Impact of Rule 9B of Companies (Prospectus and Allotment of Securities) Rules, 2014: Need an Amendment to Protect Private Companies

According to the definition of 'private company' in Section 2(68) of the Companies Act, 2013 ('the Act'), a company is treated as a private company if its articles of association include the three conditions mentioned in clauses (i), (ii), (iii) of the definition. In other words, unless the articles of association of a company include these three conditions, the company cannot be treated as a 'private company'. It should be noted that, a mere inclusion of these conditions in the articles of a company is not enough. The company must actually follow and comply with them.

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INTRODUCTION

THE UNIQUE POSITION OF A PRIVATE COMPANY

Perhaps, a private company limited by shares is the most popular type of organization through which many entrepreneurs prefer to carry on their businesses. The very fact that in India the number of private companies is as much as 90% of the total number of companies incorporated under the Companies Act, indicates the popularity of a private company. A private company is variously described, such as, 'quasi-partnership', 'family concern', 'close corporation', 'a partnership in the clothes of or under the guise of a private company', or a 'company which is in substance a partnership', etc.

A private company has many advantages over the public company. The benefit of 'corporate entity' and 'limited liability' are two vital attractions that lure businessmen towards a private company, as opposed to a partnership firm, as a form of business organization.

The Companies Act confers on private companies several privileges and exemptions which a public company cannot enjoy.

In one case[1] the court explained the unique position of a private company as against a public company in these words:

"The distinction between a private company and a public company is marked and real. In the case of the former, a family or other private group can confine their shareholdings to themselves or render their transfer subject to their approval. In the case of the public limited company, however, when the public at large is invited to subscribe to the shares, and the benefit thereof is availed of by the company, it cannot still claim to retain the complexion of being the bastion or domain of a limited group where any intrusion by outsiders in the form of acquisition of shares is resisted and monopolistic vested defences set up. The basic character of a public limited company that any member of the public is entitled to subscribe to its shares remains, and must be upheld to the exclusion of any individuals or groups interests".

According to the definition of 'private company' in Section 2(68) of the Companies Act, 2013 ('the Act'), a company is treated as a private company if its articles of association include the three conditions mentioned in clauses (i), (ii), (iii) of the definition. In other words, unless the articles of association of a company include these three conditions, the company cannot be treated as a 'private company'. It should be noted that, a mere inclusion of these conditions in the articles of a company is not enough. The company must actually follow and comply with them.

RESTRICTION OF TRANSFER OF SHARES

One of the ingredients of the definition, which it is mandatory to include in the articles of association of every private company, is that a private company, by its articles, restricts the right to transfer its shares. A company cannot be considered a private company unless its articles contain, *inter alia*, provisions concerning restrictions on transfer of shares of the company.

The Companies Act, 2013 and all its predecessors have recognised the restrictive transferability of shares in a private company and contained an appropriate statutory

1. *Ganesh Flour Mills Co. Ltd v T P Khaitan and Others (1984) 3 Comp LJ 298,*

prescription for it. For example, Section 2(68) of the Companies Act, 2013 defines "private company"; and one of the ingredients of the definition is that a private company, by its articles, restricts the right to transfer its shares. According to it, among other things, a private company means a company which by its articles, restricts the right to transfer its shares. Section 2(68) contains a statutory mandate (and not a discretion) which every private company is obliged to observe, apart from the fact that no private company would wish that the shares of the company are freely transferable.

While the definition of 'private company' mandates that the articles of association of a private company to restrict the right to transfer of its shares, Section 58(1) of the Act recognises the right of a private company to refuse to register any transfer of the company, whether in pursuance of any power of the company under its articles or otherwise, to register the transfer of, or the transmission by operation of law of the right to, any securities or interest of a member in the company; and subsection (2) declares that "Without prejudice to sub-section (1), the *securities or other interest of any member in a public company shall be freely transferable*." This makes it clear that securities or other interest of any member in a private company shall not be freely transferable. The words "whether in pursuance of any power of the company under its articles or otherwise" in Section 58(1) recognises the power of private companies to restrict the transfer of their shares.

What restrictions the articles of a private company is not indicated in the Act; nor does Table F in the First Schedule to the 2013 Act, provide any direction or guidance in this regard. The Companies Act, 1956 also did not contain any provision in this regard. Consequently, one has to ascertain from the case law (which has abundance of decisions on this issue) as to what articles of private companies can and cannot contain in order to restrict the right to transfer of the shares.

Whatever restrictions are imposed by the articles, they are binding upon the members of the company by virtue of Section 10 of the Act. To what extent and in what form the right to transfer can be restricted has been left to the discretion of these companies. In my opinion, in the absence any specific provision outlining restrictions of any kind (even illustratively) and leaving the matter completely to the discretion of the companies, we cannot read into the statute any provision treating certain kinds of restrictions valid and certain kinds of restrictions invalid, since it is well settled principle of statutory construction that no words can be added in, or deducted from, a statute. It is a corollary to the general rule of literal construction that nothing is to be added to or taken out from a statute unless there are adequate grounds to justify the inference the legislature intended something which it omitted to express.[2]

Accordingly, it is to be expected that, in the articles of such a company, the control of the directors over the membership may be very strict indeed. There are very good business reasons, or there may be very good business reasons, why those who bring such companies into existence should give them a constitution which gives to the directors' powers of the widest description.[3]

It is, however, well-settled principle that a share, being personal property, is *prima facie* transferable, although the conditions of the transfer are to be found in the terms laid down in the articles. If the right of transfer, which is inherent in property of this kind, is to be cut down, it should be done by language of sufficient clarity to make it apparent that that was the intention.[4]

As held by the Supreme Court, the provisions of the Companies 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 movable property and transfer thereof is regulated by the articles of association of the company. Shares in a company are transferable like any either movable property. The only restriction on transfer of 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 registration of shares purchased by him on a ground other than that stated in the articles. The articles of a private company may contain provisions restricting the right to transfer of shares, but any restriction outside the articles (e.g., a private agreement between the shareholders) is inoperative and unenforceable.[5]

Although private companies are free to impose any restrictions, however in character, on the rights of transfer and prescribe any manner in which the shares can be transferred, yet the mandatory provisions of Section 108 of the Act are as much applicable to the transfers of shares of private companies as they apply to public companies. Furthermore, the articles laying down the manner of transfers are equally binding upon the members and the company as well.

MANNER AND EXTENT OF RESTRICTION ON TRANSFER OF SHARES

The Act does provide any direction in this regard. However, conventionally, certain common restrictive provisions are found in the articles of most private companies. Two main of them are: one, the directors are given absolute and uncontrolled discretion in the matter of approval of transfers for registration, and second, the members are given the right of pre-emption for purchasing the shares offered by any member. There is, however, nothing to limit the restrictions which a company's articles may place on the right of transfer;[6] but there cannot be complete fetter on the right.

2. *Maxwell on the Interpretation of Statutes, 12th edn, page 33*

3. *Smith & Fawcett Ltd [1942] 1 All ER 542.*
4. *Greenhalgh v Mallard and Others [1943] 2 All ER 234 (CA).*
5. *V B Rangaraj v V B Gopalkrishnan [1992] 73 Comp Cas 201:AIR 1992 SC 453.*
6. *Crawley and Co (1889) 42 Ch D 209.*

Any restriction 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.[7]

The following are the most common pre-emption provisions:

"1. Except where the transfer is made to a shareholder selected as aforesaid, the person proposing to transfer any share (hereinafter called the 'proposing transferor') shall give notice in writing (hereinafter called 'the transfer notice') to the company that he desired to transfer the same.

2. Such notice shall constitute the company, the agent of the retiring member for the sale of such shares to any member of the company or a person selected as aforesaid at the fair value. No sale notice shall be withdrawn except with the sanction of the Directors."

3. Such notice shall specify the sum one proposing transferor fixes as the fair value and shall constitute the directors, his agent, for the sale of the share to any shareholder at the price 90 fixed by the auditor as hereinafter provided in these articles. The transfer may include several shares and in such case shall operate as if it were a separate notice in respect of each share. The transfer notice shall not be revocable except with the sanction of Directors.

4. If the Directors within the space (the space of six months after being served with such notice) find a shareholder willing to purchase the share ('hereinafter called the purchasing member') and shall give notice thereof to the proposing transferor he shall be bound upon payment of the price so fixed to transfer the share to the purchasing member.

5. Notwithstanding the foregoing articles, the Board of Directors of the Company may in their absolute and uncontrolled discretion refuse to register any proposed transfer of shares, and clause 20 of Table A shall be modified accordingly. No shares shall in any circumstances be transferred to any infant, bankrupt, or person of unsound mind. Save as hereby otherwise provided, no share shall be transferred to any person who is not a member of the company so long as any member or failing such member any person selected by the directors is willing to purchase the same at the fair value which shall be determined as hereinafter provided."

THE PRE-EMPTION RIGHT OF MEMBERS

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. 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.[8]

A shareholder has a property in his shares, a property which he is at liberty to dispose of, subject only to any express restriction which may be found in the articles of association of the company. If, for instance, to take a common case, the articles provide that before transferring to a stranger the shares shall be offered on certain terms to other shareholders, a man coming into that company takes subject to that restriction, and he cannot transfer to a stranger without having first made an offer of the shares to the shareholders. So, if there was a condition … that no transfer should be made to a married woman, that condition would, I think, be perfectly good. Subject to that right, the shareholder is at liberty to transfer a share as much as he is at liberty to sell a chair or table or any other property.[9]

The pre-emption clause, however, 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.[10]

It has, however, been consistently held by the courts that subject to the restrictions imposed by the articles, a shareholder is free to transfer his shares to a person of his choice and that the articles cannot put a complete ban or unreasonable restrictions on the right to transfer. While shares in a private company are not freely transferable and are subject to the restrictions imposed by the -articles of the company, shares in a public company are freely transferable. A private company is obliged to restrict the transfer, but to what extent and in what manner a private company can restrict it, has not been spelled out by the Companies Act.

TRANSFER BETWEEN ONE MEMBER AND ANOTHER MEMBER

Usually, a transfer from a member to a member is freely permitted. The provisions in the articles of a private company may restrict this right of transfer as well or subject it to procedural formalities and conditions. But courts are generally inclined to interpret such provisions in favour of member-to-member transfers being allowed freely.

For instance, in *Delavenne v Broadhurst* [1931] 1 Ch 234, the articles of association contained the following articles:

Article 5: "The Directors may in their absolute and uncontrolled discretion refuse to register any proposed transfer of shares, and clause 20 of Table A shall be modified accordingly. No shares shall in any circumstances be transferred to any infant, bankrupt, or person of unsound mind. Save as hereby otherwise provided, no share shall be transferred to any person who

7. *Curtis v JJ Curtis & Co. Ltd. 1986 BCLC 86 (CA).*

8. *Borland's Trustee v Steel Brothes & Co Ltd (1901) 1 Ch 279; Ontario Jockey Club Ltd v Samuel Mc Bride [1927] AC 916;AIR 1928 PC 291.*

9. *In e Bede Steam Shipping Company Limited [1916] 2 Ch 123.*

10. *Chiranjilal Jasrasaria v Mahabir Dhelia AIR 1966 A & N 48; Babulal M Varma v New Standard Coal Co Pvt Ltd (1967) I Comp LJ 161 (Cal): (1967) 37 Comp Cas 446.*

is not a member of the company so long as any member or failing such member any person selected by the directors is willing to purchase the same at the fair value which shall be determined as hereinafter provided."

Article 6: "In order to ascertain whether any member or person selected as aforesaid is willing to purchase a share at the fair value, the person whether a member of the company or not proposing to transfer the same (hereinafter called 'the retiring member') shall give notice in writing (hereinafter described as a 'sale notice') to the company that he desires to sell the same, and until otherwise determined by the company in general meeting the same shall be offered among the holders of ordinary shares in proportion as near as may be to their existing holdings thereof and any not accepted by them shall be offered to such other persons as the Directors shall determine. Such notice shall constitute the company the agent of the retiring member for the sale of such shares to any member of the company or a person selected as aforesaid at the fair value. No sale notice shall be withdrawn except with the sanction of the Directors."

The question before the court was, whether, in terms of these articles, one member was entitled to transfer shares to another member. It was held that, there was nothing in the language of arts. 5 and 6 which gave rise to the necessity of implying any restriction upon the right of a member of the company to transfer shares therein to another member. So far there is an absolute prohibition on a shareholder of the right to transfer a share to an infant, a bankrupt, or a person of unsound mind, and a prohibition against the transfer to any person who is not a member of the company so long as a member of the company or, failing any such member, a person selected by the Directors is willing to take the shares. There is no express prohibition of the right of one member to transfer shares to another member. Article 6 is mere machinery for the purpose of enabling a member to transfer shares to some person who is not a member of the company. It is machinery for the purpose of ascertaining whether or not there is a member of the company who is willing to purchase at a fair value or a person selected by the directors who is willing to purchase at a fair value.

As to the restriction on transfer of shares which forms part of the definition of 'private company' and private companies are required to include in their Articles of Association, in one case, the Court observed:

"... the Articles of Association forbid transfer of shares to persons who are not already shareholders of the company. Such a provision is usually contained in the articles of association of private companies and the underlying object of incorporating restrictions on the right of transfer of shares is that the ownership should be confined to a close circle of members connected with one another by ties of kinship or friendship or closer relationship of a similar character, and with a view to avoid the intrusion of a stranger unless his admission is acceptable to the existing members. The restrictions which a private company is obliged to require by its articles have been left undefined as they may be of wide and varied character. The articles of association also confer a right on the Directors to refuse to register transfers of shares in the capital of the company without the previous sanction of the Directors and who may withhold their sanction without assigning any reason. The Directors of this company have such an absolute discretion under Article 9 of the Articles of Association of this company. Pre-emption clauses of various types are usually found in the articles of private companies, the object being in consonance with the character of a private company or a "close corporation" as it is called in America. But it is one thing not to permit acquisition of shares of a private company freely by members of the public which characterises the constitution of a private company from that of a public company; it is, however, a different thing to place stringent conditions the result of which might be to prevent transfers of shares between members and thereby virtually depriving them from exercising a fundamental and most useful right which is incidental to the exercise of proprietary right."[11]

> The Companies Act, 2013 and all its predecessors have recognised the restrictive transferability of shares in a private company and contained an appropriate statutory prescription for it. For example, Section 2(68) of the Companies Act, 2013 defines "private company"; and one of the ingredients of the definition is that a private company, by its articles, restricts the right to transfer its shares.

TRANSFER BETWEEN MEMBER AND NON-MEMBER

A restriction in the articles of a private company that no share shall be transferred to an outsider (a person who is not a member of the company and whom the promoters or other shareholders of the company do not wish to take in as a shreholder) so long as any member is willing to purchase it, is the most commonly found restriction in the articles. The purpose of the article is plain: to prevent sales of shares to strangers so long as other members of the appellant company are willing to buy them at a price prescribed by the article. And this is a perfectly legitimate restriction in a private company.[12]

Where articles of association of a private company restrict the transfer of shares by a shareholder to a person who is not a shareholder, by providing that the shares can be so transferred only if an existing shareholder is not willing to purchase the same at a price, to be fixed, according to the procedure prescribed in the articles, and in case

11. *Jarnail Singh v Bakshi Singh (1960) 30 Comp Cas 192 (Punj): AIR 1960 Pun 455.*
12. *Lyle & Scott Ltd v Scott's Trustees [1981] AC 763: [1959] 2 All ER 661; [1960] 30 Comp Cas 30 (HL).*

of dispute about the price also a procedure is provided and the articles further provide that the transferor shall send a notice to the company that he wants to transfer the share, if he intends to transfer the same to the name of a person other than a shareholder, and that, if the Directors within the space of six months of receipt of the notice find a shareholder willing to purchase the share, they shall give notice to the proposing transferor in that regard, the transferor shall be bound upon payment of the price so fixed to transfer the shares to the purchasing member, then, if any transfer of shares is rejected without notice or a valid notice to the holder thereof such transfer would be illegal and invalid, rectification of which would have to be ordered by the court. [13]

These provisions, it should be noted, 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.[14]

PRE-EMPTION PROVISIONS MUST BE STRICTLY COMPLIED WITH

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 member desiring to transfer his shares and the company. Failing to comply with the requirements under the articles by either of them would result into breach of the articles and the transfer made in breach of such requirements would be invalid and can be undone by rectification of the register of members by removing from it the name of the transferor and restoring the name of the member whose shares were transferred.[15]

BOARD'S POWER OF REFUSAL

The articles of private companies invariably contain provisions empowering absolutely the Board of Directors to refuse to register transfers on any ground and without assigning any reason. The Board of a private company has, where the articles so provide, very wide discretion in the matter of refusing transfers.

However, the general principles are the same as in the case of refusal of registration of transfer of a public company and in considering exercise of discretion by the directors of a private company, some more leeway should be given to them in view of the fact that a private limited company is a corporate firm or a partnership or more or less of that nature.[16] In this case a provision in the articles of the private company empowered the Directors to decline, at any time in their absolute discretion without assigning any reason, to register any proposed transfer if the purchaser be a person of whom they do not approve. The Gujarat High Court held:

"Even bearing this principle of a close corporation in mind, we have to see to it that the right of a shareholder to transfer his shares is not unduly restricted or is not fettered by the exercise of discretion by the Board of Directors of the private company for reasons which are not germane to the exercise of that power. … If the Directors do not approve of the purchaser', these words upon the question of approval put a limitation on the power of the directors while exercising power under articles … and the limitation is that there must be something personal to the purchaser which prompts the Directors not to approve of that particular purchaser."

If a private company, which is a closed corporation, decides not to entertain or admit a person as a member, due to the compulsions of the articles of association to the effect that if another member offered to purchase the shares which were 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. The anxiety of the company to prefer a member, and not an outsider, to hold the shares, cannot be considered unreasonable or arbitrary.[17] The refusal may take place on the ground that the number of members of the company will be increased beyond the statutory limit of fifty or that the company will be exposed to the provisions of Section 43A of the 1956 Act (since omitted) thereby forcing the company to become a deemed public company.

APPROVAL OF TRANSFER

It should be noted, approval of a transfer of shares in a company by the Board of Directors is necessary. If the Board has delegated this power to any committee of Directors or any other officer of the company, such committee or officer may approve a transfer. But approval is a must. Articles of association of companies usually provide for such approval, especially in the case of a private company because transfer of shares in a private company is restricted (the definition of "private company" in the Companies Act does not recognise a company as a private company unless its articles restrict transfer of shares). The approval of the Board must be express approval by a resolution passed at a valid Board meeting (or by a circular resolution unless it is prohibited by the articles).

It is now well settled that articles of association of a company is a contract between the parties. The articles of association of the company in instant case required previous sanction of the Directors. The concept of previous sanction of the Directors connotes that there should be a written resolution accepting the transfer from

13. *Malabar and Pioneer Hosiery Pvt Ltd, In re (1985) 57 Comp Cas 570 (Ker) affirmed by the Division Bench in Chandran (P V) v Malabar and Pioneer Hosiery Pvt Ltd (1988) 2 Comp LJ 146 (Ker): (1990) 69 Comp Cas 164 (Ker); Amrit Kaur Puri v Kapurthala Flour, Oil & General Mills Co (P) Ltd (1984) 56 Comp Cas 194 (P&H). See the Supreme Court's Judgment in Claude-Lila Parulekar v Sakal Papers Pvt. Ltd. (2005) 124 Comp Cas 685: (2005) 4 Comp LJ 499 (SC).*
14. *Greenhalgh v Mallard (1943) 2 All ER 234.*
15. *Tett v Phonix Property & Investment Co. Ltd. [1986] BCLC 149;(1986) 2 BCC 99, 140.*
16. *Master Silk Mills P Ltd v Mehta (D H) (1980) 50 Comp Cas 365 (Guj).*
17. *Chandran (P V) v Malabar and Pioneer Hosiery P Ltd. (supra).*

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shareholder in favour of transferee and such previous sanction should be preceded by handing over of the shares. In absence of such an action the transfer of the shares held by shareholder in favour of the transferee was not valid in law.

IMPACT OF RULE 9B OF COMPANIES (PROSPECTUS AND ALLOTMENT OF SECURITIES) RULES, 2014 (THE RULES)

As noted above, transfer of shares of a private company is restricted by its Articles of Association and, consequently, shares of a private company are not freely transferable, unlike shares of a public company. Dematerialisation of shares of a company renders them freely transferable.

Section 29(1)(b) of the Act read with rule 9B of the Rules provide the following requirements with respect to dematerialisation of securities of a private company:

(i) Issue of securities by a private company must be made only in dematerialised form;

(ii) Private company shall facilitate dematerialisation of all its securities, in accordance with provisions of the Depositories Act, 1996 and regulations made thereunder;

(iii) Before making any offer for issue of any securities or buyback of securities or issue of bonus shares or rights offer, a private company shall ensure that the entire holding of securities of its promoters, directors, key managerial personnel has been dematerialised in accordance with the provisions of the Depositories Act, 1996 and regulations made thereunder;

(iv) Every holder of securities of a private company who intends to transfer such securities, shall get such securities dematerialised before the transfer; and

(v) Every holder of securities of a private company who subscribes to any securities of the concerned private company whether by way of private placement or bonus shares or rights offer on or after the date when the company is required to comply with this rule shall ensure that all his securities are held in dematerialised form before such subscription.

Sub-rule (2) of rule 9B of the Rules specifies the period within which the requirements of rule 9B must be complied with by a private company. According to sub-rule (2), a private company, which as on last day of a financial year, ending on or after 31st March, 2023, is not a small company as per audited financial statements for such financial year, shall, within eighteen months of closure of such financial year, comply with the provisions of this rule.

In view of the above rule which is plain and unambiguous, a private company which is not a small company as on 31 March 2023 as per audited financial statements for such financial year can continue to issue and transfer securities in physical manner up to 30 September 2024 i.e. up to eighteen months of closure of the financial year ended on 31 March 2023.

In other words, up to 30 September 2024, a private company has the option of not complying with the any of the requirements specified under rule 9B. In view of this, up to eighteen months of closure of the financial year ended on 31 March 2023, the requirements under rule 9B are voluntary but not mandatory. However, after 30 September 2024, all the requirements under rule 9B must be mandatorily complied, failing which would amount to violation of the provisions of the Act.

As a result of mandatory dematerialsation of shares of private company, there is a (genuine and justifiable) fear that these companies are likely to be exposed to free transferability thereby making statutory protection against free transferability a dead letter. The private companies will virtually lose control on restricted transfer of shares and the Board's power to refuse to register transfers in violation of the articles of association and thereby not allow anyone to acquire the company's shares. This clearly runs contrary to the definition of private company and would have the adverse effect of 'close corporation' character of a private company.

In view of the requirement of rule 9B the mandate and consequential right to restrict transfer of shares will get affected as there will be no transfer document that will come before the Board for approval and transfer in demat form will go through without the knowledge of the company. A private company (requiring compulsory demat of shares) cannot include a clause in its articles stipulating that no transfer, even in demat, can take place without the approval of the board. The only way out is to omit rule 9B or make dematerilization optional or at least amend the rule and make it applicable subject to a proviso that the depository shall refer the case to the company whenever it received a request for the transfer of the company.