



## ‘Private Company: Restriction on Transferability of Shares’

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**Abstract:** *Private limited company holds a unique position under company law as it enjoys certain privileges and exemptions as opposed to public company and Government Company. The benefit of separate legal entity and limited liability are two vital attractions of private company over other form of companies. Shares prima facie considered transferable but the definition of a private company imposes certain conditions to be fulfilled; one of such condition is that there must be some restrictions on transferability of the company’s shares. Whenever we hear the term ‘restriction’, it gives negative connotation and often misunderstands or misinterprets with prohibition, which is not the actual case. To enjoy the benefits associated with private company like, business secrecy, restricted entry of outsiders, and limited area of activates among family members or small group of members restrictions on transferability of shares are justified until and unless they turn out to be prohibitory in nature and violates the right of pre – emption of the shareholders. In Chiranji Lal Jasrasaria v. Mahabir Dhelia it was held that restriction which precludes a shareholder altogether from transferring may be invalid but a restriction which does no more than a give right of pre – emption is valid. Articles of association of a company considered to a Bible on the matter of the transferability of shares of a private company. Any restriction imposed through its articles is binding upon the members of a company. Chief ones of them are giving unrestricted and uncontrolled power to directors to approve the share transfer transaction and the members given the right of pre-emption for purchasing the shares offered by any member. On the other side, this creates a boundary that absence of restrictions in the articles of association gives the right to shareholder to transfer any shares without the consent of anybody, even to the stranger. In this paper, author has attempted to highlight the significance of the restrictions, modes of restriction, exception to this clause and analytical approach would be given to understand the intention of the legislation behind incorporating this clause in the statute through judicial pronouncements.*

**Keywords:** *Private Limited, Government, Shares prima facie, Business.*

### I. PURPOSE/OBJECTIVE

The main purpose of this paper is to analyze the nature of restrictions imposed on the transferability of shares of a private company, significance of such restrictions to maintain the private character of the company and insignificant role of Articles of Association of a company and Board of Directors of a company.

### II. INTRODUCTION

The intention behind a modern private company is dual: Firstly, to facilitate small traders or private persons carrying on a family business to avail the advantages of corporate trading. Secondly, to act as a subsidiary in a group of companies to avoid having to establish a public company, given the plethora of exacting requirements they are required to follow.

Section 2(68) of the companies Act, 2013 defines the term ‘private company’. It is called a glorified partnership or closed corporation. In view of the definition, a private company required by law to incorporate certain specified restrictions, prohibitions and limitations with regard to transfer of shares. One of the three ingredients of the definition is that a private company, by its articles restricts the right to transfer its shares.<sup>1</sup> Shareholding of a private company, and so transferability of its shares, is confined to a limited group of persons. The restriction is required to be mentioned in the Articles of Association. To what extent and in what form the right to transfer can be restricted has been left to the discretion of the companies. However, certain common restrictive provisions are found in the articles of most private companies. Two chief of them are<sup>2</sup>:

1. The directors are given absolute and uncontrolled discretion in the matter of approval of transfer for registration;
2. The members are given the right of pre – emption for purchasing the shares offered by any other member.

The distinction between a private company and a public company is marked and real. In the case of private company, a family or other private group can confine the shareholdings to them or render their subject to their approval. In the case of public company, however, when the public at large is invited to subscribe to the shares and the benefit thereof is availed of by the

<sup>1</sup> Section 2(68)(i) of the Companies Act, 2013

<sup>2</sup> Ghosh M.K. & Dr. Chandratre R.K., Company Law with secretarial Practice, 2006 – 07, 13<sup>th</sup> Edition, Vol.1, Bharat Law House, New Delhi



company, it cannot still claim to retain the complexion of being the bastion of or domain of a limited group where intrusion by outsiders in the form of acquisition of shares is resisted and monopolistic vested defenses set up.<sup>3</sup>

Any restrictions imposed by the articles are binding on the company and its members as the Articles of Association of a company constitute a contract between the company and its shareholders.

### III. RESTRICTIONS ON THE RIGHT TO TRANSFER SHARES

Transferability of shares is considered to be one of the important features for incorporation of any company. As discussed above and keeping in mind the definition of the private company, to maintain the private character of the company certain reasonable restrictions can be imposed on private company only under the provisions found in the Articles of Associations. There are two kinds of provisions which can be incorporated in the Articles of the Company for this purpose. They are:

#### A. Power of Directors to refuse transfer of shares:

The articles of private companies invariably contain provisions empowering the Board of Directors of the company to refuse to register transfer of shares on any ground without giving any reason. The board of a private company has very wide discretion in the matter of refusing transfers. If board of directors, decides not to entertain or admit a person as a member, due to the compulsion of the articles of association to the effect that if another member offered to purchase the shares which are available for transfer, such member shall have priority over an outsider and the court cannot find that such decision to decline admission to the outsider is improper or capricious or arbitrary or oppressive.<sup>4</sup>

The power to refuse to register a transfer must be exercised by the directors in good faith and for the benefit of a company and not for some extraneous purpose because the articles of a private company usually carry rigid restrictions upon the right of transfer and they also empower the directors with a blanket power to refuse to accept a transferee who in their judgment is not a desirable person to be admitted into the company. If such power is permitted to be used arbitrarily, the position of the shareholder of a private company would be very miserable.<sup>5</sup>

Usually court did not intend to interfere in the matter where power has been exercised by the board of the private company and of the opinion that judicial interference would be possible only when there is a mala fide exercise of the power or the reasons for the refusal which they voluntarily disclosed were not adequate to support their decision.

The Board of Directors does not always exercise its powers of refusal in good faith or bona fide. In the name of acting in the interests of the company the Board may abuse its power and refuse to register transfer of shares. The fact that close ties of kinship and friendship generally bind the directors in a private company would make such abuse easier.<sup>6</sup> There are certain instances of such situation where judicial interference had become necessary. They are:

If directors exercise the power in order to prevent the transferor from selling his shares at all, or because of their hostility towards him, or because the directors wish to gain control of the company themselves and they consider that the acquisition of the shares by the transferee may prevent them from doing so, than the court will order the company to register the transfer<sup>7</sup>; or

If the directors approve a transfer of their own shares in order to escape liability for unpaid capital which will inevitably have to be called up to pay the company's existing debts<sup>8</sup>; or

If they approve a transfer of a member's share to themselves when they have bought the shares in order to stifle an inquiry into irregularities in the management of the company, their approval is inoperative and court will order the transferor's name to be restored to the register of members<sup>9</sup>;

Where the transferor paid the directors the amount of money which they demanded as the price of their approval, and the fact that the directors undertook to apply the money towards meeting the company's debts made no difference<sup>10</sup>

It is further necessary that the board should exercise the power of refusal strictly on the grounds specified in the article. No other ground can be imported into the matter. The only permissible restrictions on transferability are those contained in the

<sup>3</sup> Ganesh Flour Mills Co. Ltd v Khaitan (1986) 60 Comp Cas 28 (Del).

<sup>4</sup> Chandran (P V) v Malabar and Pioneer History P Ltd. (1990) 69 Comp Case 164 (ker)

<sup>5</sup> Ramaiya A., Guide to the Companies Act, 16<sup>th</sup> Edition, Part – 1, Wadhwa, Nagpur

<sup>6</sup> Restriction on Transfer of shares available at <<http://www.lawteacher.net/finance-law/essays/restriction-on-transfer-of-shares.php>> visited on October 2, 2014

<sup>7</sup> Robinson v Chartered Bank of India (1865) LR 1 Eq 32, Tett v Phoenix Property and Investment Co. Ltd., (1984) BCLC 599

<sup>8</sup> Re, Accidental Death Insurance Co., Allin's Case (1873) LR 16 Eq 449

<sup>9</sup> Re, Mitre Assurance Co., Eyre's Case (1862) 31 Beav 177

<sup>10</sup> Re, Cameron's Coalbrook Steam Coal and Swansea and Lougher Rly Co., Benmett's case 91854) 5 De GM & G 284



company's article of association. Any additional restriction not contained in the articles but in a private agreement between two shareholders is not binding either on the company or on the shareholders.<sup>11</sup>

The burden of proving that the directors have wrongfully accepted or objected to transfers of shares rests on the person making the allegation. The Courts will always presume bona fide on the part of the directors.

## B. Pre – emption Rights

It is common practice to provide in the articles that any member intending to transfer his shares should offer the shares first to other members of the company at a price ascertained in accordance with a formula set out in the articles, or at a fair price at which the shares are valued by the directors or by the company's auditors and he shall transfer the shares to his proposed transferee only if the other members do not exercise their right of pre-emption.<sup>12</sup> The articles usually contain elaborate provisions as to the manner in which the shares can be offered by an intending transferor, the directors shall deal with it and the manner in which the right of pre – emption shall be exercised by the members. Such restrictions are not invalid.<sup>13</sup> In private companies, the articles often provide a non – statutory pre – emption right in favour of the remaining shareholders if a shareholder is desirous of disposing of and transferring his shares. “The object of such non – statutory right is to preserve the character of the private company as a ‘close corporation’ and to prevent an unwelcome outsider from buying himself into the company and taking it over”.<sup>14</sup> In *Bishan Singh v. Khazan Singh*,<sup>15</sup> the Court stated that the right of pre-emption is not a right to the thing sold but a right to the offer of a thing to be sold.

These provisions seek to restrict the transfer between a member and a non – member and, therefore subject to the wording of the articles. These provisions do not restrict the transfer between one member and another. The transfer between members is completely unrestricted and such transfer does not bring into operation the provisions of the pre – emption clause. This clause is not a complete bar to the transfer to an outsider. The articles of a private company can restrict the right of transfer, but they cannot completely prohibit the transfer.<sup>16</sup> Pre – emption clauses have a binding effect even though the price payable by the other member is considerably less than their market value of the shares and even though the exercise of the right will result in the company only having one member.

The pre-emption clause goes a long way in ensuring that the control of the shares does not fall into the hands of undesirable persons by allowing the existing shareholders the first opportunity to buy the shares.<sup>17</sup>

If it is desirable by the members of the company that they should maintain the proportionality of shareholdings as between themselves, it is desirable to extend the right of pre – emption further still and to make it applicable to transfer to a fellow member also and to the transfer of shares on the death or insolvency of a member as also to transfer of a director's shareholding when he ceases to be a director.<sup>18</sup>

A pre – emption provision in the articles bind a mortgagee of a member's share and also the company itself if it claims a lien on the shares under its articles. Before exercising the power to sell the shares to realize the mortgage or to enforce the lien, the mortgagee or the company must offer the shares to the other members of the company in accordance with the pre – emption clauses.<sup>19</sup>

The conditions imposed and the formalities prescribed by the articles, such as notice of transfer by the intending transferor and the notice, in turn, by the company to other members, are mandatory and must be strictly followed by both. The notice to be given by the company to its members must be properly given; however, in appropriate cases the notice may be inferred from the facts and circumstances as, for instance, where a resolution approving a transfer to a non-member is passed by the consent of all the directors of the company who are the only shareholders of it.<sup>20</sup>

In *Satyanarayana Rathi v. Anna Maliar Textiles Pvt. Ltd.*,<sup>21</sup> the articles of association of a private company provided that no share of the company shall be transferred to any person who is not a member of the company so long as any member of the company is willing to purchase the same at a fair price which shall be determined by directors from time to time. The appellant, in

<sup>11</sup> Dr. Chandratre R.K., ‘Restrictions on transfer of shares in a private limited company : Law & Practice’, July 2003, available at <<http://www.bcasonline.org/articles/artin.asp?49>>, visited on October 5, 2014

<sup>12</sup> Subhashini R., ‘India: Restriction on Transferability of Shares,’ June 14, 2010, at <<http://www.mondaq.com/india/x/102852/Directors+Officers/Restrictions+on+Transferability+of+Shares>>, visited on October 5, 2014

<sup>13</sup> *Borland's Trustee v steel Bros and Co* (1901) 1 Ch 279

<sup>14</sup> *Devaraj Dhanram v Firebricks & Potteries* (1994) 79 Comp Cas 750 (Kant)

<sup>15</sup> AIR 1958 SC 838

<sup>16</sup> *Dhamija Ashok, 'Power to refuse free transfer of shares'*, Financial Express, August 2, 1999

<sup>17</sup> *Supra* n. 6

<sup>18</sup> Share transfer restrictions under companies Act available on <<http://www.legalserviceindia.com/article/1232-Share-Transfer-Restrictions.html>>, visited on September 29, 2014

<sup>19</sup> *Supra* n. 13

<sup>20</sup> *Supra* n. 11

<sup>21</sup> (1999) 32 CLA 56



whose favour certain shares were pledged for dues for supply of cotton, asked the company to register the transfer of shares in his favour as the dues were outstanding. The company refused to register the transfer as it would have been violating the law. The Company Law Board (CLB) upheld the decision of the Board. It observed that a close scrutiny of the above articles will show that no share shall be transferred to an outsider if any member of the company is willing to purchase the same at a fair price which shall be determined by the directors. Further, transfer to an outsider is permissible only when the Board is unable to find a willing member to purchase the shares within a stipulated period. The members of the company were willing to purchase the pledged shares at a fair price in exercise of their pre-emptive right. The CLB emphasized that any transfer of shares of a private company shall be in strict compliance with the articles of association, failing which the transfer will be violative of the provisions of articles and such transfer is liable to be set aside. In the present case, the prayer of the petitioner to register the shares in his name is against the provisions of the articles. The company is, therefore, bound to refuse the transfer of shares in favour of the appellant, which it did.

In this way these are the general restrictions on the transferability of share mentioned in the Articles of Association of private companies, which are mandatory to be followed by all class of shareholders.

#### IV. PRIVATE AGREEMENT BETWEEN SHAREHOLDERS

The Companies Act compulsorily requires private companies to impose restrictions on the transfer of shares by incorporating such restrictions in their articles. However, the Act does not specify any particular mode of restriction or prescribe the extent of the restriction required. Thus the restrictions may be as slight or as severe as the framers of the articles desire. Such restrictions should be general and apply unvaryingly to all shareholders and on all types of shares.

The only permissible restrictions on transferability are those mentioned in the Articles of Association of company. Any additional restrictions which are not contained in the articles but in the private agreement between the two shareholders, which places further obstacles in the way of transferability of shares is not binding either on the company or on the shareholders. Thus, an agreement restricting the right to transfer contrary to or inconsistent with the provisions in the articles is not enforceable.<sup>22</sup> It is a well established principle that a share in a company is an item of property freely alienable in the absence of express restrictions under this article.<sup>23</sup> 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.<sup>24</sup>

In the Rangaraj case, the articles of a private company provided: the first part of the articles states that no new member shall be admitted in the company except with the consent of the majority of the members. The second part states that on the death of any member, his heirs 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.<sup>25</sup> It is therefore clear that even a new member can be admitted provided the majority of the members are agreeable to do so.

Where the articles of a private company expressly provide that “no transfer of any share in capital of company shall be registered or made without the previous sanction of the directors; any transfer so made without the previous sanction of directors or without a written resolution accepting the transfer preceded by handing over of shares is not valid in law”.<sup>26</sup> Even court cannot intervene in such situation unless directors abuse their powers which prejudice the interest of the company, because articles of the private company clearly mentions the power of the Board of Directors with regard to transfer of shares.

So it is pretty much clear that, the articles hold the prominent position in case of transfer of shares. Any transfer in violation of the articles of the company is not permissible.

#### V. RESTRICTION NOT TO INCLUDE PROHIBITION

Shares are transferable in the manner provided by the articles of the company. There cannot be an absolute prohibition on the right to transfer shares. These restrictions are not to be construed as a ban or a prohibition on the transfer of shares. The right to transfer may be subjected to restrictions contained in the articles and though such restrictions may be either very stringent or very slight, it would be alright so long as it does not amount to total ban on transferability. Restriction upon transfer means any restriction that will give some control to the company over transferability of shares.<sup>27</sup>

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<sup>22</sup> Rangaraj (V B) v Gopalkrishnan (V B) (1992) 73 Comp Cas 201 (SC)

<sup>23</sup> Swaledale Cleaners Ltd; In re, (1968) 1 All ER 1132 (CA)

<sup>24</sup> Supra n. 7

<sup>25</sup> Supra n. 22

<sup>26</sup> John Tinson & Co. Pvt. Ltd. v Surjeet Malhar AIR 1997 SC 147

<sup>27</sup> Johri's commentaries on Companies Act, Vol 1, 2006, Kamal Law House, KolKata



The framers of the articles should always be very clear in the choice of their words because such provisions are generally construed very strictly and the narrowest possible meaning is put on them.<sup>28</sup> Where the restriction in question is capable of having two meanings, than the less restrictive meaning would be adopted by the court.<sup>29</sup>

Restriction which amounts to a prohibition on transfer of shares or which precludes a shareholder altogether from transferring is invalid.<sup>30</sup> “In the absence of restrictions in the articles, the shareholder has by virtue of the statute the right to transfer his shares without the consent of anybody to any transferee, even though he be a man of straw, provided it is a bona fide transaction in the sense that it is an out and out disposal of the property without retaining any interest in the shares.”<sup>31</sup>

It is relevant to note that restrictions upon transfer of shares in private company are inapplicable in the following cases<sup>32</sup>:

- (i) On a member's right to transfer his shares to his representatives.
- (ii) In the event of death of a shareholder, legal representatives may require the registration of share in their name.

Transferability is the general nature of property and even when there is a restriction on transfer, when the person dies the restriction will not apply.

## VI. CONCLUSION:

After covering all the aspects of restrictions on transferability of shares in private company, conclusion can be drawn out that, a private company is usually an association of persons bound together by close ties of kinship, friendship, and sharing a camaraderie and trust, which cannot be easily shared with another person. Any form of restrictions that company wants to put on its members with regard to transfer of shares must mandatorily be mentioned in the Articles of Association of the company as per the provision of section 2(68) (i) of the Companies Act. Such restrictions on the rights of the members to transfer shares considered to be one of the main characteristic of a private company and are considered something intrinsic to a private company given that it is based on the partnership principle because partnership principle is the soul of the private company.

It is important to note that the Act does not specify the forms and extent of the restrictions which can be imposed. It is open to the framers of the articles to frame these restrictions in such a manner which helps the company to maintain its private character and controlling power remains with the members of the company rather being transferred to the member unfavorable or hostile to the existing members. Framers only decide the extent and scope of these restrictions. Another important aspect with regard to the role of judiciary in case of any conflict is, court has very limited intervention in this matter as it is a very private affair between the company and its members and articles are considered to be constitution for transferability of shares. So unless and until matters specified in earlier chapter court usually avoids intervening and acts as a guardian of these restrictions and enables the private company to achieve its aims and objectives.

There are certain problems in keeping the private character of the company. These restrictions create certain uncertainties. First, there is ambiguity with respect to valuation of shares in the case of exercise of pre-emption rights. Sometimes it may become difficult to fix a price as per fair market value when transferring to another member of the company. Second, proper care must be taken that these restrictions do not exceed the scope defined in the articles. Otherwise this could hamper the rights of the shareholders, transferees and thus, the company may be adversely affected. Thirdly, Board of Directors are given very wide powers with regard to refuse transfer of shares. So many times this power is abused by them in a manner which is in their personal interest and not in the interest of the company. However, we must not become complacent and should constantly search for innovative means of checking such abuse. Section 111 of the Act adequately provides for the remedies available in case of abuse of this power. The Courts too have done their best to check abuse of this power and ensure that no injustice or prejudice is caused to the aggrieved person.

So from this it is important that companies themselves take precaution and draft the articles with utmost good faith, care, and foresight. All these were relevant and important aspects to be discussed with regard to transfer of shares in private company.

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<sup>28</sup> Share transfer provisions available at < [http://www.companylawsolutions.co.uk/articles\\_share\\_trans.shtml](http://www.companylawsolutions.co.uk/articles_share_trans.shtml)>, visited on October 1, 2014

<sup>29</sup> *Supra* n. 27

<sup>30</sup> *Chiranji Lal Jasrasaria v. Mahabir Dhelia* AIR 1966 Assam 48

<sup>31</sup> *Delavenne v Broadhurst* (1931) 1 Com Cases 414

<sup>32</sup> N.Vijja Kumar, “Transfer of Shares” SEBI and Corporate Laws, Vol. 35 (2002) at 122.



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