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Absolute Discretions of the Board in Allotment of Unsubscribed Shares: An Analysis

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ABSTRACT

A company needs additional capital and keeps the voting rights of the existing shareholders proportionately balanced, the company issues Rights shares. The issue is called so as it gives the existing shareholders a pre-emptive right to buy new shares at a price that is lesser than market price. This article covers who has the absolute authority over the allotment of unsubscribed shares, as well as the related statutes and case law. It talks about Sec. 62 of the Act which gives the board unrestricted or an absolute authority to allotment process of the unsubscribed stocks to issue rights to a non-shareholder, as long as the allocation is not damaging to the firm or its any of the shareholders. The article also covers how the Act, is silent on how unsubscribed shares may be distributed to third parties.

I. INTRODUCTION

A rights issue is a shareholder's right to participate in a transaction. It, is the recognition of an equity shareholder's fundamental right to prevent dilution of his investment in the company. The equity shareholder has the first right of refusal to subscribe to his proportionate share of any future issuance of equity shares. As a result of their standing, current stockholders have first access. The offer must be made in proportion to present shareholders' interests in the rights issue. It's up to the Shareholders who are given the option to subscribe that they may they can may or may not choose to accept to the offer in part or in whole. Shareholder approval of a right issuance does not require a separate resolution. It's the Board who has sole control over setting the prices of the securities, which do not have to be computed using the assessment of a recognised valuer.

Occasionally, there is a desperate need of capital in companies to expand their day-to-day operations. Given the need and time is of the essence in obtaining cash/capital, Companies jump to the rights issue of shares as it gives them a straightforward, quick, and relatively simple route. The framework for rights issues of shares is governed by Sec. 62 of the Companies Act, 2013 ("the Act"). The provision mostly maintains the prior dominion outlined in Sec. 81 of the Companies Act of 1956, but with a few key adjustments. The rule established by Apex court

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 [ISSN 2581-9453]

in this matter through various judicial rulings on preceding legislation remains unaltered.

The rights issues provides the company with two additional benefits as opposed to raising money through a preferential allotment or a private placement of securities.

1. As compared to a private placement or preferential allocation, this does not necessitate approval of shareholders via a Special resolution.
2. The Board gets the complete discretion in setting the price of the securities in question, which does not have to be based on a valuation performed by a registered valuer.

A private placement or preferential allotment of securities, on the other hand, must adhere to the price standards outlined in the Companies (Prospectus and Allotment of Securities) Rules, 2014 and the Companies (Share Capital and Debentures) Rules, 2014. Listed entities seeking a private placement or preferential allocation must also follow the price requirements outlined in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

SEC. 62(1)(A) OF THE COMPANIES ACT, 2013

When a company puts forward an offer to increase its subscribed capital by issuing additional shares, they must be offered to equity shareholders in proportion to the paid-up share capital via a letter of offer, which shall be subject to the following conditions –

- the offer must specify the number of shares offered, and the acceptance period must be 15 to 30 days.
- Unless the company's AOA say otherwise, the offer is presumed to include a right of renunciation if it is not accepted within this the given period.
- Once the time mentioned in the notice has expired, or upon receipt of an earlier indication from the person that he does not wish to accept the shares offered, the Board may dispose of the shares in a way that is not detrimental to the company or the shareholers.

The provisions set out in Sec. 62(1)(a) of the act are exhaustive, and a rights issue can be carried out without the shareholders' prior permission. However, it is important to highlight that, according to Sec. 179(3)(c) of the Act, a rights matter can only be pursued after gaining Board consent with a resolution passed at a the BM.

II. LANDMARK JUDGEMENTS

The principles governing the Board's authority to pursue a rights matter have been codified in key rulings of Apex court, such as ***Needle Industries (India) Ltd v. Needle Industries Newey (India) Holding Ltd.***[2], and ***Nanalal Zaver v. Bombay Life Assurance Company***[3]**,** The validity of the rights issue was questioned in the Nanalal Zaver case on the grounds that it was not created for the benefit of the company; rather, the goal was to retain control over the firm's affairs. The Supreme Court ruled that if the directors exercise

[2] Needle Industries (India) Ltd v. Needle Industries Newey (India) Holding Ltd., AIR 1981 SC 1298.

[3] Nanalal Zaver v. Bombay Life Assurance Company, AIR 1950 SC 172.

their ability to issue additional shares not for the benefit of the company, but for their own personal gain and to the harm of the firm, the court will forbid them from doing so. However, if the directors utilise their power for the benefit of the company while also having a secondary motive that does not impact the interests of the company or the existing shareholders - there is no need for the Court to intervene.

This approach was reaffirmed in the Needle Industries case, which ruled that the test to be used is whether the *"issuance of shares is simply or wholly for the profit of the directors."* If the shares are issued in the best interests of the firm, the decision to issue shares cannot be challenged on the grounds that it benefited the directors as shareholders incidentally. Furthermore, if the directors happen to retain control of the corporation as a result of the rights issue, this does not constitute an abuse of their fiduciary duty.

Unsubscribed Shares and its Allotment of to a 3rd Party

According to Sec. 62(1)(a)(iii) of the Act, a company's Board of Directors may dispose of unsubscribed shares in a way that is "not dis-advantageous to the shareholders and the company." Notably, the directors were authorised to dispose of unsubscribed rights issue shares "in such manner as they judge most beneficial to the company" under Sec. 81(1)(d) of the 1956 Act (which equates to Sec. 62(1)(a)(iii) of the Act). While no justification has been provided under the 'Notes on Clauses' of the Companies Bills or the Parliamentary Standing Committee Reports as to why the change was made from 'most beneficial' to 'not dis-advantageous,' the authors believe the consequence of this alteration is significant.

Determining what is most helpful to the company gives the Board greater power, however determining what is not detrimental to the company and the shareholders is more practical – as it considerably reduces the pressure on the Board to justify their choice in such cases. The Gujarat High Court held in the case of ***In Re: Mafatlal Industries Ltd.***[4]**,** that the Board's power to dispose of such surplus shares arising from failure to subscribe by shareholders or through renunciation is very broad under the 1956 Act, and the Board can dispose of such surplus shares to non-members as well. It was also determined that the law imposes no time limit on the Board's receipt of subscriptions for the disposal of surplus shares.

As a result, if the eligible shareholders of a company to whom a rights issue offer is made either declines the offer or does not respond within the offer period specified in the rights issue notice, the Board of a company is empowered under Sec. 62(1)(a)(iii) of the Act to dispose of the unsubscribed shares in a manner that is not disadvantageous to the company or its shareholders. One of the preferred methods of disposing of unsubscribed shares is to allot them to third-party investors who are not now shareholders of the company.

[4] In Re: Mafatlal Industries Ltd. (1996) 87 CompCas 705 (Guj).

 [ISSN 2581-9453]

As a result, the question is whether the Board is compelled to implement Sec. 42 of the Act, which governs private placements of securities, when allocating the unsubscribed equity shares of the rights issue to a third party. However, the Act is silent on the procedure for transferring unsubscribed shares to a third party.

Sec. 62(1)(a) of the Act, which sets the framework for rights issues, does not require a corporation to comply with the provisions of Sec. 42 of the Act in order to dispose of the unsubscribed portion of the equity shares offered to eligible shareholders through a rights issue. The language of Sec. 62(1)(a)(iii) permits the Board to dispose of the shares in its discretion, as long as it is not detrimental to the firm or the shareholders.

Unlike the language of Sec. 62(1)(c) of the Act, which states that "*subject to the compliance with the applicable provisions of Chapter III and any other conditions as may be prescribed*," Sec. 62(1)(a) of the Act has no such qualifying language. Furthermore, the Explanation to Rule 13 of the Share Capital Rules states that the term "Preferential Offer" refers to a company's preferential issue of shares or other securities to any select individual or group of persons and *"does not include shares or other securities offered through rights issue."* As a result, it might be argued that unsubscribed share allotment to a third party under Sec. 62(1)(a) of the Act functions independently of private placement and preferential allotment under the Act.

However, because the definition of a 'public issue' is broad, companies should exercise caution when conducting a rights issue to ensure that, for the purposes of the unsubscribed portion of such a company's equity shares, its Board of Directors does not dispose of such unsubscribed shares by offering or inviting to subscribe to, and thus allotting to more than 200 people in aggregate.

Evaluating what is truly beneficial to the company provides the Board more authority, however recognising something that is not detrimental to the company or its shareholders is far more practical as it lowers the burden of proof on Board's shoulders in such cases. In the case of In Re: Mafatlal Industries Ltd[5], the Gujarat High Court determined that the Board's ability to discharge extra shares resulting from shareholder inability to conform or abandonment appears to be very broad under the 1956 Act, and that the Board can even sell excess shares to non-members. It was also determined that there is no time limit for the Board of Directors to receive subscriptions for the sale of residual shares under the law.

If shareholders of a company who are qualified and to whom a rights issue offer is made, they either drop the proposal or fail to comply with the time frame specified in the said proposal of the rights issue, the Board of Directors of a company is authorised under Sec. 62 of the Act to try to get rid of the unsubscribed shares in a way that is not unfavourable to the company or its shareholders. One of the most popular strategies for disposing

[5] *Ibid*.

of unsubscribed shares is to allocate them to any 3rd party investor who is not even a current shareholders of the company in question.

Giving rise to, “the next issue is whether the Board is required to follow Sec. 42 of the Act, which governs private placements of stocks, when distributing the rights issue's unsubscribed equities to a third party.” The Act, on the other hand, is silent on the procedure for allowing third-party distribution of unsubscribed shares, Sec. 62(1)(a) of the Companies Act, 2013 governs the structure for rights issues, of a company and prohibits it from adhering to the rules of Sec. 42 of the Act for the specific purpose of handling and disposing of the unsubscribed fraction of the shares provided to qualified shareholders by a company through a rights issue. Sec. 62(1)(a)(iii) allows the Board to dispose of shares at its discretion if it is “not harmful to the firm and shareholders.”

Furthermore, Rule 7A of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 states that a person residing outside of India who has acquired a right to the unsubscribed portion of a rights issue from a person residing in India who has renounced it may acquire equity instruments (other than share warrants) in exchange for the said rights in accordance with the pricing guidelines specified in Rule 21 of the NDI Rules. This has changed the previous position because the Explanation to Rule 7 of the NDI Rules, which stated that a non-resident who is eligible in the event of renunciation by a resident shareholder could subscribe to a rights issue at the same price as a resident shareholder of a company, has been removed.

III. Conclusion

Sec. 62 of the Act imposes no constraints on the Board’s discretion in allotting unsubscribed rights issue shares to a non-shareholder, as long as such allocation is not detrimental to the company or its shareholders. If it is determined that such allotment of unsubscribed shares to non-shareholders constitutes a ‘private placement’ under Sec. 42 of the Act, then the provision becomes almost unworkable because the company cannot change its course mid-stream to comply with several other Sec. 42 and PAS Rules requirements. Nothing in the scheme of Sec. 62 suggests such a stance. Companies, on the other hand, would be required to follow the NDI Rules for any subscription made by a non-resident shareholder in excess of his rights entitled. It must also be verified that the number of non-shareholder subscribers does not exceed 200. The Board’s discretion in this regard otherwise remains unfettered.

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