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## PRE-EMPTION RIGHTS AS A SHARE-TRANSFER RESTRICTION UNDER THE SHAREHOLDER'S AGREEMENT

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### ABSTRACT

Shareholder's Agreement is a contractual agreement among the company, founders of the company and its shareholders. This Agreement determines the rights and obligations of the shareholders, governing the details with respect to share issuance, specifies the decision-making process of the company and its business operation in its entirety. It is an essential document for every closely held corporation, where the company is having more than one shareholder<sup>1</sup>. Among its various clauses, Pre-emption rights are one of the most common and significant clauses, particularly for shareholders in private companies. The research aims to analyse the nature and scope of pre-emption rights, with specific emphasis on Right of First Refusal (ROFR) under the Shareholder's Agreement. This Research Article examines their mode of operation and their applicability in private and public companies in the context of Share-Transfer Restriction.

**Keywords:** Shareholder's Agreement, Pre-emption rights, Share transfer restriction, ROFO, ROFR, Closely-held corporation, Private Company, Public Company.

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<sup>1</sup> Mark R. High, Drafting Buy-Sell provisions in Shareholder's agreements, 19 Bus. L. Today 59 (2009-2010)

## I. Introduction

Shareholder's Agreement (hereinafter referred to as SHA) plays a significant role among shareholders to hold a position, status and rights in the Company's operation. Though Shareholders are denoted as owners of the company, they do not have the control and management of the company, which rather vested with the directors of the company. Prioritising the characteristics of the shareholders, these SHA are drafted and enforced. The ultimate objects that a SHA shall hold are the following<sup>2</sup>:

- i. Upholding the nature of management and ownership.
- ii. The appointment and removal of directors.
- iii. The sale being a right held by the shareholders.
- iv. The overall functions and the operation of the company.
- v. Rights put forth considering the minority shareholders.

### A. What is Share Transfer Restriction?

Basically, Share-Transfer Restriction means a limitation or restriction that is imposed on the shareholders in a company regarding the transfer of their shares. These certain restrictions must also be duly incorporated within the provisions of the Articles of Association (hereinafter referred to as AOA) of a company<sup>3</sup>, to ensure enforceability. Such restrictions are embodied in various clauses, one of the clauses among them is pre-emption rights. It is merely the private company, where there exists restraint in transfer of shares, such private company thereby curbs the transfer right of the shares through its AOA<sup>4</sup>. In case of public limited companies, its nature is contrary to the private company<sup>5</sup> and their shares are freely transferable in nature<sup>6</sup>.

In addressing the question as to why does a company impose Share Transfer Restriction, Mr. Robert B. Thompson, appealing his observation, "the illusory nature of a closely- held

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<sup>2</sup> Shriya Mishra, Sehar Sethi & Pragya Chhabria, Conflict between the Shareholder's Agreement and Articles of a Company, 5 INT'L J.L. MGMT. & HUMAN. 1893 (2022).

<sup>3</sup> V.B. Rangaraj vs V.B. Gopalakrishnan and Others, (1992) 1 SCC 160

<sup>4</sup> The Companies Act, 2013, section 2(68)

<sup>5</sup> The Companies Act, 2013, section 2(71)

<sup>6</sup> The Companies Act, 1956, section 111A (2); The Companies Act, 2013, Section 58(2).

corporation having shares to be free transferability". He further stated by referring to the size of the company and the number of participants belonging to the company as reasons, emphasizing that the investors in such company lack a ready market for the disposal of their shares<sup>7</sup>.

### **B. Meaning of Pre-emption Right:**

The literal meaning of pre-emption right means right of the shareholders to buy something before other people have the right to buy it, especially shares in a company<sup>8</sup>. The origin of the term "pre-emption flows from the Latin word 'emptum', which means "to buy or to purchase" and 'pre', denotes priority i.e., the first option to buy<sup>9</sup>. It always denotes the right of first purchase by the existing shareholders. The pre-emption rights stipulated in the clauses of a Shareholder's Agreement generally relates to the issuance and transfer of shares. *The pre-emption right aims at safeguarding the voting as well as financial rights of the existing shareholders<sup>10</sup>. Legal relations of pre-emption rights are established via statutes or contracts.*

Basically, Pre-emption rights and ROFR carry the similar meaning and yet can be used interchangeably. Both relate to the offer, where the shareholders have the opportunity to purchase shares which become available before they can be offered to a third party, in the company<sup>11</sup>. This can be substantiated from the literal meaning of the right of first refusal (hereinafter referred to as ROFR), which denotes as "the right to have the first opportunity to purchase property upon the owner's decision to sell at the same terms offered by a third party or at predetermined terms" and also called pre-emption right<sup>12</sup>.

### **C. Distinction between Right of First Refusal (ROFR) and Right of First Offer (ROFO):**

ROFR refers to the offer, in which the selling shareholder, who is typically the investor, gets

<sup>7</sup> Thompson, Robert B., Corporate Dissolution and Shareholders' Reasonable Expectations, Washington University Law Quarterly, Vol.66, pg.193, (1988)

<sup>8</sup> Definition of pre-emption from the Cambridge Advanced Learner's Dictionary & Thesaurus, PRE-EMPTION | English meaning - Cambridge Dictionary

<sup>9</sup> Kanishka Shankar, Right to Pre-emption, Indian Law Portal, MAY 26, 2020, Right to Pre-emption - Indian Law Portal

<sup>10</sup> Abu Awwad, Amal, Shareholders' Preemptive Rights in Listed and Closely-Held Corporations and Shareholders' Protection Methods (February 28, 2016). Available at SSRN: <https://ssrn.com/abstract=2739375>

<sup>11</sup> Isabelle Balch, What are pre-emption rights and what do I need to be aware of? (Mar 7, 2022), What are pre-emption rights and what do I need to be aware of? - Moore Barlow LLP

<sup>12</sup> "Right of first refusal." *Merriam-Webster.com Legal Dictionary*, Merriam-Webster, <https://www.merriam-webster.com/legal/right%20of%20first%20refusal>. Accessed 20 Jan. 2024.

the offer for the shares made by a potential buyer i.e., the third party. This offer by the third party is presented before the existing shareholder and to ask them, they are willing to match the terms made by them. If the offer is accepted by the existing shareholder, an agreement to sell the shares comes into being. If not, then the selling shareholder may sell its shares, however not more favourable, but at the original terms and only to such identified third party. Whereas, a right of first offer (hereinafter referred to as "ROFO") necessitates that the selling shareholder to make an offer to the existing shareholders, if they want to sell their shareholdings in the company. An agreement to sell the shares to the existing shareholder comes into being, once the investor accepts the offer made by the existing shareholder. The free transferability begins, if the investor is not willing, and he has the freedom to sell those shares to a third party, provided that the offer must be less favourable than offer to the promoter or for a comparatively higher price and further within a stipulated time period.

Thus, it is imperative to insert either a ROFO or a ROFR clause, which is beneficial for the promoters i.e., existing shareholder since the ownership of the company is shielded from the outsider's influence<sup>13</sup>. The rule would apply is, the holder of ROFR in no way and for no reason, can compel an owner who is unwilling to sell his shares, as the offer is only exercised, when already the owner agreed to sell to the third party<sup>14</sup>.

#### **D. Pre-emption rights and Rights issue:**

Essentially, when it comes to issue of additional shares, the concept of pre-emption rights is often confused with the rights issue. The major difference is that, Pre-emption-right always applies whenever a company is intending to raise capital in any form and invite each and every one regardless of them being outsider, meanwhile rights issue is raised and invitation made only to the existing shareholders within the company and the general public is not invited to benefit from this method of capital raising.

##### **1. Significance of the study:**

One of the fertile sources of dispute and litigation is the pre-emption clause, where the existing members will be keen to enforce its term to acquire the transferor's share at the potentially

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<sup>13</sup> Arjya B. Majumdar, The (Un?)Enforceability of Investor Rights in Indian Private Equity, 41 U. PA. J. INT'L L. 981 (2020).

<sup>14</sup> Bernard Daskal, Right of First Refusal and the Package Deal, 22 Fordham Urb. L.J. 461 (1995). Available at: <https://ir.lawnet.fordham.edu/ulj/vol22/iss2/10>

favourable price or to cease the shares being transferred to the outsider<sup>15</sup>. Generally, these rights are a common clause in a SHA and is crucial for shareholders involved in such companies. They are formulated in order to protect the interests of existing shareholders within a company and regarded as a significant aspect of corporate governance.

The research would predominantly be dealing with the issuance or transfer of shares and its decision-making processes in such transfer within a company and further delves into the legal provisions surrounding pre-emption rights and their Enforcement. The research also aims to address any potential ambiguity surrounding this clause, its interpretation and implementation.

## **2. Statement of problem:**

Despite the pre-emption rights safeguards the interests of the shareholders from a dilution of shares, thereby allowing them to maintain their ownership stakes in the company, the pre-emption rights also potentially hinder the ability of the company to encourage new investors and attract external capital. So, in this regard, the concept of pre-emption often considered as upholding the company private and impeding the new investors by means of providing the right of first refusal to the existing shareholders<sup>16</sup>. The restrictive nature of pre-emption right limits the company's flexibility, however in terms of raising funds, they tend to raise capital straightforwardly from its existing shareholders. Thus, the pre-emption rights at times considered as obstructing the company's prospective growth, potentially deterring potential investors. The research aims to analyse the pre-emption rights, particularly the ROFR under the SHA and examine the fundamentals of SHA in regulating the transfer of shares.

## **3. Research Objectives:**

- To analyse the concept of pre-emption rights as a share transfer restriction.
- To study the origin and scope of pre-emption rights of shareholders and the risk associated with such rights.
- To examine the legal necessity of pre-emption clause in the SHA.

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<sup>15</sup> Robin Hollington QC., *Hollington on Shareholders' Rights*, (Ninth edition, 2020) para 4-22

<sup>16</sup> David Milman, *The Company Share (Legal Regulation and Public Policy)*, Edward Elgar publishing Limited (2018)

- To understand the pre-emption rights of shareholders under the SHA and the AOA, also in addition to that how such restriction is imposed on both the private company and public company, by interpreting the Indian Cases.

#### **4. Research Questions:**

1. What is the origin and scope of pre-emption rights? Are there risks associated with exercising such rights?
2. What if the pre-emption clause in the SHA contradicts the provisions outlined in the Articles of Association?
3. Whether there is a legal necessity to include pre-emption clause in drafting shareholder's agreement?

#### **5. Research Methodology:**

The research study primarily adopts the method of Doctrinal Legal Research, where it analyses and interprets the legal sources including statutes, case laws. This method clearly discusses how to address the legal issue in formulating the shareholder's agreement. As doctrinal legal research is all about "Abstracting ideas from diverse sources, and consolidating them through synthesis, is the essence and key strength of this process"<sup>17</sup>. The researcher relies on the sources such as working bibliographies, statutes, commentaries, newspapers, books, e-books, articles, law reviews, journals and other online websites.

#### **6. Scope and Limitation:**

The scope of the research is to study the boundaries imposed on the transferring of shares and to evaluate the significance of the SHA in place. Pre-emption rights are one of the clauses of restrictions on share transfer and it includes rights such as right of first refusal, put option, tag along or drag-along rights, which are prevalent in contractual agreements. However, the research study is limited to the scope of ROFR under the pre-emption rights of shareholders. The research highlights the cases in the Indian perspective substantiating the concept of pre-

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<sup>17</sup> P. Ishwara Bhat, Idea and Methods of Legal Research, Oxford University Press (1<sup>st</sup> edn.,2019)

emption rights and the shareholders agreement. This study is purely for academic purposes and not for any other purposes.

## II. Origin and scope of Shareholder's Pre-Emption Rights

### A. Origin of pre-emption rights:

In 1807, the concept of pre-emption was originated in the USA from the case of **Gray v. Portland Bank**<sup>18</sup>, the cause for the origination is due to the dispute that arose legally, where a bank without offering the opportunity to the existing shareholders, issued additional shares. Gray, the existing shareholder was denied chance to subscribe to the additional 2000 shares in proportion to the prior shareholdings. Therefore, the court established the doctrine of pre-emption to the existing shareholders i.e., they should be offered the chance to subscribe to new shares in line with current holdings before such additional shares are made available to others, in the sense, the third parties. This case set the precedence, where the doctrine of pre-emption rights has been universally recognized in corporate law. Also, in case of company issuing new shares, these pre-emption rights protect existing shareholders from dilution of their ownership stake.

Likewise, the USA is one such jurisdiction which viewed that when the power is exercised by the Director to place the outsiders on Pari passu with the existing shareholder, there evolved the universally accepted Doctrine of Pre-emption<sup>19</sup>. The pre-emption right was based on the judge-made doctrine and was developed from the United States decisions.

*In India, the statutory rights of pre-emption are recognized by the companies Act, 2013 and the contractual right is governed under the Indian contracts Act, 1872. The right holder gains priority over others in terms of the potential acquisition of the relevant subject matter through the exercise of these rights. The likelihood to negotiate is only extended to a third party in response to the rightsholder's denial<sup>20</sup>. Pre-emption rights of shareholders under the corporate law are based on the judge-made doctrine and was developed from the United States decisions.*

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<sup>18</sup> Gray v. Portland Bank, 3 Mass. 364 (1807).

<sup>19</sup> Right to Pre-Emption in an Issue of Capital Stock, *Columbia Law Review*, Vol. 13, No. 2 (Feb., 1913), pp. , 146-148, <https://www.jstor.org/stable/1110138>

<sup>20</sup> K. Ritika, Pre-emptive Rights of Shareholders: An Indian Perspective, *Business Law Review*, Volume 44, Issue 1 (2023) p. 44

## B. Scope of pre-emption rights:

The research study emphasizes on the shareholder's pre-emption rights. The scope of pre-emption rights has its significant role, which the company manifest in drafting the internal document, say AOA and the SHA. Pre-emption rights regulate the share transfer processes, protects the interests of the shareholders and ensures the fair treatment among shareholders per se. Also, the concept provides room for decision making and participation of shareholders in its entirety, thereby shedding lights on the aspects of corporate governance. This covers the foundational facet of corporate governance like transparency, accountability, code of conduct as well, with respect to shareholders and effectively balance their interests with the objectives of the company.

With regard to Statutory pre-emption rights, the fresh share issuance and the shareholder's first preference are governed by the Companies Act, 2013. Under the 2013 Act, Section 62(1)(a) states that "In proportion to the previous share ownership, the company issues the new shares to the current equity holders, each and every time the new shares issued for the purpose of rising the subscribed capital whenever the company issues further share in order to increase its subscribed capital, such shares are offered to the existing persons holding equity shares in the company, in proportion to their earlier owned shares.

- (i) The offer specifies the number of shares, time limit, the offer is considered denied, where within not less than fifteen days or exceeding 30 days, if the existing shareholders not accepted.
- (ii) The notice referred to in sub-clause (i) shall include a statement of this right; The offer will contain the right which the current shareholders can renounce or can pass in favour of another person unless otherwise expressly specified in the company's article.

Whereas, in the contractual pre-emption rights, these rights basically arise from the shareholders agreement or articles of the company and they are governed under the Indian Contracts Act, 1872. The primary distinction between the both remains, in contractual basis, they are not mandated by law, instead made an arrangement among shareholders within the company. This refers that the contracts or arrangement is carried on under the terms and conditions, without being governed by any legal statutes or regulations. Also, the contractual

rights are tailored in such a way according to the needs and preference of the respective company, hence draft appropriately. SEBI's approach has broadened the scope and it commenced permitting contracts associated with pre-emption, including all the clauses such as ROFR, tag-along rights etc., as the case may be, specified in the SHA or AOA.

Whereas SEBI's approach has broadened the scope. In 2013, a notification has been issued by SEBI<sup>21</sup> which allows contracts for pre-emption, including ROFR, tag-along or drag-along rights as well as the options to sell or purchase of securities, within the purview of AOA or SHA of the respective companies. The SEBI, however laid down the following conditions to be satisfied:

- i. The party who opts to sell ought to perpetually hold the title and ownership of the securities for not less than one year from the date of entering into the contract.
- ii. The sale or purchase of securities must bind by the legal frameworks.
- iii. The actual delivery of the securities is considered as settlement of the contract.

These contracts must also comply with the provisions of the Foreign Exchange Management Act, 1999. This notification does not affect contracts entered into before its issuance. This notification aligns with the proviso to section 58(2) of the Companies Act, 2013, which specifies that "Contracts or arrangements between parties regarding the transfer of securities shall be enforceable as contracts."

### **C. Risks associated with Pre-emption rights of shareholders:**

#### **i. Investors interest risk:**

When the investor subscribes to shares without the prior consent of the prevailing shareholders that violates their pre-emption rights, at that time the existing shareholders are in a position to file a case to retain their right to purchase first. So, whenever the existing shareholders exercise their pre-emption rights, the investor will face the risk of

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<sup>21</sup> SEBI permits contracts for pre-emption and options in shareholders agreements, PR No. 98/2013, October 03, 2013, [www.sebi.gov.in](http://www.sebi.gov.in)

investment failure. This cause trouble and losses to the investors<sup>22</sup>.

### **ii. Liquidity risk:**

It is a financial risk, where risk pertains to conversion of asset or security into cash or equivalent. In the event of assets like shares and bonds with significant liquidity risk, investors may experience a severe cash shortage. Thus, a problematic state arises from pre-emption rights.

It is of two forms:

1. Market Liquidity, which describes the time necessary for an asset to be liquidated and sold for cash in the secondary market.
2. Financial Liquidity, focuses on the price at which the asset was sold relative to its fair value, i.e. the size of the discount required.

Pre-emption rights stipulate that shares must be made available to current shareholders prior to being sold by a shareholder. Otherwise, Liquidity risk might rise as a result, there will be delay in the sale process.

### **iii. Reputational risk:**

This risk may not directly associate with the existence of pre-emption rights, instead it could arise from how such rights are exercised. In some instance, the existing shareholders can misuse the rights to unfairly prevent certain investors from taking part in the funding or to hinder the entry of the such investor, this could lead to negative perceptions among potential investors and result in damaging the reputation of the company in terms of fairness, transparency and good governance in place.

### **iv. Dilution risk:**

The dilution refers to the reduction in the ownership percentage of the existing shareholders, whenever the additional shares are issued. In such case, if shareholders

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<sup>22</sup> Liu Yufang, Preventing legal risk from shareholder pre-emptive rights, China Business Law Journal, 17 July 2023

choose not to exercise their pre-emption rights, their ownership stake in the company could be diluted as other shareholders purchase additional shares. This proportion excludes the selling shareholder's ownership proportion. This is because a selling shareholder will not have pre-emption rights over the shares it is selling.

### III. Conflicting Terms: Pre-Emption Clause in the SHA and in the AOA

The SHA, not a 'constitutional document' of the company, and it is distinct from MOA and AOA. Primarily, AOA, acts as a by-laws or rules that administers the management within the company under the 2013 Act. SHA is principally, hybrid in nature, where the agreement is entered into among shareholders and the company being a separate legal entity is not itself parties. AOA, though can be altered, however cannot be terminated, so the binding nature of AOA enfolds the company as well as the directors in force. Whereas, the SHA can be terminated and it lays down the exit option too in its formulation. SHA also acts as an accompanying arrangement to AOA<sup>23</sup>.

The shareholders as the ultimate co-proprietors exercise the rights such as protection against dilution, proportionate voting control over the interested in the corporate assets and earnings<sup>24</sup>. The reflection of pre-emption rights in the AOA is obligatory, while there is no valid reason for relegating this pre-emption rights to a SHA. Also, to mean that the pre-emption right belongs to the shareholder, the right to new issue shall be incorporated in the AOA<sup>25</sup>. The newly issued shares should be offered first to the existing shareholders proportionately; these pre-emption rights are also known as "subscription rights" where multiple shareholders are assigned with the optional rights<sup>26</sup>.

In the case of **V.B. Rangaraj vs V.B. Gopalakrishnan and Others**<sup>27</sup>, the supreme court held that the private agreement between the company and the shareholders of the company are on binding on the articles of association of the company. The pronouncement was, the AOA being the internal document of the company, where it entails the day-to-day internal affairs like

<sup>23</sup> Kalchev, George, Corporate Governance and Shareholder Litigation (December 1, 2008). Available at SSRN: <https://ssrn.com/abstract=1309555>

<sup>24</sup> Henry S. Drinker Jr., Pre-emptive Right of Shareholders to Subscribe to New Shares, 43 HARV. L. REV. 586 (1930).

<sup>25</sup> Ronald Charles Wolf, The Law and Practice of Shareholder's Agreement In National And International Joint Ventures: Common And Civil Law Uses, Wolters Kluwer Law & Business, chapter 2, p.25

<sup>26</sup> Victor Morawetz, The Pre-emptive Right of Shareholders, Harvard Law Review, Dec., 1928, Vol. 42, No. 2 (Dec., 1928), p. 186

<sup>27</sup> (1992) 1 SCC 160

issuance of capital, modifying business verticals, taking loans, commencing a new vertical, raising money, expanding company's growth etc., it acts as the regulator of the company. Consequently, AOA is binding both the company and its shareholders. Thus, the share transfer restriction also regulated by the AOA, if not specified in it, then as a result of which it is not binding on the company or its shareholders as well. Henceforth, the transfer of shares is governed merely by the Articles of association. In conclusion, shareholders per se cannot enter into an agreement that is inconsistent with the AOA.

#### **IV. Examining the Legal necessity to include Pre-Emption clause in drafting Shareholder's Agreement**

##### **A. Non-Applicability of Pre-Emption Rights:**

- i. In case of Treasury Shares, where the company formerly issues share for itself and the acquired by the company for its own purpose. These shares are held as treasury shares, wherein the benefit is enjoyed by the corporation. This kind of shares are not subjected to a pre-emption right of the existing shareholders<sup>28</sup>.

At present there is no specific provision governing treasury stock in India but Section 233(10) of the Companies Act, 2013, specifically prohibits the creation of treasury stock in Merger and Amalgamation. The bare text of the aforesaid provision states that:

“A transferee company shall not on merger or amalgamation, hold any shares in its own name or in the name of any trust either on its behalf or on behalf of any of its subsidiary or associate company and all such shares shall be cancelled or extinguished on the merger or amalgamation.”

- ii. The applicability of pre-emption rights to pro-rata basis by the existing shareholders. It cannot be exercised more than the pro-rata, say for instance if two shareholders in a company holds 50 shares each, and an additional 200 shares issued subsequently, one shareholder merely exercise the right over subscribing to 100 shares, now such existing shareholder can buy the entire 200 shares in order to exclude the entry of

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<sup>28</sup> Henry S. Drinker Jr., Preemptive Right of Shareholders to Subscribe to New Shares, The , 43 HARV. L. REV. 586 (1930).

outsiders. The pre-emption right's scope is something that the drafters of the articles of incorporation should carefully consider, since the answer will rely on how the clause is written<sup>29</sup>.

- iii. Consideration in the form of cash, whenever the shares are issued is applicable to the pre-emption rights within the company, because cash is fungible. Whereas, the consideration in kind like obtain property, third-party real estate, assets from other corporation are tricky, where the courts do not tend to apply pre-emption rights, until and unless the AOA explicitly mentioned.

## **B. Applicability of pre-emption clause to public and private companies:**

Generally, dealing with the public company, it enjoys free transferability of shares as provided under section 2(71) of the companies Act, 2013 defines

Public Company means “a company which is not a private company; Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles.”

Thus, there is no restriction in case of public companies. Also, the Depositories Act, 1996 undertaken substantial amendments, in so doing inserted the section 111A of the Companies Act, 1956 to provide the public company with free transferability of shares<sup>30</sup>. Wherein, the Companies Act, 1956, section 111A (2) which deals with Rectification of Register on Transfer states that shares or debentures and any interest from the company shall be freely transferable. The condition that without sufficient cause refuses to register within two months from the date of notice of transfer, in case of registration of transfer of shares by the company, then appeal can be file to the Tribunal by the company and the tribunal will then instruct the company to proceed with registering the transfer of shares.

Likewise, the Companies Act, 2013, under section 58(2) states that in a public company, any securities or other interest are freely transferable to any member of the said company, however,

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<sup>29</sup> Marco Ventoruzzo, Issuing New Shares and Preemptive Rights: A Comparative Analysis, 12 Rich. J. Global L. & Bus. 517 (2013)

<sup>30</sup> Ronak Ajmera, Corporate Law: Section 111-A v. Shareholders' Agreement: Finally at Rest? 2010 PL (CL) Sep S-11, Khaitan & Co., SCC OnLine

the condition is that there shall exist transfer of securities under the arrangement between two or more persons shall be enforceable as a contract. The law relating to transferability was laid down, where the provision was deleted on the grounds of refusal of transfer registration<sup>31</sup>. The rationale behind this provision was to ensure the listed companies with free transferability and to curtail the powers of Board of Directors, that is arbitrary in nature.

In case of a private company, the Companies Act, 2013, the articles of the company and the Shareholders agreement collectively impose restriction on transfer of shares. This is provided as under Section 2(68)(i) of the companies Act, 2013, which defines as follows:

Private company means “a company having a minimum paid-up share capital as may be prescribed, and which by its articles, restricts the right to transfer its shares.”

### **C. Cases substantiating the limitations to be imposed on public companies, not standing contrary to the AOA:**

In the case of **Messer Holdings Limited v. Shyam Ruia**<sup>32</sup>, where the German company named Messer is a public company, its securities are listed and traded in the BSE, business engaged by Messer to supply the industrial gases and it has 50% stake in the Bombay Oxygen Corporation Ltd. subsequent to the majority shareholding of share purchase agreement consisting ROFR. Consequently, Messer intended to transfer its share to a Joint venture company named Messer Holding Ltd from the so-called listed Bombay Oxygen Ltd. The issue raised in this case was enforceability of the pre-emption rights. The Bombay High Court held that the shareholders agreement being a private arrangement per se shareholders, there is no need for the company to be party to that said agreement and further held that the agreement is voluntary in nature, so the ROFR can be made enforceable, however it should be noted that it does not infringe the provision of the Companies Act, 1956, which is section 111A as mentioned above. This case emphasized the non-mandatory nature of such arrangement<sup>33</sup>. The final decision was, the governing company's byelaws, allows the share can be transferred with limitations unless otherwise hinders, then such limitation shall be enforceable.

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<sup>31</sup> The Securities Contracts (Regulation) Act, 1956, Section 22-A

<sup>32</sup> Messer Holdings Ltd. v. Shyam Madanmohan Ruia, (2016) 11 SCC 484

<sup>33</sup> Rishabh Shroff, Enforceability of Contractual Restrictions on Transfer of Shares, August 16, 2016, Enforceability of Contractual Restrictions on Transfer of Shares | India Corporate Law (cyrilamarchandblogs.com)

In **Pushpa Katoch v Manu Maharani Hotels**<sup>34</sup>, going one step further, the Delhi High Court held that all limitations were unconstitutional, whether or not they were included in the AOA of the company. The decision made in Pushpa Katoch persisted for public companies, and the Bombay High Court further upheld it in **Western Maharashtra Development Corporation v. Bajaj Auto**.

In the **Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd.**<sup>35</sup> case, a publicly traded company named Maharashtra Scooters Ltd. (hereinafter referred to as 'MSL'), which was established by the companies, Western Maharashtra State Corporation Ltd. (hereinafter referred to as 'WMSC') and Bajaj Auto Ltd. (hereinafter referred to as 'BAL'). WMSC and BAL entered into a protocol agreement by holding 24% and 27% respectively in the MSL and agreed to include ROFR clause, which states that when one party wishes to sell its share then the first right to buy is given the other party. The agreement enclosed with a condition that if any dispute arises, then they opt to approach for Arbitration in such circumstances. These terms and conditions were appended to the MSL's AOA. Subsequent to this, the dispute arose with regard to the ROFR sale price and the issue referred to Arbitration under Arbitration and Conciliation Act, 1996. The Bombay High Court upheld the section 111A (2) of the 1956 Act, signifying the importance of free transferability of shares in a listed company, reiterating the boundaries to the shares being transfer is violative of the abovementioned provision.

By examining the legal provisions referred to the aforesaid, there is a legal necessity arises to include this clause in the SHA. The shareholders agreement since entered among themselves, so it is mandatory to address their concern and to provide them with the interests. So that, they can consider the clause significant, for the purpose of disallowing the undesirable third parties; on the other hand, take the consent of the existing shareholder. The enforceability of shareholder's right can be ensured through the judicial precedents, which even permits such clause to be inserted in the listed companies, in spite of them exhibiting the feature of free transferability of shares. Overall, this can provide with flexibility to shareholders to choose in accordance with their convenience and preference. Even BVCA agreement states in its clause 9 regarding the further issue and transfer of shares.

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<sup>34</sup> Pushpa Katoch v Manu Maharani Hotels, 2005 (83) DRJ 246

<sup>35</sup> Western Maharashtra Development Corporation Ltd. v. Bajaj Auto Ltd., 2015 (4) Bom CR 499

## V. Conclusion

From a perspective of corporate governance, the gradual development of the concept pre-emption rights eventually highlights the ultimate aim of providing equality to each and every shareholder to the Company. The AOA and SHA are working towards the protection of large interest of the shareholders in order to ensure fair, unambiguous, unarbitrary and impartial decision, prevailing in the management and operation within the company.

Being an integral part of corporate regime, pre-emption right evolved through the dispute arose in the United States and further recognized in India via statutory and contractual frameworks. The conflicting terms between the SHA and the AOA, necessitates the document that has to be clear, unambiguous and consistent complying with essentials of corporate governance. The AOA wholly deals with internal management, while the SHA rather focus on the concerns of individual shareholders, the both principles must outline with each other, to confirm legal enforceability. The Judicial precedents, in the cases of V. B. Rangaraj case and Messer Holding Limited case emphasize the adherence to corporate by-laws and rules. The only concern is that, the investors must be aware of the facts, although the SHA go into constant modification in terms of shareholdings or shareholders, that changes will not be always reflected in the AOA. Therefore, there is probabilities of impairment in the investor's decision to invest might potentially affect. The reason for the peculiarity results from the contention of the company that that participation in Inter-se Governance Rights would require amending the AOA, which would be excessively cumbersome. The requisite clauses in the SHA can be added to the AOA, until the Supreme Court pass yet another final judgment via bringing clarity, it is wise to include such clause, which can prevent any obstacles, and ensures the enforceability of the agreement in question.

The Legal Principle is that unless the company's constitution or shareholders agreement explicitly states otherwise, the default provision regarding pre-emption rights will apply. If the AOA or shareholders agreement explicitly states that pre-emption rights are modified or removed, then shareholders will not have these rights as per the default rule. In such cases, the specific provisions of the AOA or SHA will prevail over the default rules of the law. Let's take an Illustration, if a shareholder sells 100 shares of the company, an existing shareholder with a 10% ownership holding can buy 10 shares from the seller. It is not necessary for the shareholder to purchase or subscribe for the whole 10%, nonetheless. This way, a shareholder with pre-emption rights cannot buy all the shares and unfairly increase their shareholding in

the company, because at that time, few shareholders might be in a financial problem and results in unable to buy the additional shares, thereby losing their percentage of ownership stake.

Therefore, the researcher concludes that pre-emption clauses are necessary and enforceable in nature and when they are reflected in the Articles of Association and their absence may cause contractual ambiguity and restrict investor confidence. In accordance with the research, the researcher wishes to propose the inclusion of a clause named the "**Share Purchase Option Clause**", which would highlight the shareholder's option to purchase additional shares from another shareholder. The ultimate purpose of providing such clause is to afford them with greater flexibility in managing their investment in the company. Pre-emption rights, being one of the forms of anti-dilution provisions. Anti- dilution is enforceable in nature, provided that is within the terms of AOA. Any restriction stemming from any basis, rather than the AOA, would neither prevent the company from accepting a share transfer nor deprive the shareholders of his right to transfer their shares<sup>36</sup>.

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<sup>36</sup> Jidesh Kumar & Richa Mehra, Beware Rights of Shareholders, 25 INT'L FIN. L. REV. 40 (2006).

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