Delhi High Court Judgment - Enforceability of Shareholders Agreements

The Delhi High Court in its recent judgment in World Phone India (P.) Ltd. v. WPI Group Inc., USA held that where the Articles of Association (AoA) of a company are silent on the existence of an affirmative vote, it would not be possible to hold that a clause in an agreement between the shareholders would be binding without being incorporated in the AoA.

Facts:

In this case, the board of directors of the company passed a resolution approving a rights issue in accordance with the AoA of the company, even though such an action required the affirmative vote of the Appellant in accordance with a shareholders agreement entered into between the shareholders of the company. The Company Law Board had held that since the provisions of the shareholders granting an affirmative vote to the appellant were not incorporated in the Articles of the company, the said provision is unenforceable and the board resolution approving the rights issue was valid. On appeal, the Delhi High Court held as follows:

“...the question to be asked is whether the provisions of an agreement, that are not inconsistent with the Act, but are also not part of the articles of association, can be said to be applicable. All that section 9 states is that the clauses in the agreement that that “repugnant” to the Act shall be “void”. This does not mean that the clauses in the agreement which are not repugnant to the Act would be enforceable, notwithstanding that they are not incorporated in the articles of association.”

Analysis:

The World Phone judgment reiterates the law laid down by the Supreme Court in the landmark judgment of V.B. Rangaraj v. V.B. Gopalkrishnan that a clause in a shareholders’ agreement that is not repugnant to the Companies Act or to the company’s memorandum would stand legal scrutiny only when it is incorporated in the company’s AoA. In this case, an agreement had been entered into between shareholders of a private company wherein a restriction was imposed on a living member of the company to transfer his shares only to a member of his own branch of the family. Such restrictions were however not envisaged nor provided for within the articles of the company. The court referred to sections of the Companies Act which provide that the articles of associations are the regulations which are binding upon the company and thus any restriction regarding transfer of shares must be provided for in the AoA.

In a subsequent case of IL and FS Trust Co. Ltd. v. Birla Perucchini Ltd. the Bombay High Court once again upheld the dicta laid down by the apex court in the Rangarajan Case. In this case, a shareholder’s agreement was entered into between parties on the basis of which a petition was filed restraining the respondent from accepting resignation of the other respondents from the post of directors of the company. The Court held that the AoA of the company did not stipulate any restriction on resignation of the respondents from the post of director and hence the same could not be enforced by the agreement. Referring to the judgment in the Rangarajan case the Bombay high court once again clarified that a restriction which is not specified in the articles of association is not binding either on the company or on the shareholders.

In 2010, the Bombay High Court adopted a more liberal interpretation in Messer Holdings Limited v. Shyam Madanmohan Ruia. The primary question before the court involved an interpretation of section 111A of the Companies Act which as the court ruled does not explicitly restrict or take away the right of shareholders to enter into consensual arrangement or agreement in respect of shares held by them. In this regard the court also enunciated that shareholders did have the freedom to enter into consensual agreements which were not in conflict with the AoA of the Company or with the existing legislations governing companies.
ARA Comments:

It has been argued that if the interpretation of the courts in the Rangaraj and Perucchini judgments is to be adhered to then it would be futile to have a shareholder’s agreement in the first place since every clause in the agreement would have to be incorporated in the AoA. Further, although the decision of the Supreme Court in Rangaraj 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 of limited precedential value as they are open to disagreements by other high courts as has been the case in Messer Holdings judgment. In the absence of any other precedents of the apex court, for the time being it is advisable that provisions of shareholders agreements be incorporated either by insertion or by reference in the AoA.