
Deciphering the classic confusion – Preferential Offer & Private Placement of shares & securities



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Introduction: Since 2014, the majority of amendments have been introduced to the Companies Act, 2013 ('the Act') with the objective of ease of doing business, eliminating conflicting provisions, etc. In spite of all efforts, 'preferential offer' and 'private placement' remains highly debated and controversial matter. The Act provides for several provisions for the issue of shares and securities, which ultimately helps the companies in raising capital from existing shareholders, promoters and external investors. In the Act and Rules, there is a reference of 'preferential offer' and 'private placement' as well. The question before professionals is whether a particular offer and issue of securities is a 'preferential offer' or 'private placement' or both.

Basic provisions: Chapter III of the Act, 2013 relates to 'Prospectus and Allotment of Securities'. Part I relates to 'Public Offer' (sections 23 to 41, both inclusive) and Part II relates to 'Private Placement' (section 42). Section 23 provides for the ways in which a private company and a public company can issue securities and raise funds. According to the provisions, a public company may issue securities: (a) To the public through a prospectus ('public offer'), (b) through private placement; or (c) Through rights issue or bonus issue. A private company may issue securities: (a) By way of rights issue or bonus issue; or (b) Through private placement. Interesting to note that there is no reference to 'preferential offer' under section 23 of the Companies Act. Section 62 of the Companies Act provides for 'further issue of share capital', which includes rights issue and section 63 of the Act provides for 'issue of bonus shares'.

For the purpose of this article, the author has referred to the following relevant provisions:

- (1) Section 42 of the Act read with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014,
- (2) Section 62 of the Act read with Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014.

Meaning of 'Private Placement': 'Private placement' means any offer or invitation to subscribe or issue of securities to a select group of persons by a company (other than by way of public offer) through private placement offer-cum-application, which satisfies the conditions specified in section 42 of the Act¹. Based on this definition, the following are the key features of 'private placement':

- (1) It is an offer or invitation (and not 'allotment') to subscribe to securities,

- (2) It relates to an offer or issue of 'securities'², 'securities' as defined in the Securities (Contract) Regulation Act, 1956³ – therefore the scope of securities is wide as it includes shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or pooled investment vehicle or other body corporate, derivative, units or any other instrument issued by any collective investment scheme to the investors in such schemes or security receipt, etc. There is no specific provision to restrict the interpretation of 'securities' like – convertible or non-convertible or redeemable or irredeemable securities, etc.,
- (3) The offer is made to a 'select group of persons'. Such persons who have been identified by the board of directors (referred to as 'identified persons' in section 42 of the Act), whose number shall not exceed 50 or such higher number as may be prescribed (i.e. 200 persons⁴). The law provides for the exclusion of certain persons from the prescribed number of persons, which includes Qualified Institutional Buyers, employees who are offered ESOPs⁵ in a financial year,
- (4) The offer is made through private placement offer-cum-application – as defined in section 42 of the Act,
- (5) The conditions of the offer comply with section 42 of the Act and Rules made thereunder.

Meaning of 'Preferential Offer': Interesting to note that, section 62 of the Act does not refer to and provide for the definition of 'preferential offer'. The same has been defined in an Explanation to Rules⁶ as – For the purposes of this rule, (i) the expression 'Preferential Offer' means an issue of shares or other securities, by a company to any select person or group of persons on a preferential basis and does not include shares or other securities offered through a public issue, rights issue, employee stock option scheme, employee stock purchase scheme or an issue of sweat equity shares or bonus shares or depository receipts issued in a country outside India or foreign securities, (ii) the expression, 'shares or other securities' means equity shares, fully convertible debentures, partly convertible debentures or any other securities, which would be convertible into or exchanged with equity shares at a later date.

Based on the discussion of Rule ¹³ of the Companies (Share Capital and Debentures) Rules, 2014, let us now refer to section 62(1)(c) of the Act which states that "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 – to any persons, if it is authorised by a special resolution, whether or not those persons include the persons referred to in clause (a)⁷ or clause (b)⁸, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer, subject to the compliance with the applicable provisions of Chapter III and any other conditions as may be prescribed."

Based on the above definitions and necessary references, the following are the key features of 'preferential offer':

- (1) 'Preferential Offer' is an issue of shares or other securities,
- (2) Such issue of shares or other securities by a company are to any select person or group of persons on a preferential basis,
- (3) 'Select person or group of persons' has neither been defined in the Act⁹ nor in the Rules¹⁰;
- (4) 'Preferential Offer' does not include shares or other securities offered through a public issue, rights issue, ESOP scheme, ESPS or an issue of sweat equity shares or bonus shares or depository receipts issued in a country outside India or foreign securities – here the exclusions are more as compared to the exclusions provided for private placement of securities under section 42 of the Act,

- (5) Under the Rule 13, 'shares or other securities' has been defined to mean – equity shares, fully convertible debentures, partly convertible debentures or any other securities, which would be convertible into or exchanged with equity shares at a later date. Here, there is no explicit reference to 'preference shares', however, the same would be included in 'other securities'. Therefore, it can be said that 'non-convertible securities' are not within the scope of 'preferential offer'. Such non-convertible securities would include – non-convertible debentures or non-convertible preference shares, etc. under the Companies Act,
- (6) Such an offer of shares can be either for cash or for a consideration other than cash,
- (7) The price of shares is determined by the valuation report of a registered valuer,
- (8) The offer of shares is subject to compliance with the applicable provisions of Chapter III and any other conditions as may be prescribed (i.e. provisions of section 42 of the Act and the Rules made there under).

The above summary points are adequate enough for academic as well as practical comparison between the 'preferential offer' of shares and 'private placement' of securities.

Additional compliances and disclosures under preferential offer¹¹: The additional compliances and disclosures under preferential offer are as follows:

- (1) Issue is authorised by articles of association of the company¹²,
- (2) Completion of allotment within 12 months from passing of special resolution¹³,
- (3) Determination of pricing of convertible securities¹⁴,
- (4) Provisions of issue of shares for consideration other than cash (in addition to an issue of shares or securities for cash consideration)¹⁵.

Key points of comparison between 'preferential offer' and 'private placement':

- (1) Section 62 of the Act provides for the issue of 'shares', whereas the relevant Rule made thereunder provides for the issue of 'shares and other securities'. The scope of a preferential offer is limited only to shares and convertible securities. The scope of section 62 of the Act is enhanced through the Rules. Section 42 and the Rules made thereunder provide for the issue of 'securities'. On this point, the scope of the private placement is wider than the preferential offer,
- (2) Section 62 of the Act provides for the issue of shares either for cash or for a consideration other than cash. Section 42 and the Rules made thereunder provide for the issue of securities for cash. On this point, the scope of the preferential offer is wider than private placement,
- (3) Section 62 of the Act provides for valuation by Registered Valuer. The price of shares or other securities to be issued on a preferential basis shall not be less than the price determined on the basis of the valuation report of the Registered Valuer¹⁶. Interestingly, Section 42 and the Rules made thereunder do not provide for the requirement of valuation by a Registered Valuer.
- (4) Section 42 of the Act and Rules made thereunder provides for detailed provisions and procedures for the allotment of securities under the private placement of securities. As compared to section 42 of the Act (and the Rules made under it), Rule 13¹⁷ emphasizes compliances and disclosures.

Where is the real conflict between 'preferential offer' and 'private placement':

- (1) Section 62(1)(c) of the Act states that "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 – to any persons, if it is authorised by a special resolution, whether or not those persons include the persons referred to in clause (a)¹⁸ or clause (b)¹⁹, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer, subject to the compliance with the applicable provisions of Chapter III and any other conditions as may be prescribed.". Taking into consideration the wordings of the provisions, the author is of the view that section 62(1)(c) of the Act is to be read with section 42 and relevant Rules made under. This is in spite of the fact that the relevant provisions are repetitive and overlapping.
- (2) The Rules made under section 62 of the Act²⁰ states that – For the purposes of clause (c) of sub-section (1) of section 62, if authorized by a special resolution passed in a general meeting, shares may be issued by any company in any manner whatsoever including by way of a preferential offer, to any persons whether or not those persons include the persons referred to in clause (a) or clause (b) of sub-section (1) of section 62 and such issue on preferential basis should also comply with conditions laid down in section 42 of the Act. i.e. taking into consideration the wording of the provisions, the author is of the view that all preferential offers shall ensure compliance with section 42 of the Companies Act and Rules made thereunder.
- (3) Requirement of Valuation – If every preferential offer has to comply with section 42 of the Companies Act, then the requirement of valuation also applies for such issue of securities (as required under section 62 and the Rules made thereunder).
- (4) One interesting and practical issue is whether section 62 of the Act and Rules will apply to the issue of non-convertible securities. Taking into consideration the above discussion on sections 42 and 62 of the Act and the Rules made there under and also applying the rules of interpretation, the author is of the view that provisions of section 62 of the Act and related Rules are not applicable to such issues.

Conclusion:

Taking into consideration the above discussion, the author is of the view that – for private companies and unlisted public companies – in the majority of cases the preferential offers of securities (u/s 62(1)(c) of the Act) fall under the private placement of securities (u/s 42 of the Act). The exceptions to the rules, create more confusion about the applicability of the provisions, though ultimately the offer is made to a select group of persons or a select group of identified persons.

Based on the above discussion, the author is of the view that private placement or preferential offer under the Act means an offer of securities to a select group of a limited number of persons (whether an existing shareholder or not). The interpretation issues and anomalies in the provisions can be addressed by the Government in the following manner: (i) Merging all the relevant provisions of Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014, and (ii) Not having reference of 'shares or other securities' in Rules and making provisions applicable to all securities.

Interesting to note that section 42 of the Act was substituted by the Companies (Amendment) Act, 2017²¹ and also Rule 14²² was also substituted²³, however, the conflicting issues were not addressed. Also, the Report on Companies Law Committee (of March 2022) does not provide for such an amendment.

Chapter V, Regulation 158 to 170 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 relates to 'Preferential Issue'. There is no reference to 'private placement of securities' in the said Regulations. Like SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2015, the Companies Act should have reference to only one concept either 'preferential issue of securities' or 'private placement of securities, covering all disclosures, compliances, approval, procedures, pricing, valuation, etc.

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1. Explanation I to Section 42(3) of the Companies Act, 2013.
 2. As defined in section 2(81) of the Companies Act, 2013.
 3. 'Securities' as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.
 4. Rule 14(2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014.
 5. Section 42(2) of the Act read with proviso to Rule 14(2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014.
 6. Explanation (i) and (ii) of the Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014.
 7. Section 62(1)(a) of the Act i.e. existing equity shareholders of the company.
 8. Section 62(1)(b) of the Act i.e. employees under ESOP scheme.
 9. Section 62 of the Act
 10. Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014.
 11. Only with reference to Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014
 12. Rule 13(2)(a) of the Companies (Share Capital and Debentures) Rules, 2014.
 13. Rule 13(2)(e) of the Companies (Share Capital and Debentures) Rules, 2014.
 14. Rule 13(2)(h) of the Companies (Share Capital and Debentures) Rules, 2014.
 15. Rule 13(2)(i) and (j) of the Companies (Share Capital and Debentures) Rules, 2014.
 16. Rule 13(3) of the Companies (Share Capital and Debentures) Rules, 2014.
 17. of the Companies (Share Capital and Debentures) Rules, 2014.
 18. Section 62(1)(a) of the Act i.e. existing equity shareholders of the company.
 19. Section 62(1)(b) of the Act i.e. employees under ESOP scheme.
 20. Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014.
 21. w.e.f. August 7, 2018.
 22. Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014.
 23. Substituted by the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2018, w.e.f. August 7, 2018.