

## PREFERENTIAL ALLOTMENT OF SHARES: USES, ABUSES AND IDEA OF CORPORATE GOVERNANCE

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### ABSTRACT

*Every corporate entity works in such a manner that it ensures liabilities do not come up in their way. Raising Capital is one of the most important aspects of a business. Raising capital without taking any charge on assets is possible by way of preferential allotment of shares. It is the widely used method to raise capital for the companies. The article puts light on the concept of Preferential Allotment of Shares which is governed by The Companies Act of 2013 and SEBI Regulations. It also focuses on how the preference shares are issued by the promoters and key managerial persons for their interest and how their preferential allotments are beneficial for the company itself. Governing provisions are being constantly amended to remove loopholes and misuse. Despite the promoters being the majority shareholders, taking advantage of their position and increasing their stake constantly through preferential allotments, it is the most preferred method of raising capital.*

**Keywords:** Preferential Allotment, Shares, Idea Of Corporate Governance.

### INTRODUCTION

A company limited by shares has two kinds of share capital i.e. equity share capital which may have voting rights along with it or it may have differential rights concerning dividends, and the second is the preference share capital. It can further issue shares in three ways and increase its subscribed capital<sup>1</sup>. A) By offering to the equity shareholders.<sup>2</sup> B) Subject to some conditions for the employees under ESOP.<sup>3</sup> C) To any person if passed by special resolution (preferential allotment of shares).<sup>4</sup>

### MEANING

According to Section 62(1) (c) of the companies act of 2013("Act"), whenever a company with a share capital proposes to increase its subscribed capital by the issuance of further shares, it can issue those shares to anyone if authorized by a special resolution either for cash

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<sup>1</sup>The Companies Act 2013, s 62

<sup>2</sup>The Companies Act 2013, s 62(1)(a)

<sup>3</sup>The Companies Act 2013, s 62(1)(b)

<sup>4</sup>The Companies Act 2013, s 62 (1)(c)

or for any other consideration, if the price of those shares is determined by the valuation report of a registered valuer subject to some conditions.<sup>5</sup> However, Following Section 42 of the 2013 Companies Act, a company may invite a selected group of individuals to subscribe for securities i.e. by way of preferential offer.<sup>6</sup> The Company whose securities are listed on a recognized stock exchange, has to follow the procedure for issuing shares according to the guidelines of SEBI(Issue of Capital and Disclosure Requirements Regulations, 2009)and the Companies Act, 2013. But in case the securities are not listed, they should comply with provisions of the ‘Act’ and Share Capital and Debentures Rules, 2013.<sup>7</sup>

### UNLISTED COMPANIES

Rule 13 of Share and Capital and Debentures Rules, 2014 describes the procedure for preferential allotment of shares<sup>8</sup> for both public and private unlisted companies.<sup>9</sup> It defines a preferential offer as issuing of shares on a preferential basis to selected persons.<sup>10</sup> Various conditions are mentioned that need to be fulfilled before making an offer i.e. the issuance of shares need to be authorized by AoA<sup>11</sup>, special resolution by the members,<sup>12</sup> disclosures(total number of issued shares, the object of the issue, price, basis for fixing price with the report of a registered valuer, person to whom the shares are being issued, date in whose reference the price has been fixed, intentions of KMPs concerning this offer, completion time of allotment, details of post preferential offer capital held by allottees, any changes in control post the offer in the company, details of all the allottees to whom the preferential offer is made this year, price, securities)to be attached with notice of the general meeting(Section 102).<sup>13</sup> In case, a special resolution is passed for the offer, the allotment process needs to be completed within 12 months from the date of passing the special resolution.<sup>14</sup> But, if the process is delayed or extended to more than 12 months, a new resolution should be passed for completing the process.<sup>15</sup> Price of the respective shares should be determined based on a report given by a registered valuer.<sup>16</sup> In case convertible preference securities are offered i.e. option to convert into equity shares, the price of the resultant shares need to be determined beforehand based

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<sup>5</sup> *ibid*

<sup>6</sup> The Companies Act 2013, s 42

<sup>7</sup> The Companies (Share Capital and Debentures) Rules 2014, r13

<sup>8</sup> *ibid*

<sup>9</sup> The Companies (Share Capital and Debentures) Rules 2014, r 3

<sup>10</sup> *ibid*

<sup>11</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(a)

<sup>12</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(b)

<sup>13</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(d)

<sup>14</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(e)

<sup>15</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(f)

<sup>16</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13 (2)(g)

on the report of a registered valuer and should comply with section 62 of the Act.<sup>17</sup> Where the consideration is other than cash for the shares or securities offered, the registered valuer should justify the valuation of his report<sup>18</sup> and in the case of preference shares where non-cash consideration takes the form of a depreciable asset, it should be dealt with according to accounting standards in the balance sheet of the company. An Independent chartered accountant with ten years of experience or a SEBI-registered independent merchant banker can make a valuation report till the appointment of a registered valuer following the provisions of the Act. According to the Companies (Share Capital and Debentures) Amendment Rules, 2014, the price of the shares issued on a preference basis should not be less than the price mentioned in the valuation report.<sup>19</sup> Rule 14 of Companies (Prospectus and allotment of securities) Rules, 2014 talks about the offer to subscribe the securities of a company through private placement.<sup>20</sup> In a single financial year, the offer should be made to equal to or less than 200 individuals.<sup>21</sup> 14(1) describes the conditions while making an offer to a person i.e. (a) offer letter to be in Form PAS-4,<sup>22</sup> (b) offer letter accompanied by an application form, addressed specifically to the person within 30 days of recording names of all persons to whom the offer is made.<sup>23</sup> 14(2) states that the offer needs to be approved by a Special Resolution by the shareholders. The explanatory statement attached to the notice of the general meeting should provide the basis for the determined price of the offer.<sup>24</sup> The investment size of such an offer should be equal to or more than 20,000 rupees of the face value of securities.<sup>25</sup> All the records of the private placement offers should be maintained in Form PAS-5 by the company.<sup>26</sup>

## LISTED COMPANIES

Chapter VII governs the provisions of preferential issues of shares for the listed companies.<sup>27</sup> It defines the preferential issue as the “issue of specified securities by a listed issuer to any select person or group of persons on a private placement basis”.<sup>28</sup> Specified securities refer to

<sup>17</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(h)

<sup>18</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(i)

<sup>19</sup> The Companies (Share Capital and Debentures) Rules 2014, r 13(2)(j)

<sup>20</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14

<sup>21</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14(2)(b)

<sup>22</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14 (1)(a)

<sup>23</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14(1)(b)

<sup>24</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r14(2)(a)

<sup>25</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14(2)(c)

<sup>26</sup> The Companies (Prospectus and allotment of securities) Rules 2014, r 14(3)

<sup>27</sup> The Issue of Capital and Disclosure Requirements) Regulations 2009

<sup>28</sup> The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 2(1)(z)

equity shares and convertible securities.<sup>29</sup> Regulation 72 describes the conditions to be fulfilled for making preferential issues i.e. special resolution to be passed by shareholders,<sup>30</sup> shares held by allottees should be in dematerialized form,<sup>31</sup> PAN of proposed allottees,<sup>32</sup> completion of conditions for continuous listing of shares of the listing agreement.<sup>33</sup> The issuer should not allot the shares to the person who has sold any shares of the company in the last six months from the relevant date and he would be considered ineligible for the same in case he has sold them.<sup>34</sup> The object of the issue, the proposal to subscribe to an offer of the promoters, KMPs of the company, shareholding pattern of the company before and after the issue, the completion time of allotment, identification of the ultimate beneficial owners of issued shares, change in control post to the allotment, refiguring the price of securities according to specific regulations, to give an undertaking to the fact that the due amount that is to be calculated on recomputation of price should be paid in given time and if not paid then the securities will remain locked in until it is paid; all these should be disclosed in the explanatory statement attached with the notice for the general meeting.<sup>35</sup> In case the preferential allotment is made for consideration other than cash to relatives, promoters, or other close entities, the valuation of such consideration should be submitted to a recognized stock exchange by an independent qualified valuer.<sup>36</sup> A copy of the certificate of its statutory auditor should be presented before the shareholders in the general meeting.<sup>37</sup> The price of the shares to be allotted must be calculated according to the relevant date as specified in the special resolution passed in the general meeting.<sup>38</sup> Allotment of shares must be completed within fifteen days following the date on which the special resolution was passed. However, this period can be extended in case there is any application pending regarding approval from the government or for exemption of applicability of regulations. In case of exception, the fifteen days will be decided according to the date of order of the application.<sup>39</sup> If the allotment procedure is not completed in 15 days, the price of the securities will be determined according to the relevant date as decided in the fresh resolution.<sup>40</sup> Specific securities or

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<sup>29</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 2(1)(zj)

<sup>30</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 72(1)(a)

<sup>31</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 72(1)(c)

<sup>32</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 72(1)(b)

<sup>33</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 72(1)(d)

<sup>34</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 72(2)

<sup>35</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 73(1)

<sup>36</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 73(3)

<sup>37</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 73(2)

<sup>38</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 73(4)

<sup>39</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 74(1)

<sup>40</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 74(2)

allotted equity shares to exercise options linked to warrants issued to promoters on a preferential basis must be locked in for 3 years (less than twenty percent of the total capital of the company can be locked in). In case equity shares are issued more than this limit, they will be locked in for 1 year.<sup>41</sup> Promoters can transfer the specific securities held by them to a new promoter on the condition that the lock-in period will remain to continue.<sup>42</sup> Transfer of securities allotted on a preferential basis is not possible till the trading approval of these securities is given by all recognized stock exchanges where shares of the issuer are listed.<sup>43</sup> If allotted to persons other than promoters on a preferential basis, the lock-in period will remain one year.<sup>44</sup> If by chance, allottees have pre-preferential shareholding, it will be locked in for six months from a relevant date.<sup>45</sup>

## USES

Preferential allotment of shares by the company involves less compliance as compared to other methods of raising capital i.e. IPO, FPO, etc. It helps promoters, VCs, and Investors to increase their stake in the company. This cost-effective method helps in resolving the problem of underinvestment in the company<sup>46</sup> and aids the capital flow.<sup>47</sup> It can issue preference shares, fully or partly convertible debentures, or security through preferential allotment.<sup>48</sup> In this method, the company can raise capital without risking its assets (no charge on assets) which is beneficial for both the company and its existing shareholders. Also, it refrains the company from borrowing from a financial institution or a bank. It decreases the debt-to-equity ratio. It benefits investors such that in case of an increase in the price of shares, they can earn extra profits through convertible securities. It is a low-risk sector that provides long-term income. It proves to be a beneficial instrument in the hands of shareholders. Less or no voting rights are given to these shareholders. The only right they have is the right to dividends and profits; they have less influence over the board meetings. This feature proves to be favourable for the directors and other key persons because in this way they need not dilute their powers. Thus they can enjoy their powers to the fullest.

<sup>41</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 78(1)

<sup>42</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 79(1)

<sup>43</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 79(2)

<sup>44</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 78(2)

<sup>45</sup>The Issue of Capital and Disclosure Requirements) Regulations 2009, reg 78(6)

<sup>46</sup>Preferential Allotment Under the Companies Act, 2013 – Step By Step Procedure (*ASC Group*, February 21 2023) <<https://www.ascgroup.in/preferential-allotment-under-the-companies-act/>> accessed 25 June 2023

<sup>47</sup>Swetha Dhinesh, 'Preferential Allotment Of Shares: Advantages & Disadvantages' (*Enterslice*, April 21 2023) <<https://enterslice.com/learning/preferential-allotment-of-shares-advantages-disadvantages/>> accessed 25 June 2023

<sup>48</sup>The Companies (Share Capital and Debentures) Rules 2014, r 3



## ABUSES

Using preferential allotment procedures, many investors tend to do unscrupulous dealings. They manipulate the prices and try to operate the stock market. They sell their shares at higher prices to gain high profits. They tend to take advantage of preferential allotments. Mostly shares are issued on a preferential basis to the relatives, or the promoters themselves. It increases their considerable control over the matters of the company. It makes it easier to pass resolutions on any significant matters and mould things according to their interest. All the considerations received upon the issue of shares on a preferential basis are not used as they are required to use for the purposes discussed in the general meeting. Instead, these funds are transferred to various entities for other uses. They sell their shares during the lock-in period and try to show fictitious long-term capital gains. These gains in turn benefit them in taxation aspects. They pay taxes at lower rates due to these long-term capital gains. The source of income also is shown as a legitimate one.<sup>49</sup>

## IDEA OF CORPORATE GOVERNANCE

Corporate governance is a mechanism that aids in managing and directing the affairs of the company. It ensures effective governance that can give long-term benefits to the company. It focuses on Accountability and transparency in the affairs of the company.<sup>50</sup> It is a mechanism that oversees the existing systems of the company and protects the interest of the shareholders. Ownership is the key aspect in the implementation of these principles. Most likely, shares are issued to promoters, and relatives on a preferential basis.

In this way, they accumulate large stakes in the company and control the governance of the company. Typically, these large shareholders consist of relatives and family connections. They issue such shares at discounted prices by passing the special resolution in the general meeting as the majority lies in them. So they take decisions according to their interest. Thus abusing their powers<sup>51</sup> and diluting the powers of other shareholders.<sup>52</sup> The relation between the two concepts lies in two terms: transparency and accountability. A company can raise

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<sup>49</sup>Ashish Rukhaiyar, 'Sebi bars 30 entities for misuse of exchange mechanism' (*mint*, February 21 2015) <<https://www.livemint.com/Money/Jp9HY5Gxs6h2f02A3FUcMI/Sebi-bars-30-entities-for-misuse-of-exchange-mechanism.html>> accessed 25 June 2023

<sup>50</sup>'What is corporate governance?' (*ICAEW*) <<https://www.icaew.com/technical/corporate-governance/principles/principles-articles/does-corporate-governance-matter>> accessed 25 June 2023

<sup>51</sup>'ACGA White Paper on Corporate Governance in India' (2010) Asian Corporate Governance Association (ACGA) Hong Kong <[https://www.acga-asia.org/upload/files/advocacy/20170402220450\\_115.pdf](https://www.acga-asia.org/upload/files/advocacy/20170402220450_115.pdf)> accessed 25 June 2023

<sup>52</sup>Nikhil Arora, Jyoti P. Gupta, 'Do Family-Held Firms Have Weak Corporate Governance?' (2012) <<https://dx.doi.org/10.2139/ssrn.1981962>> accessed 25 June 2023

capital through preferential allotment in an easy way, but it should not use this method in such a manner that it proves to be detrimental to the interest of minority shareholders. The board of directors must ensure that the process is carried out transparently giving due consideration to the principles of corporate governance. They should focus on the ultimate benefit of both company and its existing shareholders. Complying with the principles of corporate governance increases the trust of the investors in the company. This enhances the image of the company in the corporate world.

## **CONCLUSION**

Preferential allotment of shares is governed by both the Companies Act of 2013, and the SEBI Regulations (Issue of Capital and Disclosure Requirements Regulations of 2009, Share Capital and Debentures Rules of 2013). These regulations are constantly amended to remove the abuse of the process by the promoters and to prevent unscrupulous dealings. Corporate governance principles emphasize the preservation of the values that bring long-term success to the company. The idea of corporate governance concerning the preferential allotment of shares is that the management, and operation of the company's affairs i.e. to raise capital on a preferential basis be carried on in a proper way that does not distort other's genuine interest.

