

## NUANCES RELATING TO PREFERENCE SHARES IN INDIA

### Introduction

Under India's Companies Act, 1956 (the "Act"), share capital of a company is categorized into preference and equity shares. Preference shares are that part of a company's share capital which carry a preferential right to:

dividend at a fixed rate or amount; and  
repayment of capital in case of winding-up of the company.

Share capital which is not preference share capital is regarded as equity share capital. (Section 85 of the Act). Preference shares convertible at a later date into equity shares are known as convertible preference shares. Preference shares which do not carry any conversion option are known as non-convertible preference shares.

### Private companies and preference shares

All the rights and limitations with regard to preference shares are applicable only to a public company or a private company which is a subsidiary of a public company. (Section 90 of the Act). This essentially means that a private company is free to create and issue any kind of share capital and on any terms as it may deem fit. Therefore, a private company, through its articles of association, may create preference shares that carry the same or even extra rights as compared to equity shares.

However, if a private company goes public, preference shares issued with higher rights will have to be redeemed or restructured to comply with the Act. Therefore, private equity transactions in Indian public companies are commonly structured as equity investments with a small component of preference shares. This also applies to private companies, where the investor seeks an IPO exit.

### **Advantages of preference shares**

As stated above, the main advantage of preference shares over equity shares is that they enjoy a preferential right to dividend and repayment of capital in case of winding-up of the company.

Another advantage is with regard to takeovers. Under the Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeovers) Regulations, 1997 (the “Takeover Regulations”), a person who acquires 15% or more in a listed company’s equity share capital is required to make an open offer to acquire a further 20% equity shares from the shareholders of such company at a price calculated in accordance with the Takeover Regulations. (Regulation 10 of the Takeover Regulations). However, a person acquiring preference shares need not comply with these regulations. (*See* the definition of “Shares” under Regulation 2(1)(k) of the Takeover Regulations).

### **Disadvantages of preference shares**

The main drawback of preference shares is that they carry limited voting rights. Generally, an equity share confers on its holder a right to vote on all resolutions that require shareholder approval under the Act, any other law, or the articles of association of the company. Equity shareholders, among others, enjoy the right to appoint and remove directors and auditors, and approve the company’s accounts. Therefore, the control of a company is in the hands of its equity shareholders.

As distinguished from an equity share, a preference share carries voting rights only with respect to matters which directly affect the rights of the preference shareholders. In this regard, the Act clarifies a resolution relating to winding-up and repayment or reduction of capital is deemed to directly affect the rights of the preference shareholders. (Section 87(2)(a) of the Act).

Due to these limitations on voting rights, a preference shareholder does not have much control over the company. However, a preference shareholder may acquire voting rights on par with an equity shareholder if the dividend on preference shares is in arrears:

in case of cumulative preference shares, for an aggregate period of not less than two years on the date of the meeting (cumulative preference shares are preference shares on which the unpaid dividend accumulates as arrears); and

in case of non-cumulative preference shares:

for not less than two financial years immediately preceding the meeting; or

for any three years, during a period of six years ending with the financial year preceding the meeting. (Section 85(2)(b) of the Act).

The other drawback of preference shares is that they have to be redeemed within twenty years from their issue. (Section 80(5A) of the Act).

### **Foreign investment and preference shares**

The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (the “Regulations”) prescribes limits on the ownership of an Indian company’s shares by a foreign company depending on the sector. Preference shares are now included in calculating such limits. Also, the rate of dividend payable to a foreign company on preference shares issued by an Indian company cannot exceed 300 basis points over the prime lending rate of the State Bank of India prevailing as on the date of the board meeting on which issue of preference shares was recommended. (Clause 7 of Schedule I of the Regulations).

Further, in certain sectors, the preference share route is not available to foreign investors at all. For instance, the Insurance Act, 1938, prohibits life insurance companies from issuing preference shares. Similarly, the Banking Regulation Act, 1949, prohibits banks from issuing preference shares. However, the Banking Regulation (Amendment) Bill, 2005, proposes to permit banks to issue preference shares subject to the condition that preference shareholders will not acquire voting rights if the bank defaults in the payment of dividend.

### **Conclusion**

Preference shares can be tailored to give control to an investor in a private company by contract and through the company’s articles of association. However,

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preference shareholders will not be able to control a public company or a private company that will be doing an IPO. In the circumstances, deals in India involve a significant equity component.