

M&A Hotline

September 07, 2009

SECURITIES APPELLATE TRIBUNAL SANCTIFIES CONTROL THROUGH PREFERENCE SHARES

A recent order given by the Securities and Appellate Tribunal ("SAT") in the matter of Weizmann Fincorp Limited ("Company"), a company listed on the BSE, is likely to pave the way to a hitherto unexplored avenue for promoters to arrogate almost absolute control over a listed company to themselves, without delisting or making a mandatory open offer under the (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("Takeover Code").

BACKGROUND AND FACTS

Weizmann Limited, promoter of the Company ("Promoter") held 4,75,000 cumulative redeemable preference shares of the Company in addition to 65.67% of the equity shares of the Company that it held with persons acting in concert with it (together, "Promoters").

Preference shares held by the Promoter, under the provisions of Section 87(2)(b) of the Companies Act, 1956, stood vested with voting rights akin to an equity shareholder in the annual general meeting held on December 31, 2002 as dividend payable thereon remained unpaid for a period of two years preceding the meeting. Section 87(2)(b) of the Companies Act entitles a preference shareholder to vote on every resolution placed before the company at any meeting if the dividends due on the preference shares remain unpaid for an aggregate period of not less than 2 years preceding the date of commencement of the meeting.

As a result, voting rights of the Promoters stood enhanced from 65.67% to 98.32% at the annual general meeting of the Company held on December 31, 2002, which came to SEBI's notice only in 2007 when a public announcement was made by another acquirer to acquire shares of the Company.

To put things in perspective, the following dates will be important for a better understanding of the issues involved in this case.

Date	Event
December 31, 2001	Company declared dividends on the preference shares for the year closing on June 30, 2000 in its annual general meeting. No dividends paid thereafter
June 30, 2002	Dividends on preference shares remain due and unpaid for a period of two consecutive years
September 9, 2002	Preference shares excluded from the purview of the Takeover Code
December 30, 2002	Promoters are vested with the right to vote on every resolution placed before the Company

WHAT WAS THE ISSUE IN ESSENCE?

Essentially, since acquisition of any voting rights beyond 65.67% required a mandatory open offer to be made under the provisions of Regulation 11(1) of the (then applicable) Takeover Code, SEBI issued notices to the Promoters for enhancing voting rights to up to 98% without making the open offer.

Promoters, however, contended that since the voting rights were acquired at the general meeting of the Company after September 9, 2002 when preference shares were excluded from the purview of the Takeover Code, they were not obligated to make an open offer.

SEBI's view was that since dividends on preference shares became due and unpaid for two years on June 30, 2002, Promoters were entitled to voting rights immediately after June 30, 2002 and not on December 31, 2002 when the annual general meeting of the Company was held and thus the exclusion of preference shares was inapplicable at that point in time.

WHAT DID THE SAT RULE?

SAT observed that under Section 87(2)(b) a preference shareholder is entitled to vote only in a general meeting of the company. Accordingly, Promoters acquired voting rights only in December 2002 at the annual general meeting and not before. As preference shares were excluded from the purview of the Takeover Code in September, 2002, SAT ruled that the Promoters did not violate the provisions of Takeover Code as voting rights were acquired after September 9, 2002, and could not be considered to trigger the provisions of the Takeover Code.

SAT, explaining the rationale for its decision, further observed that the right to vote attached to preference shares is only temporary, which falls away on payment of dividends, and preference shares by virtue of such rights cannot be

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said to assume the color of equity shares. In essence, the SAT order completely excludes preference shares from the ambit of the Takeover Code, even if they are vested with voting rights.

ANALYSIS

Whilst the order may seem technically appropriate in light of the specific exclusion carved out in favour of preference shares, the rationale behind the order seems to ignore the spirit of the Takeover Code. The order actually permits the most sacrosanct right of equity shareholders, the right to vote in a general meeting, to be reduced to an irrelevant minority without offering an exit opportunity to the public shareholders defeating one of the objectives of the Takeover Code. Let us examine this in depth.

Why were preference shares excluded from the purview of the Takeover Code?

Prior to September 2002, preference shares were included in the definition of 'shares'. They were excluded only in 2002 on the recommendation of the reconvened committee on substantial acquisitions of shares and takeovers under the chairmanship of Justice P.N. Bhagwati. The Committee suggested exclusion of preference shares for the following reason:

"The current definition of shares includes any security which would entitle the holder to receive shares with voting rights. The issue of whether this definition of 'shares' would include redeemable preference shares as they would carry voting rights under certain circumstances was deliberated by the Committee. The Committee was of the opinion that redeemable preference shares, per se, do not carry voting rights and such share holders are permitted to vote under certain special circumstances only. Hence it may not be appropriate to equate them with shares."

Clearly, the intent was to exclude preference shares from the purview of the Takeover Code as these shares did not ordinarily carry voting rights and placing them on the same platform as equity shares or convertibles was not appropriate. But it seems unlikely that the intent was to keep preference shares exempt from the provisions of the Takeover Code even when such shares are vested with voting rights just like equity shares.

WHAT DOES THE SAT ORDER CHANGE?

For a better understanding, let us examine the implications of the order in the current scheme of things.

- Under the extant provisions of the Takeover Code, enhancement of even an iota of voting rights post 55% is not permitted (save for open market purchases of up to 5%, subject to certain conditions) without making an open offer under Regulation 11(2) of the Takeover Code.

- With the order being passed, we now have a situation where Promoters, with sanctity of SAT, gained almost absolute control over a listed company diluting voting rights of existing equity shareholders by 34.33% to an irrelevant 1.78%, without making an open offer and without offering any kind of exit to the shareholders – merely because the voting rights were attached to preference shares.

CONCLUSION

- Arguments, as always, can be on both the sides. Arguments in favour of the exclusion of the preference shares attached voting rights can be as follows. Firstly, voting rights attached to preference shares are only temporary in nature and fall away on payment of the dividends due on them. Second, the enhancement in voting rights is indeed involuntary. And, probably, most importantly, mandating a preference shareholder to make an open offer when the company defaults in paying the dividends seems unfair, as it penalizes the victim.
- Counter arguments can be as follows. First, the temporariness of the rights should not act as automatic exemption from the Takeover Code. Second, though the enhancement in voting rights is indeed involuntary, but then isn't this situation homogenous to any passive increase in shareholding, such as in case of buyback, where the shareholder is nevertheless obliged to make an open offer. Lastly, considering the extent of control exercised by the promoters in India on their listed companies, it might be a prudent not to automatically exempt such passive increase in voting rights.
- Considering the implications of such a blanket exemption, it might be advisable to require specific exemptions from the Takeover Panel under Regulation 4 of the Takeover Code in situations like this to ensure preference shares are not maneuvered to become gateways for discreet acquisition of control.

- **Sahil Shah, Ruchir Sinha & Nishchal Joshipura**

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