

## COMPANY LAW

### DIFFERENTIAL VOTING RIGHTS SHARES - NIPPED IN THE BUD

RAJESH RELAN\*

**S**ection 86 of the Companies Act, 1956 was amended with effect from 13-12-2000 whereby issue of differential shares was permitted. Where the voting rights on new shares are different from the voting rights on the equity shares already issued, the new shares are known as Differential Voting Rights Shares (DVRS). A company can issue new equity shares with higher or lower voting rights as compared to the rule of one share one vote applicable for the existing equity shares. This write-up deliberates upon law relating to differential voting rights shares.

#### Introduction

1. One of the basic characteristics of a public limited company is the separation of ownership and management. The day-to-day activities of a company are looked after by the professional management team, which acts as an agent of the owners, *i.e.*, equity shareholders. The management has to obtain prior approval of the equity shareholders for various matters. The equity shareholders possess voting rights and through these voting rights they collectively approve or disapprove the matters that are placed before them for their consideration and approval. The voting rights are directly proportional to the number of equity shares held by the shareholders, *i.e.*, the rule of one share one vote is applicable.

Section 86 of the Companies Act, 1956 was amended with effect from December 13, 2000, whereby issue of differential shares was permitted. The amended provision of the Act classifies the equity share capital into two kinds, *viz.*—

- ◆ equity share capital with voting rights
- ◆ equity share capital with differential rights as to dividend, voting or otherwise.

#### Concept of differential voting rights shares

2. Where the voting rights on new shares are different from the voting rights on the equity shares already issued, the new shares are known as differential voting rights shares (DVRS). A company can issue new equity shares with higher or lower voting rights as compared to the rule of one

\*The author is a Company Secretary.

share one vote applicable for the existing equity shares. For example, it can issue new shares where the voting right may be just one vote for every ten shares held, which are known as shares with inferior voting rights. It is also possible to issue shares where the voting right may be ten or twenty votes for each share, which is called shares with superior voting rights.

DVRS are different from non-voting shares because section 87(1) of the Act states that all the equity shares shall carry voting rights. Hence, the Indian companies cannot issue non-voting shares.

### **Pre-conditions for issue of DVRS**

3. The Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 notified by the Central Government provide that the following conditions must be fulfilled by a company before it can issue equity shares with differential voting rights:—

- ◆ The company has distributable profits, which can be used for payment of dividend, during the last three financial years preceding the year in which it is proposed to issue DVRS.
- ◆ The company has not defaulted in filing annual accounts and annual returns in the immediately preceding three financial years.
- ◆ The company has not failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay declared dividend.
- ◆ The Articles of Association of the company must authorize the issue of shares with differential voting rights. If the articles do not authorize, they have to be altered before the issuance of such shares.
- ◆ The company has not defaulted in meeting investors' grievances.
- ◆ The company has obtained the approval of its shareholders by passing a special resolution at a general meeting. Listed companies have to obtain approval of the shareholders by means of a special resolution passed through postal ballot.
- ◆ The notice of the general meeting/postal ballot notice must contain an explanatory statement stating—
  - (a) The rate of voting rights which the equity share capital with differential voting rights shall carry;
  - (b) the company shall not convert its existing equity capital with normal voting rights into equity share capital with differential voting rights and *vice versa*;
  - (c) the quantum of share capital with differential voting rights shall not exceed 25 per cent of the total issued share capital;

- (d) that a member of the company holding any equity shares with differential voting rights shall be entitled to bonus shares, rights shares of the same class; and
- (e) the holders of equity shares with differential voting rights shall enjoy all other rights to which the normal equity shareholders are entitled to, except the right to vote as indicated in (a) above.

### **Advantages of DVRS**

4. Superior voting rights shares enable the promoter group to enhance their voting rights at lesser cost and thus gain/retain complete control over the company with fewer shares/lesser investment. Thus, the promoters can altogether eliminate the possibility of hostile takeovers even if they dilute their shareholding in the company by issuing further equity shares to raise funds for expansion/diversification projects, etc. This is because they would be holding DVRS which would substantially increase their voting power.

On the other hand, the shares with inferior voting rights are meant for issue to the public shareholders since they are not much concerned about the voting rights to be exercised at AGM/EGM or through postal ballot. The basic aim of retail investors is capital appreciation and reaping steady dividends, which can be achieved through DVRS also. Rather, rate of dividend on DVRS, with inferior voting rights, is more than the normal equity shares.

### **Disadvantages of DVRS**

5. A major disadvantage of DVRS, with superior voting rights, is the possible misuse of the voting power by the promoters. The promoters may act against the interests of the public shareholders since their voting power becomes disproportionate to their economic interest/ownership in the company. The public and the institutional investors may not be in a position to put fetters on the powers of the promoter group.

Thus, the issue of DVRS to promoters shatters the foundation of corporate democracy, which is enshrined in the rule of 'one share one vote'. This may ultimately lead to lack of transparency in the business operations. The institutional investors may also not like to invest in the companies where the promoters hold superior voting rights shares due to the apprehension that the promoters' actions may not be in the best interests of the company. Lack of interest and confidence of institutional investors diminishes the chances of capital appreciation.

### **Issue of DVRS by Indian companies**

6. DVRS are quite popular in foreign countries. Some of the global giants that have issued DVRS include Berkshire Hathaway, Google and Newscorp.

However, DVRS have not yet become popular in India despite the fact that they have been on the statute book since the past more than nine years. In November 2008, Tata Motors Limited issued 6.4 crore equity shares with differential voting rights as a part of its Rs. 4,145 crore rights issue to pay back the loan taken for the acquisition of Jaguar-Land Rover. The rights issue portion comprising of normal equity shares was priced at Rs. 340 per share whereas the DVRS with 1:10 voting rights were priced at Rs. 305 per share, *i.e.*, at a discount of 10.29 per cent.

In February 2009, Pantaloon Retail (India) Ltd. issued bonus equity shares with differential voting rights to the existing equity shareholders of the company in the ratio of one bonus DVRS for every ten equity shares held. These bonus DVRS were termed as 'Class B shares'. Ten Class B shares entitled the holders thereof to cast one vote. The main benefit of DVRS is that they provide better return in terms of dividend. DVRS of Tata Motors as well as Pantaloon are entitled to additional 5 per cent dividend over and above the rate of dividend proposed for payment on the normal equity shares in any financial year. Gujarat NRE Coke Ltd. has also issued bonus DVRS 'Class B shares' to the existing equity shareholders of the company in the ratio of one bonus DVR for every ten equity shares held. Thus, so far only 3 Indian companies have issued DVRS that have got listed on the stock exchanges.

Trading volume in the DVRS of Tata Motors as compared to the normal equity shares of Tata Motors is not much. This may be due to the lack of awareness among the retail investors and also because the institutional investors do not like to invest in inferior voting rights shares. The DVRS of Tata Motors are trading at BSE (Scrip Code : 570001) and NSE (Trading Symbol: TATAMTRDVR) at discount ranging between 30 per cent and 40 per cent to the price of normal equity shares from past many months. It may be noted that the company had issued DVRS only at a discount of 10.29 per cent to the price of normal equity shares prevailing at that time. Whether such a steep discount is justified in view of the 1:10 voting rights on DVRS is a million dollar question.

### **Listing of DVRS at stock exchanges**

7. The SEBI had amended the erstwhile the SEBI (Disclosure and Investor Protection) Guidelines, 2000 with effect from February 24, 2009 by inserting a new clause 8.3.5.2 in order to facilitate listing of DVRS at the stock exchanges. A listed company may get its DVRS listed on the stock exchanges if it satisfies the following conditions :

- ◆ Such equity shares have been issued to all the existing shareholders by way of rights or bonus issue;
- ◆ the issuer company has complied with the conditions of minimum public shareholding not only with respect to the equity shares

already listed but also with respect to the equity shares with differential rights proposed to be listed; and

- ◆ the issuer undertakes to disclose the shareholding pattern of the equity shares with differential rights separately under clause 35 of the Equity Listing Agreement.

The SEBI (DIP) Guidelines have been replaced with the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 with effect from August 25, 2009. Therefore, the aforesaid provisions for listing of DVRS on stock exchanges have been issued afresh by way of a Circular dated September 3, 2009.

### **Shady issue of DVRS by one company taints the instrument's image**

8. There is no doubt in the fact that DVRS are an innovative financial instrument. However, DVRS came in the eye of a storm when Jagatjit Industries Ltd. (JIL) issued superior voting rights shares carrying voting rights in the ratio of 20 votes for each share to its promoter Karamjit Jaiswal and his company, LP Jaiswal & Sons (P.) Ltd., who together held 23.59 per cent equity stake before such issue. After the issue of DVRS, by way of preferential allotment, their combined stake in JIL increased to 32.1 per cent but since these shares conferred on them superior voting rights their corresponding voting rights/voting power jumped to 62 per cent, thereby giving Mr. Karamjit Jaiswal complete control over the company.

Meanwhile, his brothers, Anand Jaiswal and Jagatjit Jaiswal, who together held 12 per cent stake in JIL were aggrieved by the issue of the aforesaid DVRS. They filed a petition before the Company Law Board (CLB) to declare the shareholders' resolution passed on June 16, 2004 for issue of DVRS as *null and void*. The CLB concluded that the issue of differential voting rights shares is permissible under section 86 of the Companies Act read with the Rules prescribed by the Central Government. Accordingly, the CLB in its verdict delivered on March 12, 2009 upheld the validity of the shareholders' resolution. However, the DVRS issued by JIL could not be listed on the stock exchanges since they were issued to the promoters on preferential basis and not by way of rights or bonus issue as stipulated under the aforesaid SEBI Guidelines/Circular.

### **DVRS get SEBI's thrashing**

9. Subsequent to the aforesaid CLB ruling, the SEBI changed the rules of the game in order to provide a level playing field to the public shareholders. The SEBI at its Board meeting held on June 18, 2009 proposed that no listed company can issue equity shares with superior voting rights. The SEBI apprehended that the precedence set by JIL may be followed by the promoters of other listed companies also to increase their voting power

through preferential allotment of DVRS. Further, the pricing formula for preferential allotment of shares, *i.e.*, average of the closing price of the shares at the stock exchange during the last 26 weeks or last two weeks preceding the relevant date, whichever is higher, cannot be applied as it is for the issue of DVRS because the issue of superior voting rights shares on preferential basis considerably dilutes the voting power of the other shareholders *vis-a-vis* the promoter group.

The SEBI issued a Circular on July 21, 2009 instructing the stock exchanges to amend the equity listing agreement by inserting a new clause 28A thereby prohibiting issue of shares which may confer on any person, superior rights as to voting or dividend *vis-a-vis* the rights on equity shares that are already listed.

In other words, the listed companies have been forbidden from issuing not only superior voting rights shares but also inferior voting rights shares if such inferior voting rights shares confer on the holders thereof superior dividend rights. Inferior voting rights shares would always carry higher dividend rate in order to make them attractive for the investors, otherwise why would investors subscribe to such shares? It may be noted that whenever higher dividend rate would be offered on new shares with inferior voting rights, it would tantamount to contravention of clause 28A of the listing agreement because clause 28A prohibits issue of shares which would confer on the holder superior rights as to dividend *vis-a-vis* the dividend on the already listed equity shares.

Thus, the aforesaid amendment has not only altogether banned the issue of superior voting rights shares but also marred to a great extent the possibility of issue of inferior voting rights shares. Whether the aforesaid treatment meted out to the inferior voting rights shares is intentional or unintentional is not ascertainable. Although the DVRS issued by Tata Motors and Pantaloon Retail entitle the holders thereof to an additional 5 per cent dividend over and above the dividend paid on the normal equity shares, nonetheless they are valid since they were issued before the amendment in the listing agreement. However, henceforth no listed company can issue DVRS on the same terms and conditions, as issued by Tata Motors and Pantaloon, because although these DVRS would carry fewer voting rights (1:10) but they would entitle their holder to 5 per cent additional dividend every year over and above the dividend paid on the normal equity shares. The culprit in the entire episode of JIL was superior rights shares and, thus, imposing a blanket ban on inferior voting rights shares does not seem to be justified.

### **Proposal under the Companies Bill, 2009**

10. The Companies Bill, 2009, which was introduced in the Lok Sabha on August 3, 2009, also proposes to do away with the concept of equity shares

with differential voting rights. Accordingly, unlisted companies will also not be able to issue DVRS once the new Companies Act is enacted. Thus, we can say that DVRS are proposed to be nipped in the bud.

### Conclusion

11. The issuance of DVRS, whether with superior or inferior voting rights, is not bad *per se*. The only thing is that such instruments should not be exclusively issued to the constituents of the promoter group as was done in the case of JIL. Suppose, if superior voting rights shares are held by unbiased institutional investors, then perhaps they can exercise better control over the activities of the promoter group, which will be in the interest of all the stakeholders. Hence, DVRS should not be done away with completely.

The shares with inferior voting rights may be beneficial for the retail investors as these shares would not only be issued at a discount to the prevailing market price of the normal equity shares but also provide better dividend yield. Moreover, the inferior voting rights shares are not prone to misuse as compared to the shares with superior voting rights since they are issued to the investors at large. Thus, instead of restricting the scope for issue of differential voting rights shares by listed companies as per clause 28A of the listing agreement and by the unlisted companies as proposed in the Companies Bill, 2009, it would be appropriate if suitable provisions are made by the Government for issue of shares with inferior voting rights but higher dividend rate to the public shareholders.

26-SCL