

Right of first refusal: legal right and enforceability



Despite being ranked 133rd in 'Business Ease' (as per Doing Business Survey 2010 by World Bank), the institutional and legal framework in India has been sturdy enough to sustain economic downturns and not collapse under pressure. This is when we are living the 'India Story' and to make it true, we as a country encourage investor friendly atmosphere. However, entering into investor-friendly commercial transactions that simultaneously fall within the legal framework, remains a big challenge for the corporate world.

Commercial transactions contain a number of terms and legal jargons over which parties and their counsels lock horns. [Right of First Refusal](#) ("ROFR") is one such key term in commercial contracts involving shareholders of corporate entities on which considerable amount of time and effort is spent. The industry has recently witnessed certain high profile corporate battles including Anil Ambani's multi-billion-dollar amalgamation proposal with South African telecom giant MTN, Vedanta-Cairn deal, wherein ROFR clause has been decisively used.

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Legally speaking, ROFR is a pre-emptive option of a non-selling shareholder to purchase shares of a company that a selling shareholder proposes to liquidate. If the non-selling shareholder refuses to purchase such shares, the selling shareholder can sell the shares to a third party usually with a stipulation that the terms of such sale and more importantly the sale price should not be more favourable than those offered to the non-selling shareholder. In a nutshell, ROFR forms an integral part to investors' protection in a shareholders contract.

ROFR (among other shareholders' rights such as Right to First Offer, Tag Along, Drag Along), has however been viewed as a hindrance to the principle of 'free

transferability' of shares of a public limited company laid down in Section 111-A of the [Companies Act, 1956](#) ("Companies Act"). Such pre-emptive rights, though legally recognised in case of private limited companies, are highly debatable in case of listed and unlisted public limited companies. Considering this, it becomes imperative to analyse enforceability of ROFR in case of public limited companies vis-a-vis Section 111-A.

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, 1956 which now stands deleted. It is also important to note that the said Section 111-A was inserted in the [Companies Act](#) by The Depositories Act, 1996 which primarily regulates depositories in securities, shares held in dematerialised form and matters incidental thereto. Therefore, one could argue that enactment of Section 111-A was not to emphasise on free transferability of shares of public limited companies but to provide an impetus to transfer shares in dematerialised form and a mechanism to check misuse of power by board of directors of the company.

Enforceability of pre-emptive rights including ROFR vis-à-vis Section 111-A has been debated at length in a catena of judicial precedents across the country. The High Court of Bombay has, in its single bench judgment delivered in February 2010 in Western Maharashtra Development Corpn. Ltd. v. Bajaj Auto Limited (MANU/MH/0109/2010) held that pre-emptive rights go against the spirit of Section 111-A, and therefore are not legally tenable.

However, in the latest judgment delivered by the division bench of the High Court of Bombay in September 2010 in Messrs Holdings Limited v. Shyam Madanmohan Ruia ("Ruia Judgment"), the Hon'ble Court upheld the validity of such pre-emptive rights including ROFR and opined that such rights do not violate the provisions of Section 111-A. The judgment discussed various judicial precedents including the judgment of the Supreme Court in Byram Pestonji Gariwala v. Union Bank of India and others (AIR 1991 SC 2234) wherein the Supreme Court stated that freedom of contract generally exists and the legislature does not interfere except when warranted by public policy and the legislative intent is expressly made manifest.

Among various other key observations in the Ruia Judgment, Khanwilkar J. 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.

In summary, the Ruia Judgment is positive for shareholders contracts including joint ventures and private equity transactions. However, it needs to be seen if the Supreme Court upholds the liberal reading of Section 111-A by the division bench in the Ruia Judgment since the said judgment is a material departure from other judgments on similar grounds. It is respectfully submitted that the Ruia Judgment is contrary to the law of the land pronounced by the Supreme Court in V B Rangaraj v. V B Gopalakrishnan (AIR 1992 SC 453) 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. (2006, 131 Comp Case 42 (Delhi)) 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 111-A. The Ruia Judgment's view on non-applicability of Section 9 of the [Companies Act](#) (which states that the provisions of [Companies Act](#) shall prevail notwithstanding anything contrary in the memorandum and/or articles of association, agreement or resolutions of a company) to arrangements between shareholders with third parties (which contradicts the judgment in Western Maharashtra Development Corp. Ltd (Supra)) would also not hold good, if the Supreme Court rejects Ruia Judgment's conclusion that Section 111-A is not applicable to consensual arrangement/agreements between shareholders and third parties not involving the company.

In view of the above contradictions and the fact that the appeal against the judgment in Western Maharashtra Development Corp. Ltd (Supra) case is currently pending, the uncertainty regarding enforceability of pre-emptive rights including ROFR clause in shareholders contracts still lingers and would need to be finally settled by the Supreme Court.

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