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We firmly believe in setting out cutting edge research and analysis having high quality. For this issue we received over a hundred submissions of which a select few have been published after our review process. The focus is to ensure that the articles have contemporary relevance that add value to our readers.

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(Editorial Board)

DIFFERENTIAL VOTING RIGHTS: ANALYSING THE INDIAN SCENARIO

BY RISHABH SHARMA¹

INTRODUCTION

“One-Share, One-Vote” (OSOV) principle is the golden rule for maintenance of equality and healthy corporate governance. The shareholders have an inherent power of right to voting, which is also determinative of the purview of their control within the company. However, recently, the support for dual class capitalization, or differential voting rights (DVRs), has been on the rise.² It involves creating various classes of shares, where different bundle of rights are attached to each share. Presently, various countries across the world allow this, while many others have continued to remain suspicious.³ Issuance of shares with DVRs by companies like Google and Facebook is evidence of the popularity of this system of capitalization.⁴ Media houses like The New York Times and The Washington Post also adopted this scheme for preserving their integrity in journalistic operations.⁵

In India, Section 43(a) of the Companies Act, 2013 allows the possibility of having equity shares capital with differential rights w.r.t. either dividend or voting, or any other rights as stipulated in the applicable rules.⁶ The Amendment Act of 2000 allowed for DVRs even before the Act of 2013. However, in spite of such allowance, there have been very few instances of such issuance of shares in the Indian market. The aim of this paper is to analyze the existing regulatory framework, its evolution and history, the advantages and disadvantages of dual class capitalization and how it affects the Indian market.

DUAL CLASS CAPITALIZATION IN INDIA

History and Evolution:

In the Companies Act, 1956, shares with DVRs were not allowed to be issued.⁷ Members of the company, who were limited by shares, had voting rights in proportion with the amount of shares held by each such member. However, meticulous adherence to OSOV principle gradually

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² Dual class capitalization is when cash flow-rights and voting rights are separated.

³ Deekshitha Srikant, Arka Saha, *Revisting the Dual Class Share Structure Debate in India post the Alibaba IPO: Attempting to Tread the Middle Ground*, NLS Business Law Review, August 2015.

⁴ *Id* at 3.

⁵ *Id* at 3.

⁶ Companies Act, 2013, S. 43(a)(i), S. 43(a)(ii).

⁷ No bifurcation was made in S. 86 of the former Act between equity shares with voting rights & differential voting rights.

started eroding away because of management's desire of retaining control for various reasons, of which one prominent reason was protection from hostile takeovers which were frequently taking place around the era of privatization and globalization during 1990s. For addressing this, the 'Expert Study on Establishment of New Stock Exchange' was instituted in 1991 under the supervision of Mr. MJ Phewani.⁸ The committee proposed that the companies having a track record of paying dividends in the previous 2 years, or in the previous 4 out of 5, or the previous 5 out of 7 years, should be allowed issuance of non-voting shares. These are shares which are separate from the inherent voting rights. This recommendation was incorporated in the 1993 and 1997 Companies Bill, although with certain restrictions. One of the conditions was that the shares must not be more than 25% of the issued share capital with voting rights attached to it. However, these Bills could never transpire. The Act of 1956 was itself amended in 2000 since an attempt to pass a new Act had failed around that time. Section 2(46A) was inserted by the Amendment which provided that shares with differential rights could be issued in accordance with the terms of Section 86. By virtue of the 2000 Amendment, issuance of a new type of equity shares was allowed with differential rights w.r.t either dividend or voting, or otherwise, in compliance with the prescribed conditions and regulations [Section 86(a)(ii)]. As a result, Section 88 was repealed which forbid issuing shares with disproportionate rights attached. The Department of Corporate Affairs promulgated The Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 for implementation of the new provision. These rules laid down the conditions that needed to be adhered to for issuing equity shares with DVRs, whether higher or lower.

EXISTING REGULATORY FRAMEWORK

The existing regime is grounded in Section 43 of the Act of 2013 (formerly, Section 86 of the Act of 1956), the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001, and the SEBI (Disclosure and Investor) Protection Guidelines, 2000. For protection of minority shareholders, SEBI's 2009 Amendment to the Listing Agreement prohibited issuing of superior voting rights. The 2001 Rules lay down certain requirements that need to be satisfied for issuing shares with differential voting rights; annual returns must be filed without any defaults, company should have distributable profits as per Section 205 of the 1956 Act, investor's grievances must be resolved, there should be no default in repayment of deposits or interests, company should not have been convicted under a few listed Acts, the issuance of the

⁸ MJ Phewani, *Expert Study on Establishment of New Stock Exchange*, 1991.

shares in question should be authorized by the Articles of Association, shareholder's approval must have been obtained in a general meeting, among other requirements. An explanatory statement must also be issued by the company for clarifying the rate of voting rights, the extent to which they may vary, any prohibitions on converting such shares, etc.

ANALYZING DIFFERENTIAL VOTING RIGHTS

Positive Aspects:

Presently, large public companies are composed of complex hierarchical structures, whose primary objective is maximization of shareholder's wealth as well as the company's overall value. This often results in informational asymmetry between the company's management and the shareholders, because of difference of resources, lack of inside knowledge, etc.⁹ Due to misinformation, or the lack of information, the shareholders may sell control of the company in the form of shares, and the inherent right to vote possessed by them, possibly resulting in a hostile takeover.¹⁰ This leads to deleterious consequences. An apprehension of such an event taking place may prevent the company's management from engagement in decisions and policies whose communication to the shareholders might be difficult, even though such decisions and policies in themselves may benefit the value of the company. This shifts the focus to short-term maximization of profit instead of long-term growth and development. Hostile takeover is also a possible threat when the rate of declared dividend decreases which causes an apprehension that a trend of such decline might continue, thereby increasing the chances of a profit-oriented shareholder to sell his shares in the company and facilitate hostile takeover.¹¹ A solution to all these scenarios is dual class share structure. By conferring greater control of the company to the management with shares comprising greater voting rights, the problem of asymmetry in information can be coped with, and the management would not have to model its policies based on the contingencies mentioned above.

For combating the threat posed by predatory takeovers, a defense tactic called 'kamikaze' is often employed by the companies for appearing less alluring to the hostile acquirers.¹² They do this by acquisition of assets to raise the debt liability of the acquiring company, or by alienating

⁹ *Supra* note 3.

¹⁰ Allen Franklin, Michaely Roni, *Payout Policy*, Wharton Financial Institutions Center Working Paper No. 01-21-B, North-Holland Handbook of Economics and Finance, 2002.

¹¹ Jeffrey Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Cal. L. Rev., 1988.

¹² *Supra* note 3.

the most valuable assets of the company, or by issuing large amounts of bonds with the condition that they shall be bought back at increased rates in case of a hostile takeover. However, these tactics have a detrimental effect on the financial position and value of the corporation which adversely affects the shareholders. In such cases, it is beneficial to have dual class shares since a considerable part, if not majority, of the voting rights are in the management's possession, thereby enabling them to negotiate on the shareholder's behalf for maximization of the overall wealth. This protects the non-controlling shareholder from such hostile takeovers by predatory companies, consequently curtailing the possibility of relinquishment of control by them.

Apart from this, dual classes of shares will also benefit the investors who are only driven by the motive of making profit and are merely institutional investors as they would be offered a greater dividend.

Negative Aspects:

A downside of presence of such a dual class share structure is the flagrant defiance of the OSOV rule. Even though this rule is not enshrined anywhere, it has developed into a market standard.¹³ It is in furtherance of creating an equitable corporate governance system where a shareholder, without investing and purchasing a sizeable equity, can have the opportunity of exerting control over the company affairs. Violation of such an arrangement is, in a sense, violation of the contract which forms the bedrock of any company. There is no connection between a shareholder's right to residual income and his control in the company. In such a scenario, self-interest also tends to supersede the company's interests as a shareholder with disproportionate voting rights can comfortably pass on the risk to other shareholders or the company, without having to bear the ramifications of the decisions so made.

Disproportionate voting rights, i.e., fewer voting rights to the shareholder, have a necessary implication of superior or higher voting rights to the management, which tremendously brings down the answerability of these larger shareholders.¹⁴ Likelihood of prospects like re-election of the board of directors, managerial entrenchment would then increase significantly.¹⁵ This will also jeopardize the executive or independent directors who will then be contingent on the

¹³ Siddharth Ranade, *Separation of Voting Rights from Cash-flow Rights in Corporate Law: In search of the optimal*, Legal Studies Research Paper No. 2013-07, Last accessed at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2246757 (on April 8, 2019).

¹⁴ Abhishek Tripathi, Uttam Maheswari, *Shares with Differential Voting Rights: A Legal and Economic Analysis*, 15 Student B. Rev. 74, 2003.

¹⁵ *Id.*

disposition of the shareholders with superior voting rights.¹⁶ This issue is particularly pertinent in India because after the Companies Act, 2013 was passed, an Amendment was made to Clause 49 of SEBI's Listing Agreement [Clause 49 (IIB)], and the requirement for independent directors was introduced in Section 149(4) of the Act itself. The concept of an independent director was put in place for keeping a check on any biases and the managerial conduct. This would be crippled in its entirety in the presence of a dual class share structure. The likelihood of institutional investors exiting would also increase if such a structure is instituted.

A structure such as this, might even backfire as a defense against hostile takeovers. Usually targets of predatory takeovers are those companies which are inefficiently managed, where the price of the stock is the measure of inefficiency. The system under consideration would grant unabated reign to the management, resulting in inefficient standards of management since greater control would be granted to shareholders who have lesser equity, further making the company vulnerable to a hostile takeover. Poor management would adversely affect the stock price. Given the fact that greater voting rights are attached to some of the stocks compared to others might lead to a further devaluation of shares with lower voting rights, and resultantly reduce the price of the common stock as a whole.

STUDYING INDIAN CASES

Although DVRs were permitted to be issued in India since the year 2000, first such issuance was done after almost a decade in late 2008, by Tata Motors.¹⁷ The company took such a decision to raise money for Jaguar-Land Rover acquisition. 6.4 crores of DVR shares, priced at Rs. 305 per share, with 1/10th of voting rights, were issued by Tata Motors whereas the ordinary shares were priced at Rs. 340. The company also paid a higher dividend on the said shares. However, these shares were not traded in high volumes for lack of awareness about such shares.¹⁸

Pantaloons made the next issue of such shares in the year 2009.¹⁹ Even these shares had 1/10th of the voting rights in comparison to the ordinary shares, while they offered 5% additional dividend. However, what needs to be noted here is that these shares were bonus shares and not

¹⁶ George Dent, *Dual Class Capitalisation: A Reply to Professor Seligman*, 54 Geo. Wash. L. Rev., 1986.

¹⁷ Rahul Oberoi, *How to Benefit from Shares with Differential Voting Rights*, Last accessed at: <http://businesstoday.intoday.in/story/how-to-benefit-from-shares-with-differential-voting-rights/1/192706.html> (on April 8, 2019).

¹⁸ Apeksha Dhanvijay, *Differential Voting Rights and its Treatment under Companies Act, 2013*, CORPORATE LAW JOURNAL, Last accessed at: http://corporatelawreporter.com/2017/06/24/differential-voting-rights-and-its-treatment-under-companies-act2013/#_ftn16 (on April 8, 2019).

¹⁹ *Pantaloons Offers Bonus DVR Shares*, The Indian Express, Last accessed at: <http://archive.indianexpress.com/news/pantaloon-offers-dvr-bonus-shares/340185/> (on April 8, 2019).

fresh shares, which were offered on purchase of the ordinary shares. This explains their success and the considerably greater volume of trade in comparison to the Tata shares.

In 2009, a debate over the issue of dual class shares was started in *Re Anand Pershad Jaiswal v. Jagatjit Industries Ltd.*²⁰ The issue in the case dealt with higher voting rights where 20 votes were attached to each share that was issued, skewing the voting rights in the promoter's favor who now became holders of more than 60% rights of voting despite holding less than 1/3rd of the economic stake. The contention against consolidation of control without making a public issue was not accepted by the court and it upheld the issue of shares, since all the regulations had been followed in making such an issue, despite the apparent threat to corporate governance and the possibility of an adverse effect on minority shareholders. In response to the judgment, issue of DVR shares with greater voting rights was prohibited by SEBI.²¹ Issuance of DVRs was also outright forbidden by the 2009 New Companies Bill.²²

Following the above discussed amendments as well as passing of the Act of 2013, a handful of cases have been there where there has been an issue of shares with differential rights, by companies like Future Enterprises Ltd., Gujarat NRE, Jain Irrigation Ltd., however, these cases are far and few.²³

CONCLUSION

Majority of the literature that was analyzed failed to provide a conclusive finding against capitalization of dual class capitalization. There were a few reports which did conclude negatively against such type of capitalization, however, those were from the initial years of the 20th Century which cannot be compared to contemporary times as there was no wave of takeovers or OSOV golden rule which was witnessed by the said era.²⁴ Most of the reports had consensus on the requirement of having certain pre-conditions that must be fulfilled for an issue of securities (shares, in particular) to be successful, some of them being the requirement of having liquid markets with well-informed investors and a robust and fast-track grievance redressal mechanism for shareholders to ensure that the advantage garnered does not get exploited.²⁵ It is recommended that India must prioritize the liquidation of markets as it fares

²⁰ *Anand Pershad Jaiswal v. Jagatjit Industries Ltd.*, (2010) 1 Comp LJ 509.

²¹ Clause 28A, Amendments to the Listing Agreement (Circular SEBI/CFD/DIL/ LA/2/2009/21/7).

²² Companies Bill, 2009, S. 37, Last accessed at: http://www.mca.gov.in/Ministry/actsbills/pdf/Companies_Bill_2009_24Aug2009.pdf (on April 8, 2019).

²³ Pradiptarathi Panda, Differential Voting Rights issued by Indian Companies, 2016, Last accessed at: <https://www.researchgate.net/publication/318276455> (on April 8, 2019).

²⁴ *Supra* at 12.

²⁵ *Supra* at 3, 12.

poorly as compared to other economies permitting dual class capitalization structures. India should learn from the experience of Hong Kong since many issues which have plagued the Hong Kong market such as enormous businesses run by families also exist in India.²⁶ India's framework is also unique in the sense that there is an explicit prohibition on issuing shares bearing superior rights which has led to confusion among stakeholders as to the distinction that exists between differential rights and rights of a superior nature. It can be argued that an issue of shares with differential rights merely ends up creating an issue of shares bearing superior rights but having different quantification/ numerical values.

Notwithstanding all the aforementioned defects and failings, the researcher would like to conclude that India needs to permit dual class shares since it is not only required by companies in the intellectual property rights sector but would also be a huge boost for start-ups since such share structures are extremely helpful for entrepreneurs to maintain their control over major decisions of the enterprise while raising the much-needed capital.²⁷ It has also been observed that the OSOV golden rule need not end up conferring the right to vote on those shareholders who have an incentive to vote and there have been bold claims from experts that scrapping the OSOV rule would contribute significantly to corporate governance.²⁸ Thus, it is quintessential to ensure that all pre-conditions are in place before above-suggested structure is adopted. In reference to the discussion above, it also needs to be noted that a mere adoption of the structure in place in the stock market in the US, i.e. the laissez faire system would be insufficient. Additional safeguards such as providing tag-along rights to minority shareholders in scenarios of takeovers (as present in Canada), provision for obtaining shareholder consent through a special resolution requiring super majority (as present in the UK), coat-tail safeguard, etc. would be necessary.²⁹ The objective is thus to achieve a largely beneficial compromise of safeguarding shareholder's rights while allowing for the issue of votes with differential rights.

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²⁶ *Supra* at 3.

²⁷ *Supra* at 12.

²⁸ *Id.*

²⁹ *Supra* at 3.

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