Concept of Entrenchment under Companies Act, 2013

Section 5(2) of the Companies Act, 2013 has introduced the concept of entrenchment for incorporating regulations in the articles of association, with an objective to protect interest of capital, intellectual property rights of shareholders, which can be amended by following the conditions more restrictive than special resolution. Companies Act, 2013 has also introduced Section 58(1) and (2) to remove all restrictions on transfer, Sections 106(3), 179(1) and 164(3) of the Act encompass the enabling provisions. Section 6 of the Act also provides that articles and memorandum cannot override the Act. Hence the scope and width of powers of entrenchment cannot override the democratic functioning, role of independent directors and exercise of powers of the board and shareholders in meetings including restrictions and prohibitions on the directors. Read on to understand the concept of entrenchment under the Act…

Entrenchment until the enactment of the Companies Act, 2013 (the Act, hereafter) is not a legally-recognised phrase with its purport and width widely understood. The dictionary on legal concept has not at all listed the term entrenchment. However, a normal dictionary defines *entrenchment* as:

1. To establish solidly so as to make changes difficult
2. Surround with trench, place in strong defensive position.

Section 5 of the Act, subject to Section 6, provides that articles of a company can have the regulation of entrenchment, which firmly establishes shareholders in their position to protect their capital and intellectual property contributed towards the operation of business and goodwill of their company. However, a limitation laid down in the Section 6 that article cannot override the Act, needs to be complied. Nowadays, businesses are global and customer must perceive certainty of continuity and sustainability for continuous growth of business. Hence, the regulation of entrenchment articles not only provides protection of capital,

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intellectual property, business but also ensures certainty of continued existence to its customer. Such protection and guarantee to customer is essential for survival of business.

In common parlance, the meaning loosely meant by certain court judgments in the use of the word *entrenchment* implies gaining an unauthorised entry into the jurisdiction of a court. However, it appears that the Act has not intended *entrenchment* in that sense and has used the word in the sense of normal dictionary meaning.

In order to define the contour of regulations in the article having force of entrenchment, such articles of entrenchment must not be in conflict and rather be in harmony with the fundamental philosophy of the Act, as laid down in its various provisions.

Fundamental Philosophy, Spirit and Scheme of the Act

The company form of organisation normally envisages that a large number of shareholders, by contributing capital or intellectual property, set up business, managers administer business and directors representing shareholders oversee the management of business, and managers in the course of managing business become directors and also acquire shares as part of their remuneration. Large private businesses also operate under the company form of organisation for limiting liability. Hence, directors lay down the policy framework, managers manages business and surplus or profit generated is distributed among shareholders as dividend, remuneration among directors and managers. Directors oversee the functioning of business within policy parameters by virtue of reports which are reviewed in multiple meetings and shareholders oversee functioning and performance through the service of notices and annual accounts; meetings are held with the right to speak.

It is a fundamental philosophy of the Act that shareholders investing their capital shall have the right to vote. The voting right with show of hands is counted in terms of numbers for the purpose of majority, disregarding the capital invested by shareholders. However, voting on poll is in proportion to the capital invested by shareholders. Hence, higher amount of invested capital will mean higher value of vote, in case of poll in a general meeting. All the shareholders have a right to personally participate, speak and vote on various resolutions proposed in the meetings. This fundamental principle is known as *corporate democracy*. Likewise, certain powers are exclusively reserved for the consideration of shareholders in meetings under Section 180 of the Act. Such a democratic mode and powers of shareholders cannot be taken away by the articles of entrenchment.

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Shareholders may be large in number and lack expertise in managing complex businesses, which necessitates employing directors and key managerial personnel having whole or substantially whole management of affairs of the company. Hence, the board of directors represents the interests of providers of capital and managers provide expertise to manage the business. Directors and managers should act in fiduciary capacity and avoid conflicting situations by balancing such interests; in this regard, Section 166 of the Act incorporates the duties of directors. The Act has also reinvigorated the concept of independent directors pioneered by the Listing Agreement. Provisions of the Act provide independence, ensure objectivity and check and balance through independent directors in governance and functioning of company, which is strengthened by the code for independent directors in the Schedule IV to the Act that regulates the role, functions, duties, selection, appointment, eligibility, resignation and removal including functioning and evaluation. Thus, specific and general duties prescribed for the independent directors have the all pervasive effect on the governance of a company.

The Act has not only laid down the duties of a board through its Section 166, unlike the previous Companies Act, 1956, the Act (2013) has by virtue of *proviso* to the Section 179(1) has provided various limitations in respect of the procedure of exercise of powers of a board. Section 106(3) provides the mode of exercise of voting differently by the same person for shareholding representing different interests. Section 194 provides a prohibition on the rights of directors to enter into a forward contract for purchase or sale of shares of a company. Section 195

prohibits insider trading and Section 185 prohibits loans to directors and restrictions on their powers including their remuneration. Private companies are authorised to add more criteria for disqualification according to the Section 164(3). In view of these features of the Act, regulations in the articles of entrenchment cannot override the aforesaid framework of governance according to the Act.

Case Law on Areas of Entrenchment under Companies Act, 1956

Case laws regarding the byelaws governing the rights of shareholders through the articles have been dealt by various courts. Following issues have emerged:

1. *State of Karnataka vs. Mysore Coffee Curing Works Ltd. [55 company cases 70]:* The state of Karnataka was having the right to nominate directors including the chairman in the respondent company due to the shareholding agreement. However, such a majority shareholding has gone down to a minority and the right of state of Karnataka to nominate directors and chairman was challenged. It was held that the right has flowed from the agreement and hence, unless the operation of agreement is made conditional upon the majority of shareholding, such right emanating from the agreement cannot be taken away.
2. *V. B. Rangrajan vs. V. B. Gopalkrishna A.I.R. 1992SC543:* It is a case of a private company and its shareholders were from one family. The agreement between them prohibited the transfer of shares absolutely; such prohibition was held to be void as per the Companies Act, 1956, as the prohibition to transfer was absolute.
3. (i) *Mafatlal Industries Ltd. vs. Gujarat Gas Co. Ltd. [97 Company cases 301(Guj.)]*
   (ii) *Pushpa Katoch vs. Manu Maharani Hotels Ltd. [131 Company cases 42 (Del.)]*
   (iii) *Western Maharashtra Development Corp. Ltd. vs. Bajaj Auto Ltd. [154 Company cases 593 (Bom.)]*
   (iv) *Madhusoodanam vs. Kerala Kaumudi (P.) Ltd. [117 Company cases 19 (Ker.)]*

The first three cases relate to public limited companies, and any restriction on the transfer of shares by public limited companies even by consensual private agreement are considered to be void, as it has been held that there should not be any restriction on the transfer of shares of public limited companies. Likewise in the fourth case, since it was a private company, it is distinguished from the second case where the restriction on transfer was considered absolute, while in the fourth case, that was considered limited. Hence, such restriction on transfer was held to be legally enforceable.

An identical controversy of restriction on the transfer of shares of public companies in *M/s. Messers Holdings Ltd. vs. Shyam Madan Mohan Ruia [159 company cases 29 (Bom.)]* said restriction was held to be valid and enforceable, independent from the articles of association only amongst the shareholders by the High Court. Such controversy has failed to stand the test before the Supreme Court and the said judgment of Bombay High court appears to have been reversed.

4. *Rolta India Ltd. vs. Venire Industries Ltd. [100 Company cases 19 (Bom.)]:* Any restriction on the rights of directors cannot restrict the exercise of rights to be exercised in fiduciary capacity.
5. *Master Gautam R. Padivial vs. Karnataka Theatres Ltd. [100 Company cases 124 (Kern.)]:* The issue pertaining to restriction on the right to vote to the extent of 1/10th of share holding has been held to be legally enforceable.
6. *Mohta A & S works vs. Mohta Finance & Leasing Co. Ltd. [89 Company cases 227(Kol.)]:* Articles in practice can contain the widest possible powers of delegation both to individual directors and other agents chosen by the board.
7. *Baker Hughes Ltd. vs. Hiroo Khushlani [102 Company cases 203 (Bom.)]:* An Indian joint venture company having the right to use the name of a foreign company by virtue of the joint venture agreement, conditional upon 40% shareholding of the foreign company in the Indian company, such shareholding was sold and foreign company instituted suit to restrain joint venture company from using the foreign name, though the articles of association have no such clause of restraint. But a restraint from the use of trademark was granted to the Indian joint venture company in view of the provisions of the Trade Marks Act on account of the illegitimate passing off.

Section 195 prohibits insider trading and Section 185 prohibits loans to directors and restrictions on their powers including their remuneration. Private companies are authorised to add more criteria for disqualification according to the Section 164(3).

Thus, the Companies Act, 1956 and the courts were categorical regarding any prohibition on the transfer of shares which appear to have been removed under Section 58(1) and (2) of the Act, and even private agreements as to restrictions on the transfer of share are enforceable. Restriction in the articles on fiduciary powers of directors is not removed in the Act.

8. *IL & FS Trust Co. Ltd. vs. Birla Perucchini Ltd. [121 Company cases 335 (Bom.)]:* The law is well-settled that subject to the provisions of the Companies Act, 1956, a company and its members are bound by the provisions contained in its articles of association. The articles regulate the internal management of the company and define the powers of its officers. The articles also establish a contract between the company and members and between the members *inter se*. The contract governs the ordinary rights and obligations incidental to the membership in the company.

A distinction exists between a case where special voting rights are conferred on a particular class of shares and a situation where a provision is made that no alterations can be made in the articles without the consent of a particular person. The conferment of special voting rights does not deprive the company of power to alter its articles. The position is different, if it is provided that the alteration of articles cannot be made without the consent of a particular person.

There was a subscription *cum* shareholders agreement between the parties and by virtue of such agreement, Rs. 8/- crore were invested in optionally convertible preference shares. According to the articles, shareholders are authorised to nominate directors in proportion to their capital and such directors have, unless sought leave of absence, to be part of the quorum and their affirmative vote is essential in the appointment of further directors from the shareholders or from any member of the public and for adopting and approval of accounts. Appointment of further directors and approval of accounts in the absence of affirmative vote of such directors in meeting are invalid acts.

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Provisions Governing Articles of Entrenchment

In order to elucidate the concept of entrenchment, it is also necessary to go into the contextual provisions of company law in the Act, for laying down appropriate boundaries of scope and width of entrenchment. Such provisions are contained in:

(A) Provisions of Entrenchment

Section 5(2), (3) and (4) enacts the enabling provisions of entrenchment and provides that

(i) Articles may contain provisions for entrenchment;

(ii) That said articles can be altered only if conditions as that are more restrictive than those applicable in case of special resolution are specified;

(iii) Such articles shall be incorporated either at the time of formation of company or subsequently thereof in articles if agreed to by all members in case of private company and by a special resolution in case of public company;

(iv) Information of such article of entrenchment either on formation of company or its amendment has to be given to registrar of companies;

(B) Enabling Provisions of Entrenchment

(v) Section 179(1) lays down the enabling provisions for different procedures like approval in general meeting to be followed for exercise of powers by directors;

(vi) Section 58(1) and (2) lays down the powers to restrict the right to transfer shares in public and private companies by a separate contract which are now enforceable;

(vii) Definition of control indicate mode of embodying right of control either by way of resolution or by agreement or by regulation in the articles; and

(viii) Section 106(3) indicates the mode of exercise of voting in respect of shareholding by an individual representing different capacities for whole of shareholding and not in identical manner for whole of shareholding.

In case Section 5(2) of the Act has connected words with first condition that the articles may contain provisions for entrenchment by the phrase *to the effect* to second condition. Phrase to the effect, according to the Stroud's Judicial Dictionary, means *form, tenor, in accordance, with form, manner* and hence, if words in accordance with are read connecting first and second condition in the Section 5(2), it implies that the amending articles of entrenchment must be in accordance with conditions which are more restrictive than special resolution. Therefore, the conditions of amendment of articles of entrenchment are cumulative with the first condition and mandatory and all four conditions are cumulative. Hence, Section 5(2) implies that all articles of entrenchment should have procedure of amendment more restrictive than those applicable in case of special resolution. Hence, the power of amendment of articles of entrenchment can be exercised with affirmative votes of particular director or group of directors or with unanimous consent of all directors or subject to veto power by particular director. However, the articles for entrenchment shall always have to be *conterminous* with the scope and effect with primary understanding of parties as to particular project including the regulation of amendment of such articles. Hence, its drafting shall always be dependent upon facts of each case and it is most creative and imaginative application of knowledge of company law, which balances the interest of various groups and incorporates their understanding into the articles of entrenchment for successful working and governance of a company. If such articles are not properly drafted, it can result into a deadlock in the functioning of a company due to serious misunderstanding. Hence, ascertaining appropriate intent of parties and their drafting accordingly shall also play a key role. It is not a tool merely to protect the interests of the majority shareholders but also for minority ones. Shareholders can also use such articles for strengthening the governance of a company.

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Areas of Articles of Entrenchment

As we have adverted to the scheme of Act, normally the articles of entrenchment should not interfere and abrogate or control and/or vary procedures for exercise of:

(a) Rights of shareholders to participate and vote at meetings on subjects according to law or as decided to be laid before general meeting;
(b) Fiduciary capacity of directors, duties and power of directors to be exercised in meeting;
(c) Fiduciary capacity, duties and mandatory participation of independent directors in matters laid down in law;
(d) Constitution and functioning of audit committee, remuneration committee, shareholders relation committee, vigilance mechanism and participation of independent directors in meetings authorising related party contracts; and
(e) Restrictions on the powers of directors under Sections 179, 180, 182, 185, 186, 187, 188, 191 and 192, and prohibition contained in Sections 194 and 195, and restrictions relating to remuneration.

The aforesaid fundamental pillars of governance have to be adhered to for the drafting of articles of entrenchment, or the purported article of entrenchment shall be void according to Section 6 of the Act. Case laws based on previous Companies Act, 1956 do not throw more light on the mode of entrenchment. However, the Act (of 2013), has various enabling provisions which not only enables but throws light on areas where the articles of entrenchment can exit.

However, after looking into the limitations and enabling provisions under the Act, the following areas are still open for the articles of entrenchment:

(a) Appointment of directors, affirmative voting of directors on particular items of agenda in meeting, participation in quorum.
(b) Appointment of chairman or vice chairman and affirmative voting in the event of exercise of casting vote.
(c) Managerial decisions:
  (i) Increase in capital
  (ii) Diversification of business by acquisition of new company, divestment or demerger or joint venture, or adopting new product line or services or forming consortium or abandoning

particular product line or services or setting up new production facilities or service facilities or opening branch in foreign countries or setting up of subsidiaries in India or outside India or amalgamation or substantial capital expenditure for tangible and intangible assets

(iii) Dividend distribution

(iv) Appointment of key managerial personnel or other managerial or functional heads

(v) Acquisition of new technology, know how or any intellectual property rights in any form or initiating research and development for new product or restructuring requiring substantial investment

(vi) Policy pertaining to all regulatory and statutory matters as well as for functioning and operation of business such as environment labour laws, internal audit, *etc.*, excluding all routine, ministerial and administrative repetitive tasks

(vii) Services of notice to directors for board meeting

(d) Exit of shareholder and exercise of right of first refusal, drag along, tag along, valuation of shares including call and put option, *etc.*;

(e) Procedure for amendment of articles of entrenchment may lay down procedure of affirmative votes or unanimous consent or exercise of veto power.

Thus, the aforesaid areas may be covered in the articles of entrenchment, which shall almost include all matters of control to protect substantial amount of money invested by any investor or developer of any intellectual property rights in the course of carrying of business, still the facts of each case may dictate various other areas for articles of entrenchment according to the provisions in the Act. ■

(**Disclaimer:** This article attempts to broadly analyse the provisions of entrenchment as contained in the Companies Act, 2013 and this analysis may be applied after ascertaining the facts and understanding among the parties *vis-à-vis* independent analysis of provisions in its entirety with the help of a legal counsel only.)