to transfer his shares in whichever manner. This means that unless there are explicit provisions in the AoA restricting a shareholder's right to transfer his shares, his right is only subjected to the limited restriction set by the law, and he can transfer his shares whichever way he likes unless he goes against such law.

It has been established in Palmer's Company law<sup>14</sup> that a shareholder has a right to transfer his shares to whomever he wants as long the contrary has not been provided for in the AoA. Palmer also mentions that the right to transfer does take root in the provisions of the AoA. Instead, the company laws themselves give a shareholder this right. However, curtailment to these rights may arise from the provisions set out in the AoA. This means that a shareholder can transfer his shares to another person in whatever manner unless he has been restricted by the provisions of the AoA.

In Pennington's Company law<sup>15</sup>, it has been advanced that shares are presumably freely transferable, and restriction on such transfer must be construed strictly and embodied in the AoA and if these restrictions can create ambiguity, then the court must adopt the less restrictive

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<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

<sup>11</sup> *Re Swaledale Cleaners Ltd.* (1968) 1 All ER 1132.

<sup>12</sup> *Tett v. Phoenix Property and Investment Co. Ltd. and Ors.* 1986 2 SCC 99.

<sup>13</sup> SIR FRANCIS GORE-BROWNE, *GORE-BROWNE ON COMPANIES* (43<sup>rd</sup> ed. 1977).

<sup>14</sup> FRANCIS BEAYFORT PALMER, *PALMER'S COMPANY LAW* 608-609 (24<sup>th</sup> ed., 1987).

<sup>15</sup> ROBERT R. PENNINGTON, *PENNINGTON'S COMPANY LAW* 753 (6<sup>th</sup> ed., 1990).

interpretation.

### III. V.B. RANGARAJ VS V.B. GOPALAKRISHNAN AND OTHERS<sup>16</sup>

This case presented itself in front of the Supreme Court as an appeal against the decision of the Madras High Court, filed by defendants 1 and 4 to 6. The question that lay in front of the Apex court was whether the shareholders could among themselves enter into an agreement that is contrary to the [AoA] of the company.<sup>17</sup>

This case was a dispute between members of a family. Two brothers, Baluswamy Naidu and Guruviah Naidu, owned a private company, of which they were the sole shareholders, and the shares were equally distributed between the two.<sup>18</sup> The two brothers entered into an oral agreement that each branch of the family (one branch starting with Baluswamy and another with Guruviah) would continue to hold an equal number of shares, and the right to transfer one's shares would be restricted to the extent that a member, who wished to sell his shares, would be obligated to 'give the first option of purchase'<sup>19</sup> to the other members of the same branch he belongs to and only after this offer was declined, could the shares then be sold to people outside the branch. This restriction was imposed as an advancement to the right of pre-emption propounded in the SHA. However, after the death of the two brothers, one of the sons of Baluswamy (defendant 1) went against this agreement and sold his shares to the three sons of Guruviah (defendants 4 to 6) without offering the first option of purchase to his brothers from the same branch (the plaintiffs).

The matter was first presented before the Trial Court, where after close observations, it was held that sales of the said shares was invalid and not binding on the plaintiffs and the second defendant (another son of Baluswamy Naidu, joined as a pro forma defendant).<sup>20</sup> The Court further directed the defendants 1 and 4 to 6 to transfer the disputed shares to the plaintiffs.

The matter then reached the High Court as a second appeal, where it was held the lower courts had proceeded on a wrong basis. The High Court stated that the current suit sought to question the enforceability of the SHA that provided for pre-emption, and thus, the Court must mould the reliefs accordingly.<sup>21</sup> The Court finally held that the agreement was binding on the shareholders, as well as the company and thus, the sale of shares by defendant 1 to defendants 4 to 6 was invalid, making the plaintiffs and the second defendant entitled to purchase the said

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<sup>16</sup> AIR 1992 SC 453, *supra* note 3.

<sup>17</sup> AIR 1992 SC 453, *Ibid.*

<sup>18</sup> AIR 1992 SC 453, *Ibid.*

<sup>19</sup> AIR 1992 SC 453, *Ibid.*

<sup>20</sup> AIR 1992 SC 453, *Ibid.*

<sup>21</sup> AIR 1992 SC 453, *Ibid.*

shares and the company would be bound to rightfully register those shares in their names.<sup>22</sup> And it was this decision against which the defendants 1 and 4 to 6 appealed before the Supreme Court.

The defendants 4 to 6 argued that since the restriction on the transfer of shares was an additional one imposed by the SHA, which was not incorporated in the AoA, it was not binding on the shareholders or a vendee of the disputed shares. They further contested that the agreement was unenforceable law and hence, could not be binding on the company. This would mean that the sale of shares from defendant 1 to defendants 4 to 6 was not invalid.<sup>23</sup>

The first defendant argued that even though the sale of shares was invalid vis-à-vis the SHA, it could not be held that it was invalid entirely, and further, the high court could not direct the transfer of shares in favour of the plaintiffs because under no circumstance could a shareholder be forced to sell his shares to someone, he would not.

On the other hand, the plaintiffs contested that the aim of the agreement was to maintain the ownership of the company in the family and to ensure that the two branches of the family had 'equal shares in the management, the profits, and the losses of the company'<sup>24</sup>, and since the AOA did not prohibit an agreement of this character, the shareholders were bound by it.

The Supreme Court, while deciding the matter, first decided upon the validity of the sale of shares. The Court observed the following sections of the Act to understand the position of law on the matter:

- i. Section 3(iii) of the Act defines private company to mean a company which by its [AoA], restricts the right to transfer its shares, if any, and limits the number of its shares to 50.<sup>25</sup>
- ii. Section 26 of the Act provides that in the case of a private company limited by shares, there shall be registered with the Memorandum, [AoA] signed by the subscribers of the Memorandum prescribing regulations for the company.<sup>26</sup>
- iii. Section 28 provides that the [AoA] of a company limited by shares may adopt all or any of the regulations contained in Table A in Schedule I of the Act.<sup>27</sup>

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<sup>22</sup> AIR 1992 SC 453, *Ibid.*

<sup>23</sup> AIR 1992 SC 453, *Ibid.*

<sup>24</sup> AIR 1992 SC 453, *Ibid.*

<sup>25</sup> AIR 1992 SC 453, *Ibid.*

<sup>26</sup> AIR 1992 SC 453, *Ibid.*

<sup>27</sup> AIR 1992 SC 453, *Ibid.*

- iv. Section 36 states that when the Memorandum and [AoA] are registered, they bind the company and the members thereof.<sup>28</sup>
- v. Section 82 defines the nature of shares and states that the shares or other interests of any member in a company shall be movable property transferable in the manner provided by the [AoA] of the company.<sup>29</sup>

After thoroughly studying these various sections of the Act, Apex Court established that shares are movable property and their transfer is regulated by the AoA, which are regulations binding on the company, “therefore, the only restriction on the transfer of the shares of a company is as laid down in its [AoA], if any. A restriction which is not specified in the [AoA] is, therefore, not binding either on the company or on the shareholders”<sup>30</sup>.

The Court then analysed the legal stands taken in the judgement of *S. P. Jain vs Kalinga Tubes Ltd.*, and the holdings laid out by Gore-Browne, Palmer and Pennington and extended the prior legal positions to uphold that the restriction of shares can solely be regulated by the AoA and this restriction should be explicitly and unambiguously incorporated in the AoA. Further, in cases where additional restrictions are levied on the parties by an agreement, such restrictions need to be added to the AoA to gain the sanctity of enforceability. In other words, the SHA can only be enforceable if it is consistent with the AoA and to the extent where its provisions are incorporated in the AoA. The court, thus, overturned the decision of the lower courts and dismissed the plaintiffs’ suit.

#### IV. CURRENT LEGAL POSITION

In 2012, the Supreme Court, while deciding the matter of share transfer rights in the *Vodafone case*, took a different approach, slightly digressing from the general legal position. They relaxed the regulation of transfer of share by holding that they disagree with the view laid out in the *Rangaraj case*, as per which the provisions of the SHA are enforceable only when they are incorporated in the AoA, even if such provisions are consistent with the Company legislations. The Court in the *Vodafone case* established that the SHA, in essence, is a contract between two or more parties (shareholders), conferring rights and obligations that go over and beyond the rights and obligations provided by the Act, on such shareholders that are party to the SHA and not the remaining shareholders. The court was of the view that “*the essential purpose of the SHA is to make provisions for proper and effective internal management of the company (and to that effect) the shareholders can enter into any agreement in the best interest*

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<sup>28</sup> AIR 1992 SC 453, *Ibid.*

<sup>29</sup> AIR 1992 SC 453, *Ibid.*

<sup>30</sup> AIR 1992 SC 453, *Ibid.*

of the company, but the only thing is that the provisions in the SHA shall not go contrary to the AoA”<sup>31</sup>.

By holding that an SHA is enforceable unless its provisions are ‘contrary’ to the provisions of the AoA, in which case the latter will prevail, the Supreme Court did not necessarily overrule the judgement of the Rangaraj case, but it “merely expanded the partisan view taken in”<sup>32</sup> by the Apex court earlier, by making it more flexible. Consequently, this leaves room for ambiguity in the interpretation of the current laws regarding the enforceability of an SHA.

In 2013, the Delhi High Court, while deciding the matter of *World Phone India Pvt. Ltd. & Ors. v. Wpi Group Inc.*<sup>33</sup> held that since the SHA provision for an affirmative vote of the chairman was not incorporated in the AoA, it would not be enforceable.

Similarly, while deciding on the matter of *HTA Employees Union (Regd.) vs Hindustan Thompson Associates CO.*<sup>34</sup>, the Delhi High Court held that no rights or claims were provided for in the original AoA but contravened an amended AoA of a Company, could be enforceable.

“It is therefore evident that the cases adjudicated by these High Courts have chosen to ignore the *Vodafone [case]* ruling”<sup>35</sup> and stuck to the holdings of the *Rangaraj case* because the former did not definitively overrule the latter. To date, there has been no case that has tackled this ambiguity to once and for all straighten out the laws regarding the enforceability of the SHA.

The inconsistency in the laws of share transfer rights is not limited to the lack of a strong stance as per the enforceability of the SHA. Section 58(2)<sup>36</sup> of the Act recognises the prevalence of the provisions of an SHA if the AoA is silent on the matter; however, this provision is enjoyed only by public companies and not private companies. This means that if the shareholders of a public company enter into an agreement that levies a restriction of their right to transfer their shares, and such provision is not contrary to any provisions of the AoA, then the SHA is binding and enforceable. However, the Act does not give the same provision to a private company or to its shareholders.

## V. CONCLUSION

Due to the inconsistency and the ambiguity caused by the existence of the holdings of both the

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<sup>31</sup> (2012) 6 SCC 613, *supra* note 6.

<sup>32</sup> Shankar & Prabhakar, *supra* note 4.

<sup>33</sup> *World Phone India Pvt. Ltd. & Ors. v. Wpi Group Inc* (2013) 178 Comp Cas 173 (Del).

<sup>34</sup> *HTA Employees Union (Regd.) vs Hindustan Thompson Associates CO. A* (SB) No. 102 of 2012.

<sup>35</sup> Shankar & Prabhakar, *supra* note 4.

<sup>36</sup> *supra* note 5.



*Rangaraj case* and the *Vodafone case*, in congruence, Courts have wide discretion to enforce or invalidate an SHA from a case-to-case basis. This can be avoided by either overruling the stance adopted by the Delhi High Court, stemming from *Rangaraj v. Gopalakrishnan*; or by making the non-enforceability of the SHA provisions valid under company law but recognising it as a breach under contract law, thereby allowing for relief under the Indian Contract Act, 1872.<sup>37</sup> However, if the latter were practised, the purpose of an SHA would diminish drastically.

As for the inconsistency caused due to the distinction between the share transfer rights in a public company as opposed to the rights in a private company, though it can be argued that “if a public company, instituted on the basis of free transferability of shares, has the right to incorporate (limited and not absolute) share transfer restrictions, by that logic, shares of a private company that feature the spirit of restrictive transfers should also be allowed to restrict transferability by entering into private contracts”<sup>38</sup>, the Act as per Section 3(1)(iii)(a)<sup>39</sup>, mandates that a private company must incorporate the restriction on the transfer of shares into the AoA.

Thus, keeping these current legal positions in mind, it would be best for the parties of an SHA to amend the AoA to incorporate the provisions of the SHA to avoid future disputes or hurdles in enforcing such provisions.

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<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.*

<sup>39</sup> *supra* note 5.