

Rights Issue (Sec. 62) [Part-1]

1. Rights issue (Pre-emptive Rights)

There expression 'rights issue' is used in many sections of the Act but the same is not defined or explained at any part of Act. However sub-clause (zg) of regulation 2(1) of SEBI (ICDR) Regulations, 2009, defines as follows: This definition is applicable to listed companies.

(zg) "rights issue" means an offer of specified securities by a listed issuer to the shareholders of the issuer as on the record date fixed for the said purpose.

Meaning: In general, fresh shares offered to existing shareholders in proportion to their existing holding in the share capital of the company are termed as "Rights shares" popularly known as rights issue. In the rights issue the shareholders have a right to participate in the issue. It is pre-emptive rights given by the status to existing shareholders. In this rights issue, the offer is required to be made to the existing shareholders on pro-rata to their existing holdings. The shareholders who are offered may or may not subscribe to the same. They may subscribe partly or fully the offer. They have a power to renounce the shares offered to any other person who need not be an existing shareholder of the company.

It is the power of the board of directors to decide the time, price, number of shares, **pro-rata** and other terms and conditions of the issue. The rights issue is not necessarily made at the time of requirement of the funds. It can be even made to create the desired number of shareholders to enable the company to exercise its legal powers or to comply with legal requirement. [In Re. Needle Industries (India) Ltd. V Needle Industries Newey (India) Holding Ltd (1981) 51Com Cases 743 (at p 816):AIR 1981 SC 1298.]

2. Power of the Board

In what way, mode and manner the additional resources are to be raised, it is for the board to decide.

The minority shareholders can't approach the court to stop the rights issue saying they don't wish to subscribe the same and it would lead to oppression. [In Re. Sri Hari Rao V Gopal Automative Limited (1999) 96 Comp Cas 493 CLB].

Honourable Baboo Lall Jain, J. while dismissing the case Milan Sen vs Guardian Plasticote Ltd. on 12 April, 1996: (1998 91 Comp Cas 105 Cal) observed as follows:

The principle is that although primarily the power is given to enable capital to be raised as and when required for the purposes of the company, there may be occasions when the directors may fairly and properly issue shares for other reasons, so long as those reasons relate to a purpose of benefiting the company as a whole, as distinguished from a purpose, for example, of maintaining control of the company in the hands of the directors themselves or their friends. An inquiry as to whether additional capital was presently required is often most relevant to the

ultimate question upon which the validity or invalidity of the issue depends; but that ultimate question must always be whether in truth the issue was made honestly in the interests of the company' . . .

Financial difficulty of the shareholder to subscribe the proposed rights issue does not need to be considered while offer the rights issue made by the Company. (In Re. Freewheels (P) Ltd., New Delhi vs Veda Mittra And Anr. AIR 1969 Delhi 258, 1969 39 Comp Cas 1 Delhi, ILR 1969 Delhi].

In this case the holding company held 52 per cent in the subsidiary. The subsidiary company was admittedly a prosperous concern, and the holding company was the selling agent of the product of the subsidiary company. This selling agency admittedly yielded good profits to the holding company. On 22nd July, 1968, the subsidiary company by a resolution of the Board of Directors, decided to issue a further capital, of Rs. 3,00,000.00- and to offer the same, in accordance with section 81, to the holders of equity shares in the subsidiary company. If the holding company were in a position to subscribe to the additional capital issued, they would retain their majority of 52 per cent. as under section 81 the shares have to be offered to the existing equity shareholders in proportion, as nearly as the circumstances admit, to the capital paid up on their shares. A communication was accordingly addressed by a letter, dated 24/7/1968 by the subsidiary company to the holding company offering to the latter 1568 equity shares out of the fresh issue. The holding company due to financial difficulties being unable to subscribe went to court to stop the rights issue. The court declined the same.

3. **Statutory right of shareholders**

The right provided under the rights issue of shares is a statutory right to the shareholders to subscribe new share in the company in proportion to their existing holding. However, unless and until the board offers the rights issue, the preemptive right of the shareholder does not exist.

4. **Subscribed capital - share and other securities**

Subscribed capital includes equity and preference share capital. Hence this section also applies to issue of the preference shares. It does not apply to issue of nonconvertible debenture or non-convertible bonds or non-convertible. Further the phrase "subscribed capital" does not include the convertible debentures (whether fully or partly convertible optionally or compulsorily convertible) other convertible securities. Though convertible securities are regarded as potential equity, however by issuing these types of convertible securities the subscribed capital of the company is not increased until the conversion takes place. It appears that these convertible securities can't be offered under the rights issue. However, these convertible securities can be issued either under preferential offer under clause (c) of sub-section (1) of section 61 of the Act or under private placement offer under section 42 of Act alone. At the explanation provided under sub-rule (1) of Rule 13 of Companies (Share Capital and Debentures) Rules 2014 the expression 'Preferential Offer' is defined as means as "issue of shares or other securities". Further expression "shares and other securities" is explained as it means equity

shares, fully convertible debentures, partly convertible debentures or any other securities (convertible or exchanged at later date into equity).

The words used “For the purpose of this Rule” at the explanation are confined only to rules made under clause (c) of sub-section (1) of section 62 of the Act and not for entire section. We can't borrow this extended definition of “shares and other securities” same for clause (a) or clause (b) of sub-section (1) of section 62 of the Act.

As per clause 86 of Section 2 of the Act, “subscribed capital” means such part of the capital which is for the time being subscribed by the members of a company. It is an exclusive definition. It says such part of capital subscribed by the members of the company. The persons who had subscribed to equity or preference shares can be called as members. However the persons who had subscribed to convertible securities like convertible debentures can't be called as members of the company till such time of conversion.

One can draw a conclusion for the purpose of clause (a) [Rights issue] or clause (b) [ESOPs] of sub-section (1) of the Section the expression “shares” used in main part of sub-section(1) of the Section means only the shares as defined in sub-clause (84) of section 2 of the Act. Whereas purpose of clause (c) of the shares means “shares and other securities” accordingly extended definition provided at rules should be taken into account while determining the scope of this section.

It seems it must have been a draft error at exclusive definition of expression provided at rules. It says “shares and other securities” means “equity shares, fully convertible debentures, partly convertible debentures or any other securities.....” It does not include “preference shares”. Even we can't assume expression “other securities” may include ‘preference share. But following qualifying sub- clause of convertibility must be a condition to consider other securities as such. However definition of shares provided at section 2(84) needs to be taken for the expression of ‘shares’ mentioned rules, as the rule can't over ride the Act.

5. Holders of equity shares

As per this section only equity shareholders are entitled to pre-emptive rights not the preference shareholders even if they hold convertible preference shares. In Re. Kedar Nath Agarwal V Jay Engg. Works Ltd [1963] 33 Comp. Case 102(Cal), the Calcutta High Court held that a ‘member’ may be a holder of shares but a holder may not be a member. A person whose name appears on the register of members may have sold his shares and from the moment his property in the shares has passed to purchaser and he has ceased to be ‘holder’ of those shares. This case was relevant under 81 of the Companies Act 1956. The same seems to be relevant to the present section.

The Supreme Court in Balkrishna Gupta v. Swadeshi Polytex Ltd. [1985] 58 Comp Case 563 held that:

“The privileges of a member can be exercised by only that person whose name is entered in the register of members. A receiver whose name is not entered in the

register of members cannot exercise any of those rights unless in proceedings to which the company concerned is a party and an order is made therein

In case of *Howrah Trading Co. Ltd. v. CIT* [1959] 29 Comp Case 282 the Supreme Court observed that even where the holder of a share whose name is entered in the register of members hands over his share with blank transfer forms duly signed, the transferee would not be able to claim the rights of a member as against the company concerned until his name is registered in the register of members.

The Supreme Court further held: In some situations and contingencies the 'member' may be a holder of shares but a holder may not be a 'member.'

Pre-emptive rights provided under section are available only to the equity shareholders not to the preference shareholders whether convertible or not.

In many sections throughout the Act terms 'members', 'shareholders', 'equity shareholder', 'holder of equity shares' are synonymously used as some places as substitutes.

For the purpose of this section the expression "holder of equity shares" means subject to provisions section 126 (keep in abeyance) of Act those persons whose names are appeared in the register of members on a particular day (it may be book closure date or record date). The company needs to send rights issue offer letters only to such persons. It is immaterial to the company whether the particular member still holds the shares or not. The company does not need to recognize the actual holder of equity shares as on particular date.

However the company should keep such shares in abeyance in case of those shares the company has received duly executed transfer instruments along with required documents before the date of such particular decided date and the company has not registered the same i.e. pending registration of share transfers. In other words, the rights issue offer letters are not required to be sent to the registered member of such shares. Rights shares will be kept in abeyance till share transfer is registered by the Company. Once the transfer of shares is effective in the records of company, then the transferee would be entitled the rights issue offer to subscribe.

In case of disclosure of beneficial interest made under section 89 of the Act, though it is constructive notice on the company, the company is required to offer the rights shares to registered owner only. Disclosure of beneficial interest in the share does not take away the rights and power of the company and shareholder as well. Disclosures made under section 89 are not directions to the company. This section is not guided by the section 89 of the Act. The rights shares should be offered to the registered member alone. However, registered member acting in accordance with the beneficial owner may renounce the same in favour of beneficial owner.

Further in case of death or insanity, pledge of shares and other legal constrains, the company may need to keep in abeyance the rights issue on such shares based on facts available with the company.

6. Offer to be made proportionately

In the rights issue, the shares should be proportionately offered to equity shareholders to their existing shareholding. However the expression “as nearly as circumstances admit” used in the sub-section (a) of sub-section (1) of this section gives a leeway to the board to decide such nearest number of shares by avoiding the fractions.

7. Renunciation:

Under this section pre-emptive rights includes the right to renounce if it is not restricted by the articles. Public and private companies both can have a suitable provisions at articles either to restrict or prohibit the right to renounce the rights shares. If permitted, renunciation of issue rights shares can be made fully or partly in favour of any person, who need not be an existing shareholder of the Company.

7.1 Private Companies: The right to renunciation in favour of any other person is wholly inconsistent with the structure of a private company having three characteristics contained at section 2(68) of the Act. As this section is made applicable to all companies, in order to protect its basic fabric of among the existing members, private companies may need to incorporate suitable provisions at articles to restrict the right of renunciation similar to restrictions imposed in case of a transfer of shares by existing member. Otherwise the existing shareholder having received rights issue may renounce to any person and board of directors shall be bound to make allotment to such persons. Their entry into the company as shareholders may not be advantageous to company.

7.2 Listed Companies: In case of listed company, such restrictions or prohibitions imposed under articles do not have any impact on rights shares to renounce unless those are approved by the stock exchanges where the shares are listed. The clause 23(c) of listing agreement reads as the company agrees to make such issues or offers in a form to be approved by the Exchange and unless the Exchange otherwise agrees to grant in all cases the right of renunciation to the shareholders and to forward a supply of the renunciation forms promptly to the Exchange. Further Regulations 39 of Securities and Exchange Board of India (Listing Obligations And Disclosure Requirements) Regulations, 2015 (Hereinafter called as Listing Regulations, 2015) mandates the listed companies to comply with regulations 19 of the Securities Contract (Regulation) Rules 1957.

Further rule 19(3)(q) of Securities Contract (Regulation) Rules 1957, every company proposed to list should inter alia agree to grant to shareholders the right of renunciation in all cases of issue of rights, privileges and benefits and to allow them reasonable time not being less than four weeks within which to record, exercise, or renounce such rights, privileges and benefits and to issue, where necessary, coupons or fractional certificates or provide for the payment of the equivalent of the value of the fractional right in cash unless the company in general meeting or the stock exchange agrees otherwise.

To be continued...