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[2024] 169 taxmann.com 584 (Article)©Date of Publishing: **December 25, 2024****Whether Company Law mandates valuation for issuing redeemable or non-convertible securities on preferential basis?****GAURAV PINGLE**

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The law relating to issue of securities has been a very interesting topic of research as the law paves the way for companies to raise capital (either from public or from private investors). In the Companies Act, 2013 ('Companies Act') there is a dedicated chapter for such issue of securities along with Rules made there under. Valuation is an essential and important requirement for raising money. In this article, the author has discussed whether the extant provisions of the Companies Act mandates valuation by Registered Valuer for issuance of redeemable (i.e. non-convertible) preference shares on preferential basis OR for issuance of redeemable (i.e. non-convertible) debentures on preferential basis? There is also a brief discussion on preferential offer and private placement of securities. Readers should note that this article is analysis of the provisions of the Companies Act and not under any other laws – e.g. Income Tax Laws, Foreign Exchange Laws, Securities Laws, etc.

Meaning of offer of shares on preferential basis & required compliance: Pursuant to the provisions of section 62(1) (c) of the Companies Act, a company can offer the shares to any persons (i.e. any third party or any one director or any shareholder(s) or any promoter of the company), if it is authorised by a special resolution. Such issue of shares can be either for cash or for consideration other than cash. However, the price of such shares is determined by the valuation report of a registered valuer. Such issue shall be subject to the compliance with the applicable provisions of Chapter III of the Companies Act (relating to 'Prospectus and allotment of securities') and any other conditions as may be prescribed (i.e. Companies (Prospectus and Allotment of Securities) Rules, 2014). The said offer of shares is termed as 'Offer of shares on preferential basis'.

Therefore, for offer of shares or debentures on preferential basis, a company (private company or public company, both) would be required to be comply with following provisions:

- (1) Section 62(1)(c) of the Companies Act,
- (2) Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014,
- (3) Section 42 of the Companies Act,
- (4) Rule 14 Companies (Prospectus and Allotment of Securities) Rules, 2014,
- (5) Section 55 of the Companies Act,
- (6) Rule 9 of the Companies (Share Capital and Debentures) Rules, 2014,
- (7) Section 71 of the Companies Act,
- (8) Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014.

The aforementioned provisions are briefly analysed below:

Brief discussion on section 62 and Rule made thereunder : Section 62(1)(c) of the Companies Act is briefly discussed above. Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 provides for the applicability, pre-requisites for such issue, disclosures in explanatory statement, procedural aspects, time limit for completion of activities from the date of passing the resolution, valuation requirement for issue of convertible securities, requirements for issue of share for consideration other than cash, requirements for issue of share for non-cash consideration.

Brief discussion on section 42 and Rule made thereunder : For the purpose of this analysis, section 42 of the Companies Act and the Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 are not discussed in detail. Section 42 of the Companies Act relates to 'issue of shares on private placement basis', though the entire provision relates to 'securities' and not shares. It provides for making an offer only to 'identified persons', mandatory requirement of payment through banking channels only, withdrawal of offer, timelines for completion of private placement of securities, pre-requisite of not issuing public advertisement, filing of return of allotment with the Registrar of Companies.

Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 provides for detailed disclosures to shareholders, requirements and format of placement cum application letter, maintenance of records of the said allotment, minute details for filing return of allotment with Registrar of Companies.

Interesting to note that neither section 42 of the Companies Act nor Rule 14 provides for specific requirement of valuation of shares, base price, qualification of the professional doing the valuation of securities. The source for requirement of valuation is provided in section 62 and the Rules made thereunder (as discussed below).

However, Rule 14 provides for contents of explanatory statement that is annexed to notice for shareholder's approval, under which the companies are required to disclose – basis or justification for the price (including premium, if any) at which the offer or invitation is being made. This is content of explanatory statement and not a condition for issuing shares on private placement basis.

Valuation requirements under Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014: The rules relating to valuation requirement are compiled and summarised as follows:

- (1) Price of shares to be issued on a preferential basis by a listed company shall not be required to be determined by the valuation report of a registered valuer;
- (2) Explanatory Statement (annexed to notice of general meeting) shall disclose the following points w.r.t. valuation: (i) Price or price band at/within which the allotment is proposed, (ii) Basis on which the price has been arrived at along with report of the registered valuer, (iii) Relevant date with reference to which the price has been arrived at;
- (3) Price of the shares or other securities to be issued on a preferential basis, either for cash or for consideration other than cash, shall be determined on the basis of valuation report of Registered Valuer;
- (4) Where convertible securities are offered on a preferential basis with an option to apply for and get equity shares allotted, the price of the resultant shares shall be determined beforehand on the basis of a valuation report of a registered valuer. This clause is not applicable to issuance of non-convertible / redeemable securities;
- (5) Where convertible securities are offered on a preferential basis with an option to apply for and get equity shares allotted, the price of the resultant shares pursuant to conversion shall be determined: (i) Either upfront at the time when the offer of convertible securities is made, on the basis of valuation report of the registered valuer given at the stage of such offer, or (ii) At the time, which shall not be earlier than 30 days to the date when the holder of convertible security becomes entitled to apply for shares, on the basis of valuation report of the registered valuer given not earlier than 60 days of the date when the holder of convertible security becomes entitled to apply for shares. This clause is not applicable to issuance of non-convertible / redeemable securities;
- (6) Where shares or other securities are to be allotted for consideration other than cash, the valuation of such

consideration shall be done by Registered Valuer who shall submit a valuation report to the company giving justification for the valuation;

- (7) Price of shares or other securities to be issued on preferential basis shall not be less than the price determined on the basis of valuation report of Registered Valuer.

Section 55 of the Companies Act and Rule made thereunder : Section 55 of the Companies Act relates to 'Issue and redemption of preference shares'. According to the said provisions, a company cannot issue any preference shares which are irredeemable. A company limited by shares may, if authorised by its Articles of Association, issue preference shares which are liable to be redeemed within a period not exceeding twenty (20) years from the date of their issue subject to the prescribed conditions. A company may issue preference shares for a period exceeding twenty (20) years for infrastructure projects, subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders. Section 55 provides for the sources for redemption of preference shares and also provides for creation of Capital Redemption Reserve Account. The said provision provides for a situation where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue.

Rule 9 of the Companies (Share Capital and Debentures) Rules, 2014 provides for 'Issue and redemption of preference shares'. The said Rules provide for the conditions for issuance of preference shares: (i) Issue of such shares has been authorized by passing a special resolution in the general meeting of the company, (ii) The company, at the time of such issue of preference shares, has no subsisting default in the redemption of preference shares issued either before or after the commencement of the Companies Act, 2013 or in payment of dividend due on any preference shares. The said Rules also prescribes the particulars to be prescribed in the resolution for issuance of preference shares, which includes: (i) Priority with respect to payment of dividend or repayment of capital vis-a-vis equity shares, (ii) Participation in surplus fund, (iii) Participation in surplus assets and profits, on winding-up which may remain after the entire capital has been repaid, (iv) Payment of dividend on cumulative or non-cumulative basis, (v) Conversion of preference shares into equity shares, (vi) Voting rights, (vii) Redemption of preference shares.

The said Rules also provides for disclosures to be made in the explanatory statement under section 102 of the Companies Act, maintaining Register of Members under section 88 of the Companies Act. According to the said Rules, a company intending to list its preference shares on a recognized stock exchange shall issue such shares in accordance with the regulations made by SEBI. According to the Rules, a company may redeem its preference shares only on the terms on which they were issued or as varied after due approval of preference shareholders under section 48 of the Act.

Interesting to note that neither section 55 of the Companies Act nor Rule 9 of the Companies (Share Capital and Debentures) Rules, 2014 provides for specific requirement of valuation of shares, base price, qualification of the professional doing the valuation of securities.

Section 71 of the Companies Act and Rule made thereunder: According to section 71 of the Companies Act, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption and such issue shall be approved by special resolution at the shareholders meeting of the company. Companies are prohibited to issue debentures that carry any voting rights. Companies can also issue secured debentures subject to the prescribed terms and conditions. Section 71 of the Companies Act provides for creation of debenture redemption reserve, appointment and role/duties of debenture trustees, failure of the company to redeem the debentures.

Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 provides for detailed procedure for issuing secured debentures, procedure for appointing debenture trustees, duties of every debenture trustee, calling of meeting of all debenture holders convened by debenture trustee, execution of trust deed and filing with the Registrar of Companies, requirements of debenture redemption reserve, inspection and copy of trust deed, etc.

Interesting to note that neither section 71 of the Companies Act nor Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 provides for specific requirement of valuation of debentures, base price, qualification of the professional doing the valuation of securities.

Interpretation issue in valuation requirements for non-convertible securities under Companies Act : Interesting to note that in section 62 – there is a reference of 'shares' whereas in Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014, there is a reference to the expression 'shares or other securities' which 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. Firstly, the Rules override the basic provision of the law by introducing 'shares or other securities'. To rectify this either section 62 shall be amended to introduce 'securities' (instead of 'shares') or Rule 13 needs to be amended for replacement of 'shares' with 'shares or other securities'.

Be that as it may, based on the interpretation of the said Rule, non-convertible preference shares (NCPS or redeemable preference shares) or non-convertible debentures (NCDs or redeemable debentures) are not 'shares or other securities'. Hence, it can be said that the Rule 13 is not applicable to the issue of such NCPS and NCDs. Because of such interpretation – does it mean that section 62 of the Companies Act is also not applicable and other provisions (as discussed above) are applicable along with section 42 and Rules made thereunder? If this is the interpretation, then valuation requirement may not be applicable, as neither section 42 of the Companies Act nor Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 provides for specific requirement of valuation of shares and securities. At the same time, the companies would prefer to raise NCPS and NCDs at face value, pay dividend or interest in the interim time and repay at face value (or premium as per terms of issue). Though this may be convenient for companies to raise the funds by private placement of NCPS and NCDs, however this interpretation issue shall be addressed to avoid misuse of the said provisions, as NCPS and NCDs are ultimately 'securities' as defined under Companies Act and Securities Contracts (Regulation) Act, 1956.

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