

V. B. RANGARAJ

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v.

V. B. GOPALAKRISHNAN AND ORS.

NOVEMBER 28, 1991

[P. B. SAWANT AND B. P. JEEVAN REDDY, JJ.]

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*Companies Act, 1956 :*

*Sections 3(iii), 26, 28, 31, 39, 40, 82, 109 and 110—Transfer of shares—Shareholder's right to transfer—Subject to restrictions contained in the Articles of Association of the Company—Agreement among shareholders restricting transfer of shares—Not specified in the Articles of Association—Whether binding on the company or on shareholders—Shares—Nature of—Transferable like any other movable property.*

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Of the total shareholding of 50 in a private limited company, 25 shares each were held by two brothers B and G of a joint family. It was agreed among the two brothers that each of the two branches of the family would continue to hold the shares in equal measure, viz. 25 each and if any member in either of the branches desired to sell his share/shares, he would give the first option to the members of the branch to which he belongs and only in case the offer was not accepted, the shares could be sold to others. However, the Articles of Association of the said company were not amended in conformity with the oral agreement.

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After the death of the two brothers B and G, one of the sons of B sold the shares to sons of G, which was contrary to the oral agreement. The other sons of B not having got the option to purchase as per the said oral agreement, filed a suit against their brother, for a declaration that the sale was void and not binding on them. Defendants 4 to 6 were the purchasers of shares. Defendant No. 2, another son of B was made proforma defendant. The Trial Court decreed the suit and held that the sale of the said shares was invalid. The first appellate court dismissed the appeals preferred by the defendants. In the second appeals filed by the defendants, the High Court held that the sale of the shares by the first defendant in favour of defendants 4 to 6 was invalid and hence the plaintiffs and the second defendant became entitled to purchase the said shares; that the said oral agreement was binding on the company, and that the company was bound in law to register the said shares in the plaintiffs' names.

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- A Aggrieved against the High Court's decisions, the defendants preferred appeals before this Court contending that the said oral agreement in effect imposed an additional restriction on the right to transfer the shares, which was not envisaged by any of the Articles of Association; that it was not binding on any shareholder or a vendee of the shares; that it was unenforceable at law and therefore, not binding on the company.
- B It was further contended that the High Court could not have directed the transfer of shares in favour of plaintiffs as the first defendant could not be forced to sell the shares to the plaintiffs.

- C The respondents contended that the shareholders were bound by the oral agreement; that the agreement was entered into to maintain the ownership of the company in the family and to ensure that the two branches of the family had an equal share in the management and profits and losses of the company; that there was nothing in the Articles of Association which prohibited such agreement and that the two branches of the family being party to the agreement, it was enforceable against them.

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Allowing the appeals, this Court,

- E HELD: 1.1 Whether under the Companies Act or Transfer of Property Act, the shares are, transferable like any other movable property. The only restriction on the transfer of the shares of a company is as laid down in its Articles, if any. A restriction which is not specified in the Articles is, therefore, not binding either on the company or on the shareholders. The vendee of the shares cannot be denied the registration of the shares purchased by him on a ground other than that stated in the Articles. [6 G,H]

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- G 1.2 In the instant case, the private agreement which is relied upon by the plaintiffs whereunder there is a restriction on a living member to transfer his shareholding only to the branch of the family to which he belongs in terms imposes two restrictions which are not stipulated in the Article. There was a restriction on a living member to transfer the shares only to the existing member and another restriction was that the transfer has to be only to a member belonging to the same branch of the family. The agreement obviously, therefore imposes additional restrictions on the member's right to transfer his shares which are contrary to the provisions of the Article 13. They are, therefore, not binding either on the shareholders or on the company. The finding recorded by the
- H courts below that the sale by the first defendant of his shares to

defendants 4 to 6 is invalid as it is in breach of the agreement, is erroneous in law. [9 F-H, 10-A]

1.3 Even a new member can be admitted as a shareholder provided the majority of the members are agreeable to do so. It also appears from the word "nominee" that a living member has a right to nominate even a third party to succeed him as a member on his death. The restriction on transfer by way of a right of pre-emption which is incorporated in the third part of Article 13 is only in respect of the shareholding of the deceased member and not of a living member. Whereas the heirs/nominees are as a matter of right entitled to become members if they are willing to do so, the restriction on the transfer of shares steps in only when they are unwilling to become members, in which case the shares of the deceased member shall be first distributed among the existing members equally. The transfer may be to any existing member whether he belongs to one or the other branch of the family and in such case there is no need for consent of the majority of the members. The Article in fact envisages the distribution of the shareholding of the deceased member (and not of the living member) equally among the members of both branches of the family and not of any one of the branches only. Even the shares of the deceased member can be transferred to any new member when his heirs/nominees are not willing to become members. However, this can be done only with the consent of the majority of the members. [9A-E]

*S.P. Jain v. Kalinga Tubes Ltd.*, [1965] 2 SCR 720; *Re: Swaledale Cleaners Ltd.*, [1968] 1 All ER 1132 and *Tett v. Phoenix Property and Investment Co. Ltd. & Ors.*, [1986] 2 BCC 99, 140, referred to.

*Palmer's Company Law*, 24th Ed., pages 608-9; *Halsbury's Laws of England*, 4th Ed., para 359; '*Restrictions on transfer of shares*' in *Penington's Company Law*, 6th Ed. at page 753, referred to.

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1946-47 of 1980.

From the Judgment and Order dated 8.2.80 of the Madras High Court in Second Appeal No. 1994 and 2165 of 1978.

K.Parasaran, K.N.Bhatt, T.K.Scshadri and D.N. Mishra for the Appellant.

- A T.S.Krishnamurthi Iyer, R.N.Keshwani, K.Ram Kumar, Ms. A.Anjani, A.T.M.Sampath (NP), Mrs. J.Ramachandra and Sri Narain (NP) for the Respondents.

The Judgment of the Court was delivered by

- B SAWANT, J. These two appeals, Civil Appeal No. 1946 of 1980 filed by defendant 1 and Civil Appeal No. 1947 of 1980 filed by defendants 4 to 6, are against the decision dated February 8, 1980 of the Madras High Court. The main question that falls for consideration in both the appeals is whether the shareholders can among themselves enter into an agreement which is contrary to or inconsistent with the Articles of Association of the company.

- C 2. The third defendant is a private limited company which all along had a total shareholding of 50. Before the joint family of the plaintiffs and defendants came to hold all the 50 shares of the company, the family was a minority shareholder holding 13 shares, the rest 37 shares being held by outsiders. In course of time, the family acquired the rest 37 shares and became the sole shareholder of the company. The family consisted of Baluswamy Naidu and Guruviah Naidu who were brothers, and each of the brothers held 25 shares in the company. The plaintiffs and defendants 1 and 2 and one Selvaraj are the sons of Baluswamy Naidu and defendants 4 to 6 are the sons of Guruviah Naidu. Baluswamy Naidu died on February 5, 1963 and Guruviah Naidu died on January 10, 1970. The plaintiffs alleged that in 1951 there was an oral agreement between Baluswamy Naidu and Guruviah Naidu that each of the branches of the family would always continue to hold equal number of shares, viz., 25 and that if any member in either of the branches wished to sell his share/shares, he would give the first option of purchase to the members of that branch and only if the offer so made was not accepted, the shares would be sold to others. Although on behalf of defendants, it was disputed that there was any such agreement entered into between the two brothers, the finding recorded by all the courts below is against the defendants. It is not in dispute that the Articles of Association of the company were not amended to bring them in conformity with the said agreement.

- G Contrary to the said agreement, the first defendant, i.e., son of Baluswamy Naidu sold the shares to defendants 4 to 6 who are the sons of Guruviah Naidu. Hence the plaintiffs who are Baluswamy's sons filed the present suit for (i) a declaration that the said sale was void and not binding upon the plaintiffs and the second defendant (who is also the son of Baluswamy Naidu but was joined as a pro forma defendant) and for (ii) an
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order directing defendants 1 and 4 to 6 to transfer the said shares to the plaintiffs and the second defendant and for (iii) a permanent injunction restraining defendants 4 to 6 from applying for registering the said shares in their names and from acting adversely to the interests of the plaintiffs and the second defendant on the basis of the transfer of the said shares.

3. The Trial Court decreed the suit by holding that the sale of the said shares was invalid and not binding on the plaintiffs and the second defendant, and directed both the first defendant and defendants 4 to 6 to transfer the said shares to the plaintiffs, and granted permanent injunction as prayed for. The appeals filed by the first defendant and defendants 4 to 6 were dismissed. In the second appeals filed by them the High Court held that the courts below had proceeded on a wrong basis. According to the High Court the suit was in effect one to enforce the agreement providing for pre-emption and the court was entitled to mould the reliefs on the facts proved in the case and accordingly the High Court modified the decree by directing substitution of the plaintiffs as shareholders in place of defendants 4 to 6. In other words, the High Court in terms held that (i) the sale of the shares by the first defendant in favour of defendants 4 to 6 was invalid and hence the plaintiffs and the second defendant became entitled to purchase the said shares, (ii) the agreement was binding on the company, and (iii) the company was bound in law to register the said shares in the plaintiffs' names.

4. Shri Parasaran appearing for defendants 4 to 6 in C.A. No. 1946 of 1980 contended that the agreement in effect imposed an additional restriction on the right to transfer the shares. The restriction was not envisaged by any of the Articles of Association. Hence it was not binding on any shareholder or a vendee of the shares from the shareholders. It was also unenforceable at law and, therefore, not binding on the company. Hence the sale of the shares by the first defendant to defendants 4 to 6 was not invalid and the High Court was wrong in directing the transfer of shares in favour of the plaintiffs. Shri Bhatt appearing for the first defendant (appellant in C.A. No. 1946 of 1980) contended that assuming that the sale of shares by the first defendant to defendants 4 to 6 was invalid in view of the agreement, the High Court could only have declared that the sale was invalid and it could not have further directed the transfer of shares in favour of plaintiffs. The first defendant could not be forced to sell the shares to the plaintiffs. Shri Krishnamurthy, on the other hand, contended that (i) the shareholders were bound by the agreement of 1951; (ii) the agreement was entered into to maintain the ownership of the company in the family and to ensure that the two branches of the family had an equal share in the management and profits and losses of the company; (iii) there was nothing in the Articles of

- A Association which prohibited such agreement and (iv) the two branches of the family being party to the agreement, it was enforceable against them, and the courts have done nothing more than to enforce the agreement.

5. The basis of the judgment and decree of the High Court and of the judgments and decrees of the courts below is the alleged invalidity of the sale of the shares. It is therefore, necessary to understand the true position of law in this behalf. Section 3 (iii) of the Companies Act (hereinafter referred to as 'the Act') defines private company to mean a company which by its Articles, restricts the right to transfer its shares, if any, and limits the number of its shares to 50 (excepting employees and ex-employees who were and are members of the company) and prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company. Section 26 of the Act provides that in the case of a private company limited by shares, such as the third defendant-company, there shall be registered with the Memorandum, Articles of Association signed by the subscribers of the Memorandum prescribing regulations for the company. Section 28 provides that the Articles of Association of a company limited by shares may adopt all or any of the regulations contained in Table A in Schedule I of the Act. Section 31 provides for alteration of the Articles by a special resolution of the company. Section 36 states that when the Memorandum and Articles of Association are registered, they bind the company and the members thereof. Section 39 provides for supply of the copies of Memorandum and Articles of Association to a member. Section 40 makes it mandatory to incorporate any changes in the Articles of Association in every copy of the Articles of Association. 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 Articles of Association of the company.

- F These provisions of the Act make it clear that the Articles of Association are the regulations of the company binding on the company and its shareholders and that the shares are a movable property and their transfer is regulated by the Articles of Association of the company.

- G 6. Whether under the Companies Act or Transfer of Property Act, the shares are, therefore, transferable like any other movable property. The only restriction on the transfer of the shares of a company is as laid down in its Articles, if any. A restriction which is not specified in the Articles is, therefore, not binding either on the company or on the shareholders. The vendee of the shares cannot be denied the registration of the shares purchased
- H by him on a ground other than that stated in the Articles.

7. We may refer to certain authorities which reinforce the above proposition. A

In *S.P. Jain v. Kalinga Tubes Ltd.*, [1965] 2 SCR 720, it was also a case of a battle between two groups of shareholders led by P & L as they were named in the decision. In July 1954 these two groups who held an equal number of shares of the value of Rs. 21 lakhs, out of a total share capital of Rs. 25 lakhs, in the company which was then a private company, entered into an agreement with the appellant who was a third party and certain terms were agreed to. Various resolutions were passed by the company to implement the agreement. However, neither the Articles of Association were changed to embody the terms of the agreement nor the resolutions passed referred to the agreement. In 1956-57, the company desired to raise a loan from the Industrial Finance Corporation and as per the requirement of the Corporation, in January 1957 the company was converted into a public company and appropriate amendments for the purpose were made in the Articles. However, even on this occasion, the agreement of July 1954 was not incorporated into the Articles. Disputes having arisen, the matter reached the Court. The appellant claimed the benefit of the agreement of July 1954. It was held by this Court that the said agreement was not binding even on the private company and much less so on the public company when it came into existence in 1957. It was an agreement between a non-member and two members of the company and although for some time the agreement was in the main carried out, some of its terms could not be put in the Articles of Association of the public company. As the company was not bound by the agreement it was not enforceable. B C D E

In *Re Swaledale Cleaners Ltd.*, [1968] 1 All ER 1132 it was held that it is well-established that a share in a company is an item of property freely alienable in the absence of express restrictions under the Articles. This view is reiterated in *Tett v. Phoenix Property and Investment Co. Ltd. & Ors.*, [1986] 2 BCC 99, 140. F

In Chapter 16 of Gore-Browne on Companies (43rd Ed.) while dealing with transfer of shares it is stated that subject to certain limited restrictions imposed by law, a shareholder has *prima facie* the right to transfer his shares when and to whom he pleases. This freedom to transfer may, however, be significantly curtailed by provisions in the Articles. In determining the extent of any restriction on transfer contained in the Articles, a strict construction is adopted. The restriction must be set out expressly or must arise by necessary implication and any ambiguous provision is construed in favour of the shareholder wishing to transfer. G H

- A In *Palmer's Company law* (24th Ed.) dealing with the 'transfer of shares' it is stated at page 608-9 that it is well-settled that unless the Articles otherwise provide the shareholder has a free right to transfer to whom he will. It is not necessary to seek in the Articles for a power to transfer, for the Act (the English Act of 1980) itself gives such a power. It is only necessary to look to the Articles to ascertain the restrictions, if any, upon it. Thus a
- B member has a right to transfer his share/shares to another person unless this right is clearly taken away by the Articles.

- C In *Halsbury's Laws of England* (4th Ed.) para 359 dealing with 'attributes of shares' it is stated that "a share is a right to a specified amount of the share capital of a company carrying with it certain rights and liabilities while the company is a going concern and in its winding. The shares or other interest of any member in a company are personal estate transferable in the manner provided by its articles and are not of the nature of real estate".

- D Dealing with 'restrictions on transfer of shares' in *Penington's Company Law* (6th Ed.) at page 753 it is stated that shares are presumed to be freely transferable and restrictions on their transfer are construed strictly and so when a restriction is capable of two meanings, the less restrictive interpretation will be adopted by the court. It is also made clear that these restrictions have to be embodied in the Articles of Association.

- E 8. Against the background of the aforesaid legal position, we may now examine the Articles of Association of the third defendant-company. It is not disputed before us that the only Article of the Articles of Association of the company which places restriction on the transfer of shares is Article 13. The Article reads as follows:

- F "13. No new member shall be admitted except with the consent of the majority of the members on the death of any member of his heir or heirs or nominee, shall be admitted as member. If such heir, heirs or nominee is/are unwilling to become a member, such share capital shall be distributed at par among the members equally or transferred to any new member with the consent of the majority of the members."
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- H The aforesaid Article in effect consists of three parts. The first part states that no new member shall be admitted except with the consent of the majority of the members. The second part states that on the death of any member, his heir or heirs or nominee/s shall be admitted as member/s. The third part states that if such heir or heirs or nominee/s is/are unwilling to



become member/s, the share capital of the deceased member shall be distributed among the existing members equally or transferred to any new member with the consent of the majority of the members. It is, therefore, clear that even a new member can be admitted provided the majority of the members are agreeable to do so. It also appears from the word "nominee" that a living member has a right to nominate even a third party to succeed to him as a member on his death. Further the restriction on transfer by way of a right of pre-emption which is incorporated in the third part of the Article is only in respect of the shareholding of the deceased member and not of a living member. Whereas the heirs/nominees are as a matter of right entitled to become members if they are willing to do so, the restriction on the transfer of shares steps in only when they are unwilling to become members. The restriction states that in the latter event the shares of the deceased member shall be first distributed among the existing members equally and if they are to be transferred to any new member, it would be done so with the consent of the majority of the existing members. It may be noticed from this restriction, that firstly there is no limitation on the transfer of his shares by a living member either to the existing member or to a new member. The only condition is that when the transfer is made to a new member, it will have to be approved by the majority of the members. The transfer may be to any existing member whether he belongs to one or the other branch of the family and in such case there is no need of a consent of the majority of the members. The Article in fact envisages the distribution of the shareholding of the deceased member (and not of the living member) equally among the members of both branches of the family and not of any one of the branches only. Even the shares of the deceased member can be transferred to any new member when his heirs/nominees are not willing to become members. However, this can be done only with the consent of the majority of the members.

9. Hence, the private agreement which is relied upon by the plaintiffs whereunder there is a restriction on a living member to transfer his shareholding only to the branch of family to which he belongs in terms imposes two restrictions which are not stipulated in the Article. Firstly, it imposes a restriction on a living member to transfer the shares only to the existing members and secondly the transfer has to be only to a member belonging to the same branch of family. The agreement obviously, therefore, imposes additional restrictions on the member's right to transfer his shares which are contrary to the provisions of the Article 13. They are, therefore, not binding either on the shareholders or on the company. In view of this legal position, the finding recorded by the courts below that the sale by the first defendant of his shares to defendants 4 to 6 is invalid as it is in breach of the agreement,

A is erroneous in law. In view of our above finding, it is unnecessary to go into the question whether the High Court was justified in directing the transfer of shares by defendants 4 to 6 to the plaintiffs even if its finding that the sale was invalid was correct.

B In the circumstances, the appeals are allowed, the decree of the High Court is set aside and the plaintiffs' suit is dismissed with costs.

G.N.

Appeals allowed.