

# RIGHTS ISSUE – INDEPTH VIEW

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1. In this Article an attempt has been made by the author to elucidate and clarify the provisions enshrined under Section 62(1)(a) of Companies Act, 2013 dealing with right issue, practical issues pertaining to right issue, which has been supported by judicial pronouncements. To analyze and answer the practical problems being faced, it is pertinent to refer the bare text of Section 62(1)(a), which is cited herein below:

## “Section 62: Further issue of share capital

(1) Where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares such shares shall be offered—

(a) to persons who, at the date of the offer, are holders of equity shares of the company in proportion, **as nearly as circumstances admit**, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely.

(i) The offer shall be made by **notice** specifying the number of shares offered and limiting a time not being **less than fifteen days** and **not exceeding thirty days** from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

(ii) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to **renounce the shares** offered to him or any of them in favour of any other person; and the notice referred to in clause (i) shall contain a statement of this right;

**(iii) after the expiry** of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, **the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company;**

**(2) The notice referred to in sub-clause (i) of clause (a) of sub-section (1) shall be dispatched through registered post or speed post or through electronic mode to all the existing shareholders at least three days before the opening of the issue.”**

## **ANALYSIS**

### **WHAT IS MEANT BY RIGHT SHARES?**

To understand the meaning of right share it would be pertinent to refer the meaning of share which is defined under Section 2(84) as, "share means a share in the share capital of a company and includes stock”.

#### **Meaning of Right Shares**

**Right shares** are those shares which are issued after the original issue of shares but having an inherent right of the existing shareholders to subscribe to these shares in proportion to their holding. Such shares must be offered to the existing equity shareholders on pro rata basis.

### **REASONS FOR A RIGHTS ISSUE**

- When a company is planning an expansion of its operations, it may require a huge amount of capital. Instead of opting for debt, they may like to go for equity to avoid fixed payments of interest. To raise equity capital, a rights issue may be a faster way to achieve the objective.
- A project where debt/loan funding may not be available/suitable, company raise capital through a rights issue.
- Companies looking to improve their debt to equity ratio or looking to buy a new company may opt for funding via the same route.
- Sometimes troubled companies may issue shares to pay off debt in order to improve their financial health.

## **WHO ARE ENTITLED TO RIGHT SHARES?**

The offer of right shares is given to the equity shareholders of the company. This means that the offer must be given to the persons who are in possession of equity share and not to person holding preference share.

## **IS APPROVAL OF SHAREHOLDER NEEDED TO ISSUE RIGHT SHARES?**

To analyze and answer this question it would be imperative to refer Section 179(1) of Companies Act, 2013 which is reproduced hereunder:

“The Board of Directors of a company shall be entitled to exercise all such powers, and to do all such acts and things, as the company is authorised to exercise and do: Provided that in exercising such power or doing such act or thing, the Board shall be subject to the provisions contained in that behalf in this Act, or in the memorandum or articles, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting:

Provided further that the Board shall not exercise any power or do any act or thing which is directed or required, whether under this Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting.”

From the perusal of above stated provision it is clear that in case the Act, Memorandum of Association and Article of Association are silent about the approval of shareholders for a particular matter, the approval of the Board shall be sufficient compliance.

Thereby, it can be safely concluded that there is no need to pass resolution in General Meeting for issue of Right Shares, the only requirement is passing of board resolution.

## **SCOPE OF DIRECTOR'S POWER**

In the case of **Sri Hari Rao v. Gopal Automotive Ltd. MANU/CL/0024/1999** the court held that there was sufficient evidence available for the director to engage in the further issue of shares. Therefore, they held that they could not restrain the

company from issuing further shares for the mere reason that the minority shareholder is unwilling to subscribe to the additional capital.

This similar aspect was considered by the court in the case of **Chandrakant Mulraj v. Tata Engineering and Locomotive Co Ltd. MANU/MH/0002/1983**. In this case, the court held that reduction in the market value of the shares is not a sufficient reason for restraining the company from the further issue of shares. This is because such a measure was undertaken keeping in view the interests of the company.

In the landmark case of **Nanalal Zaver v. Bombay Life Assurance Co.Ltd.MANU/SC/0003/1950**. The Appellants contended that the director's exercise of discretion in issuing further shares was male fide in nature as it was done to gain control of the company, the Supreme Court, while dealing with this contention held that since the directors exercised their discretion in a bona fide manner for the best interests of the company, mere incidental benefits to the directors would not warrant interference in the further issue of shares.

In the same manner exercise of director's discretion was dealt by the Supreme Court in the case of **Needle Industries (India Ltd) v. Needle Industries Newey (India) Holding Ltd. MANU/SC/0050/1981**. The Court did not restrain the acts of the director since he not only acted in a bona fide manner for the benefit of the company but also acted without any motive to promote his own cause. The Court also held that the exercise of director's discretion would be for an improper motive if it is solely done for their own benefit.

The requirement of a bonafide and proper purpose before the further issue of shares was first postulated in the landmark case of **Hogg v. Cramphorn Ltd. (1967) 1 Ch 254**. In this case, the court interfered in the further issue of shares even though they felt that he acted for the interests of the company, since he acted with the improper motive to control a greater share of the company.

The same principle was reiterated with greater force in the case of **Clemens v. Clemens Bros Ltd. 1976, 2 All ER 268**. where court held that the director was acting in breach of its fiduciary duty since the further issue was done for the sole motive to squeeze out the majority shareholders.

The landmark case which applied the said modified principle (proper purpose + bone fide requirement) was the Supreme Court decision of **Dale and Carrington**

**Invt. (P) Ltd and Anr v. P.K Prathappan and Ors. MANU/SC/0748/2004.** In this case, the Court invalidated the director's further issue since he was neither able to prove that such issue was for the benefit of the company nor was he able to prove that he was acting in a bona fide manner since his motive was to gain control of the company. The same principle was enunciated by the Supreme Court in the subsequent case of **Shri V.S Krishnan and Ors v. Westford Hi-Tech Hospital Ltd. and Ors. Case No. Appeal (civil) 1473 of 2008.**

### Conclusion

Thus, it is clear from the above judicial pronouncements that the standard for analyzing the manner of exercise of the director's discretion has shifted from a mere bona fide requirement to a modified principle of bona fide + proper purpose. This, according to me is the right standard for scrutinizing the discretion of the director in the further issue of shares. This is because the Companies Act does not provide any guidance on the aspect of the director's discretion in issuing further shares. Thus, by adopting the modified principle, the possibility of a director exercising his discretion in an irregular manner is minimized to the maximum extent possible.

Even though the existing shareholders have a preemptive right to the new stock of shares, the scope of such interference in the director's discretion is limited. It is only in exceptional situations where the further issue of shares is restrained.

### Question Bank

#### **Q. Whether warrants, are also covered under Section 2(84) of the Act?**

**A.** In order to answer this question, it would be pertinent to elaborate the meaning of 'share' in light of judicial precedents. The Hon'ble Madras High Court in case of **S. Viswanathan v. East India Distilleries and Sugar Factories Ltd, AIR 1957 Mad 341** held that share is incorporeal in its nature and it consists merely of a bundle of rights and obligations. Every one of these rights and obligations is created by a statute or under statutory instrument of powers which also define their extent, scope, boundary and instruments.

Further, share warrants find place under the definition of securities contained under Section 2(h) of Securities Contract and (Regulation) Act, 1956.

“securities” includes:

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

- (ia) .....
- (ib) .....
- (ic) .....
- (id) .....
- (ie) .....
- (ii) .....
- (ia) .....
- (iii) .....

Share Warrant finds place under sub-clause (i) of Section 2(h) beneath the words ”other marketable securities of like nature in or of any incorporated company or other body corporate”.

Since, share warrants finds place under the above mentioned words and shares finds a specific mention under sub-clause (i) of Section 2(h), it can be validly said that share and share warrant are two different types of securities and hence, provisions pertaining to right issue are not applicable to share warrants.

**Q. Whether Convertible Debentures are also covered within the ambit of Section 62(1)(a)?**

A. No, the provisions of Section 62(1)(a) shall not be applicable on Convertible Debentures whether compulsory convertible or optionally convertible, in terms of Section 62(3) which is cited hereinbelow:

‘Nothing in this section shall apply to the increase of the subscribed capital of a company caused by the exercise of an option as a term attached to the debentures issued or loan raised by the company to convert such debentures or loans into shares in the company.’

However, the securities other than debentures, such as convertible preference shares are covered within the ambit of Section 62(1)(a).

**Q. Whether the provisions contained under Section 26-41 (pertaining to Public issue) shall be complied with if the number of allottees after renunciation exceeds the limit of 200?**

**A.** In order to answer this question, it would be pertinent to refer the text of relevant Section read with judicial pronouncements and rules of interpretation.

### Rules of Interpretation

As per the golden rule of interpretation i.e. 'literal rule' words that are reasonably capable of only one meaning must be given that meaning whatever may be the result. No words shall be added in, or deducted from, a statute. It is only when the words are not clear or are capable of multiple construction, statute is to be interpreted in light of its purpose and intention.

### Relevant Statutory Provisions

#### **Section 23 of Companies Act, 2013: Public Offer and Private Placement**

(1) A public company may issue securities—

(a) to public through prospectus (herein referred to as "public offer") by complying with the provisions of this Part; or

(b) through private placement by complying with the provisions of Part II of this Chapter; or

(c) through a rights issue or a bonus issue in accordance with the provisions of this Act and in case of a listed company or a company which intends to get its securities listed also with the provisions of the Securities and Exchange Board of India Act, 1992 (15 of 1992) and the rules and regulations made thereunder.

(2) A private company may issue securities—

(a) by way of rights issue or bonus issue in accordance with the provisions of this Act; or

(b) through private placement by complying with the provisions of Part II of this Chapter.

Section 42 of Companies Act, 2013 mandates that the offer of securities or invitation by way of Private Placement, shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed [i.e. 200], in a financial year on such conditions as may be prescribed.

Section 23(1) states that public company may issue securities to public through prospectus.

The term 'prospectus' finds place under Section 2(70) in following words:

“prospectus means any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in Section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.”

From the perusal of the above definition, it can be observed that the term ‘prospectus’ is widely defined in the Act so as to include in its ambit any notice, circular, advertisement or any other documents, the purpose of which should be “inviting offers from the public for the subscription or purpose. The main function of a prospectus is, thus to invite offers from public for subscription or purchase of securities of a public company, since a private company is prohibited from issuing any invitation to the public to subscribe for any shares or debentures of the company.”

A document in order to be called a ‘prospectus’, must invite offers from the public.

The expression ‘Right Issue’ has not been defined in Companies Act, 2013. Renunciation connotes the surrender to someone else of right to share in a right issue. Persons who are not shareholders of the company are not entitled to subscribe to the rights shares directly otherwise than on renunciation.

The limit of 50 finds place in Section 42 and is relevant only for the purpose of Section 42 and not for the purpose of Section 62. Moreover neither Section 62, nor Section 23, nor Section 42, nor any other provision of Companies Act, 2013 makes the number of 50 applicable in case of right issue entitlements to other (non-members) resulting into number of non-members renounces exceeding 50.

In view of the above it can be safely concluded that the provisions of Public Issue shall not be applicable in case allottees after renunciation exceeds the limit of 200.

### **Refund of Share application money**

Allotment of share shall be made within a period of 2 months from the receipt of application money [**Explanation (a) to Rule 2(1)(c)(vii) of Companies (Acceptance of Deposits) Rules, 2014**] However, there is no provision relating payment of interest @ 12%. This application money will be treated as deposit after the expiry of 60 days in terms of **Explanation (i) to Rule 2(1)(c) of Companies (Acceptance of Deposits) Rules, 2014**. The relevant portion of the said rule is cited hereinbelow:

**Section 2(31) read with Rule 2(1)(c):**

**“(vii) any amount received and held pursuant to an offer made in accordance with the provisions of the Act towards subscription to any securities, including share application money or advance towards allotment of securities pending allotment, so long as such amount is appropriated only against the amount due on allotment of the securities applied for;**

**Explanation.- For the purposes of this sub-clause, it is hereby clarified that -**

**(a) Without prejudice to any other liability or action, if the securities for which application money or advance for such securities was received cannot be allotted within sixty days from the date of receipt of the application money or advance for such securities and such application money or advance is not refunded to the subscribers within fifteen days from the date of completion of sixty days, such amount shall be treated as a deposit under these rules.”**

**Procedure of Right Issue in case of unlisted Company**

- 1. Check weather articles authorise right issue:-** If not, take steps to alter the Articles.
- 2. Letter of offer:-** Finalize the draft letter of offer for issuing equity shares through right issue. No specific format of Letter of offer is prescribed. However letter of offer shall contain offer price, face value of shares, Mode & terms of payment and right to renounce.
- 3. Board Meeting:-** Hold Board Meeting and pass resolution for approval of letter of offer. Notice of BM to be sent atleast 7 days before date of BM.
- 4. Filing of MGT-14 :-** File MGT-14 within 30 days from passing board resolution. (This provision is not applicable to private companies).
- 5. Dispatch letter of offer:-** Dispatch Letter of Offer through registered post, speed post or electronic mode to all existing shareholders. Letter of Offer to be sent atleast three days prior to opening of issue.

**Note:-** Hand delivery of letter of offer is not permissible.

- 6. Time period of open offer:-** Offer to be kept open for minimum 15 days upto 30 days.

Provided that in case of a private company, if ninety percent of members have given their consent in writing or in electronic mode, the period lesser than those specified shall apply.

7. **Deemed refusal:-** No Intimation in 30 days would be deemed to be refusal of the offer.
8. **Another Board Meeting:-** Hold another Board Meeting to approve issue of shares to shareholders who have opted for the Right Issue of shares. Notice of BM to be sent atleast 7 days before date of BM.
9. **Issuance of shares:-** Issue shares in accordance with the list of allottees approved in the Board Meeting.
10. **Filing of PAS- 3:-** File PAS-3 within 30 days from date of allotment – return of allotment.
11. **Issuance of share certificates:-** Issue Share Certificate within 2 months from date of allotment.

### **Procedure of Right Issue for Listed Companies**

The Listed Entity shall in addition to compliance of Companies Act, 2013 shall comply with SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

#### **PROCEDURE:**

1. **Check weather articles authorise right issue:-** If not, take steps to alter the Articles.
2. **Appointment of merchant banker and other intermediaries :** The issuer shall appoint one or more merchant bankers, at least one of whom shall be a lead merchant banker and shall also appoint other intermediaries only those who are registered with SEBI, in consultation with the lead merchant banker, to carry out the obligations relating to the issue.
3. **In-Principle Approval of Stock Exchange:** The Company must obtain in-principle approval for its Rights Issue from the Stock Exchanges where the company shares are listed.
4. **Documents to be submitted before opening of the issue:** The Lead Merchant Banker shall submit the documents mentioned in Regulation 8 of chapter II of along with draft offer document.
5. **Filing of offer document:** File letter of offer atleast 30 days prior to file the same with designated stock exchanges. If SEBI specifies any change in it then issuer shall carry out such changes.

The offer document filed with the board under this regulation shall also be furnished to the Board in a soft copy in the manner specified in Schedule V.

6. **Format of Letter of offer:** Specified in Schedule VIII of part A or E specified in regulation 57(2)(b). If a company complies conditions mentioned in clause 1 of Part E, then it is required to make Letter of Offer (LOO) according to Part E.
7. **Pre-issue advertisement of Right Issue:** Atleast 3 days before opening of the issue.
8. **Abridge LOO to shareholders:** Atleast 3 days before opening of issue.
9. **Minimum Subscription:** Minimum subscription of issue size shall be 90 % of the issue size.
10. **Record Date** – 7 working days notice given for record date.
11. **Issue Opening Date:** As according to Regulation 11 of Chapter II.  
The Rights Issue must be opened for subscription for a minimum period of 15 days and Maximum period of 30 days
12. **Pricing:** The issue price shall be decided before determining the record date which shall be determined in consultation with the designated stock exchange.
13. **Over subscription:** No part of over subscription of Rights Issue shall be retained by the Listed Company; the amount has to be refunded
14. **Withdrawal of the Rights Issue:** No Rights Issue can be withdrawn by issuer after fixing the Record Date. In case, if it has withdrawn after announcing record date, no further issue of capital is allowed for a period of 12 months from the record date.
15. **LODR Requirement:**  
**Intimation to stock exchange:** atleast 2 days intimation to stock exchange as per regulation 29 of sebi, lord regulations 2015.