THE HINDU Business Line
Business Daily from THE HINDU group of publications
Wednesday, Aug 19, 2009

Why blanket ban on shares with differential voting rights?

Shikhar Kacker
Nirvaan Gupta
Kartik Ganapathy

The financial crisis has made a strong case for putting in place superior corporate governance standards. The corporate world's obsession with profit has obscured the jurisprudential principle of balancing rights with reciprocal duties. To maximise returns, rights have been increasingly carved out in favour of a select few, be it the controlling shareholder or financial investors or borrowers. Today, legislatures and regulators worldwide are faced with the challenge of resetting this balance of rights to protect minority shareholders, without unduly fettering majority shareholders.

However, the recent move in India against shares with differential voting rights ("DVR shares"), for all its merits, could be a case of throwing out the baby with the bathwater.

CONTENTIOUS ISSUE

In line with the global sentiment on corporate governance which is focused on transparency and accountability, the Companies Bill, 2008, which is pending passage in Parliament, no longer allows any private or public company to issue equity shares (common stock) with differential voting rights. DVR shares are essentially equity shares of a company that entitle the shareholder to non-proportionate voting or dividend rights.

Further, the Securities and Exchange Board of India (SEBI), in its letter dated July 21, 2009, sent to all stock exchanges, has prohibited public listed companies from issuing shares with superior voting rights or dividends. As all existing listed companies have to remain compliant with the listing agreement, as amended from time to time, SEBI's move will imply that companies with DVR shares or shares with differential dividends will now be required to bring them at par with other shares. However, no time period for such action has been provided, and such an amendment is likely to be contentious in the case of companies that have already issued DVR shares.

The proposed change in the Companies Bill means that companies will no longer have achoice of instruments to suit various investment paradigms of investors. Generally, investors desire greater financial flexibility and/or management control. While in India, the notable examples of companies that have issued DVR Shares are Tata Motors and Pantaloon Retail, in the US, DVR shares have been issued by Google, Ford and Berkshire Hathaway.

The proposed change in the Companies Bill also denies the controlling shareholder in a company the ability to attain greater degree of control to ward-off takeover threats. DVR shares were held to be legitimate anti-takeover tools by the Company Law Board in its order dated March 12, 2009, when it approved the validity of special series equity shares carrying nil dividends and 20 voting rights per share. These shares allowed Mr Karamjit Jaiswal to gain majority control over Jagatjit Industries Ltd. and successfully abort the takeover of the company by his relatives.

However, regulators can argue that DVR shares distort the balance between rights and corresponding duties for a class of shareholders. DVR shareholders could oppress the minority or obstruct legitimate participation by other shareholders.

Having voting power without commensurate economic interest in a company poses the threat of (a) mismanagement (since the board may be easily replaced); (b) misuse of voting power as little or no financial loss may be incurred; and (c) poor corporate governance.

EXEMPT PVT COMPANIES

While the regulators' effort to balance the interests of majority and the minority shareholders is commendable, the rationale for limiting the ability to issue DVR shares by private companies or closely held public unlisted companies is not clear.

Private companies merit less intensive regulation, as they are normally held by a closed group. Moreover, financial investors feel the need to contractually mandate tighter governance in private companies as against public companies, since the latter offers a ready exit and immediate liquidity. Not continuing to allow DVR shares in private companies may project India's regulatory environment as being regressive and inflexible.

As regards widely-held companies, the proposed change in the Companies Act, and SEBI's letter regarding the amendment to the listing agreement, appears to protect shareholders from being marginalised through DVR shares.

It seems to minimise diminution in value of a company's shares, when the economic interest of the shareholders is divorced from controlling/voting interest. Consequently, banning DVR shares in public companies appears to have a strong rationale. Nevertheless, the regulator may consider allowing DVR shares even in public companies in special cases for the protection of financial interests, such as protection of financial investors' interests or lenders' rights.

Simple proportionate empowerment of public shareholders by abolishing DVR shares may not result in attaining a real balance of interest in favour of shareholders of a public listed company. This is due to the generally apathetic approach of a widely dispersed shareholder population.

Therefore, in addition to limiting the restriction on DVR shares to public listed companies, with suitable exceptions , the regulators also need to propose regulations which strike at the root of the problem — shareholder apathy.

(The authors work with the law firm Nishith Desai Associates. Their views are personal. blfeedback@thehindu.co.in)