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PREFERENCE SHARES

9.1 Introduction

One of the types of shares which a company can issue is Preference Shares. However, they are not used as commonly as equity shares. This is unlike in the USA, where preference shares or preferred stock is an extremely popular means of capital structuring. Preference shares offer a lot of flexibility in transaction structuring and hence, they are very attractive. As stated earlier, preference shares are distinct from a preferential issue of shares and the two should not be confused. Nowadays, several companies have issued bonus preference shares to their equity shareholders. They are also increasingly being used in joint ventures, foreign collaborations, private equity/ venture capital funding, etc.

9.2 Companies Act

9.2.1 The source legislation from which preference shares derive their existence is the Companies Act, 1956. S.85 of the Act recognises that a company can issue two types of shares – equity and preference. The meaning of preference share capital is that part of the capital which carries two preferential rights. Firstly, as to dividend and secondly, as to repayment of the capital in the case of a winding-up of the company. Thus, in case a company has preference shares in addition to equity shares, then the preference shares have a priority over the equity shares in terms of dividend and winding-up proceeds. Preference shares may be of several types, which would depend upon their terms of issue:

- Cumulative or Non-cumulative: In case of Cumulative preference shares, the shares carry a right to receive arrears of dividends declared but not paid during the preceding years. Non-cumulative shares do not have this right.
- Participating or Non-participating: In case of Participating preference shares, the shares carry a right to share in the dividend which is declared to equity shareholders after paying off the fixed dividend to preference shares. They would also participate in the surplus on winding-up. Non-participating shares do not have this right.

- Convertible or Non-convertible: Convertible preference shares are those preference shares which are compulsorily convertible into equity shares either at a given point of time or on the happening of certain events. Once the shares are converted, there is no obligation on the part of the company to redeem them since they are no longer preference shares. Non-convertible shares cannot be so converted and hence, have to be redeemed.
- Optionally Convertible or Compulsorily convertible: Optionally convertible preference shares are those preference shares which carry an option to be converted into equity shares. The option of conversion may be given either with the company or with the shareholder or it may be a combination. Compulsorily convertible Preference Shares are those shares, which once the shares are converted, there is no obligation on the part of the company to redeem them since they are no longer preference shares.

9.2.2 The key provisions of the Companies Act which could impact the use of preference shares as a tool for capital structuring are as follows:

(a) Cumulative preference shares would carry a voting right if the dividend on such shares has remained unpaid for a period of not less than 2 years preceding the date of the General Meeting at which any resolution is put to vote. All other preference shares would carry a voting right if the dividend on such shares has remained unpaid either for 2 years immediately preceding the General Meeting or for 3 years during 6 years ending with the financial year preceding the Meeting. The voting rights are in the proportion of the paid-up value of the preference capital to the total paid-up equity capital.

(b) Preference shares can be issued at a premium. The premium must be credited to share premium account.

(c) Preference shares must be compulsorily redeemed at the end of 20 years. Hence, the maximum tenure for any preference share can be 20 years. Earlier, it was possible to issue irredeemable preference shares. However, redemption would not be required if the shares are converted prior to the tenure into equity shares.

(d) On redemption of preference shares, the company must create a Capital Redemption Reserve or CRR out of the profits of the company which are available for dividend distribution. CRR is required only to the extent of the face value of the preference shares to be redeemed. CRR is not required if the redemption is made out of the proceeds of a fresh issue. The fresh issue could be of equity or preference shares. CRR is also not required in respect of the premium on redemption of preference shares. The premium component can be redeemed out of the share premium account standing in the company’s books.

CRR is treated as the capital of the company and it can be used for issuing fully paid-up bonus shares. CRR can also be subject to capital reduction as provided u/ss. 100-104 of the Companies Act.

(e) There is no cap on the rate of dividend on preference shares. However, there is a cap under the FEMA Regulations (see para 9.4.2).

9.3 SEBI Guidelines

9.3.1 An IPO or a Public Issue or a Rights Issue could be of equity or preference shares. In case the public issue is of preference shares, then the requirements regarding public issues, stated elsewhere in the book, would apply.

9.3.2 The SEBI DIP Guidelines on preferential issue would apply to a preferential issue of convertible preference shares. In case of a preferential issue by a listed company of compulsorily/ optionally convertible preference shares, the provisions of the SEBI DIP Guidelines on preferential allotment would apply.

9.3.3 Preference shares would be covered within the definition of the term securities in s. 2(h) of the Securities Contract (Regulation) Act, 1956.

9.3.4 Under the SEBI Takeover Regulations, preference shares are not treated as shares. Hence, the acquisition of preference shares per se would not attract the Takeover Regulations. However, in case of convertible preference shares, the impact of the Takeover Regulations would need to be examined at the time of conversion.

9.4 FEMA

9.4.1 The FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, recognise that FDI by a foreign investor in a company could also be in the form of preference or convertible preference shares. In case it is an FDI then the company would also need to comply with the provisions of the Foreign Exchange Management Act and its Regulations and the FIPB Policy in this respect (see Chapter 19 on FDI Policy).

9.4.2 Some specific provisions in the FEMA Regulations/ FIPB policy which impact preference shares are as follows:

(a) The dividend on preference shares cannot exceed the Prime Lending Rate of State Bank of India + 3%. The Rate to be selected is that rate as existing on the date of the Board Meeting, of the issuer company, at which the issue of preference shares was recommended. Thus, if the prime lending rate if 10% then the maximum preference dividend payable to a foreign investor would be 13%.

(b) The Department of Economic Affairs, Ministry of Finance as well as the FIPB Policy Manual have provided that preference shares would be treated as Equity Shares for reckoning the FDI Sectoral Caps only if they are fully covertible. If they do not carry such an option they will fall outside Sectoral Caps. Recently, the Ministry has provided that if such Preference Shares are non-convertible shares, then they would be treated as External Commercial Borrowings. The amendment provides that optionally convertible, partially convertible and non-convertible preference shares would be treated as ECBs and would have to conform to the ECB Guidelines. Hence, the earlier route of treating non-convertible preference shares as quasi-equity has been done away with since they would now be treated as debt.

9.5 Takeover Regulations

Preference Shares are not treated as shares under the Takeover Regulations. Hence, acquisition of preference shares in a listed company does not trigger the Takeover Regulations. In case of convertible preference shares, the Takeover Regulations and the requirements thereunder get triggered from the date of conversion of the shares into equity shares.