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PREFERENCE SHARES – THEY MAY BE PREFERABLE FOR PROPRIETARY COMPANIES

by

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Private companies can find that preference shares are an attractive means of raising funds and, in appropriate circumstances, may be a better alternative to ordinary shares or loans, particularly in the current economic climate.

Preference shares have been a feature of the Australian corporate landscape for many years but over the last few years have been overshadowed by ordinary shares structures and cheap debt funding. The market changes mean that it is appropriate to revisit this form of funding. The Corporations Act regulates the use of preference shares and broadly classes a share as a preference share where the holder is granted some right or preference that is not enjoyed by holders of other classes of shares. A good example is where a specified share dividend is payable in any given year on a preferred basis to the preference shareholder, much like interest on a loan.

Preference shares which are carefully designed can attract investors where their rights increase the investors' protection. They are also capable of providing benefits to companies seeking capital. In fact, preference shares can have a very significant role to play in start up or developing companies which are yet to reach their full potential.

Opportunities to structure

Preference share issues can advantage a company by enabling the company to attract investors by offering them a fixed return or special priority with respect to participating in dividends or on a return or repayment of capital. For example, cumulative preference shares give the investor a fixed dividend which must be paid before ordinary shareholders are entitled to a dividend. The "cumulative" feature of the preference share has the effect of ensuring that if the fixed dividend cannot be paid, the unpaid portion accumulates in subsequent years and continues to accumulate until it does get paid. During the time it accumulates, it continues to rank ahead of ordinary shareholders, thus giving the investor a significantly advantaged position.

A preference share can also be structured so that it is redeemable which means that the company can buy back preference shares at an agreed time and price. In the same way, the buy back can be left to the option of the investor. The preference share can also be structured so that in the case of liquidation, a preference shareholder also ranks ahead of shareholders on a return or repayment of capital. Usually, however, preference shareholders are not entitled to any surplus derived from the company's assets on a winding up, thus preventing the preference shareholder from enjoying any capital appreciation. If this presents a problem to the company and the investor, then it is possible to craft the rights to the preference shares to meet the needs of the parties.

As a trade off to preferential treatment regarding dividends or capital, generally preference shares are issued with no or limited voting rights. This presents to companies opportunities to retain control and to protect existing shareholdings which would otherwise be diluted when further capital is raised.

Further, converting preference shares allow the shareholders to convert their shares to ordinary shares at a predetermined price at a future date so that, in effect, they grant to the investor the benefits of an option whilst allowing the company to raise capital. This is an attractive device for investors. It entitles reluctant investors to have significant security and protection and yet simple and clear access to the benefits of an ordinary

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shareholding with respect to dividend entitlements and capital appreciation which can be enjoyed should the company become successful.

Debt and equity tax rules

The debt equity tax rules, which came into operation on 1 July 2001, also provide structuring opportunities. The debt equity rules treat certain types of equity as debt for tax purposes. Accordingly, it is also possible under these rules to have shares treated as debt for tax purposes, as the categorisation is based on the economic substance of a financing arrangement rather than its legal form (and is dependent on satisfying the debt test). This allows the company seeking capital to enjoy a tax deduction for payments which would otherwise attract dividend imputations. The investor, in turn, receives a dividend which is assessable to the investor in the same way as loan interest.

Maintenance of capital protections for directors

The Corporations Act provides that preference share dividends, including dividends paid under cumulative preference shares, may only be paid if the company has distributable profits. This includes profits after paying all its creditors. This limitation provides an advantage to the company and its directors over debt funding.

Debt funding, of course, is a liability of the company and must be paid, regardless of whether the company generates sufficient earnings to enable it to pay the liability. If a company cannot meet its obligations under a loan or other form of debt funding and if continuing to trade will result in the company not being able to meet its debts as they fall due, then the directors have no choice but to consider placing the company into administration. The required payment under preference capital does not expose directors to this type of risk. Even though the company promises to provide a fixed return, the return is only payable if there are profits. So, although for operational purposes, a company may effectively treat the preference capital as debt, (and may also find that it will be treated as debt for taxation purposes), the legal and liability consequences may be very different.

This may also present advantages from an accounting perspective as preference shares will generally be treated as capital which enhances the gearing and debt equity ratios of the company. This is particularly significant for start up companies or companies that are undergoing a restructure.

Corporation Law requirements with respect to preference shares

The basic position under the Corporations Act is that a company is entitled to divide its share capital into as many different classes of shares with differing rights as it wishes. In effect, the Corporations Act does not impose any limits on the number of classes that a company can divide its shareholding.

This broad principle however is subject to a number of requirements. In the case of preference shares, a company can only issue preference shares if the terms of the preference shares (which include of course the preferred or priority terms) are contained in the company's constitution or are approved by the shareholders of the company by a special resolution. A special resolution means a resolution, of which appropriate notice has been given, that has been passed by at least 75% of the votes cast by members entitled to vote on the resolution. Strictly the constitution does not need to fully set out all the rights in relation to the preference shares however the relevant provision (section 254A) requires the constitution or special resolution to set out what are in effect all the material rights that are attached to the shares with respect to the main terms of the preference shares, they being: rights with respect to the repayment of capital, entitlements to participate in surplus assets and profits, entitlements to cumulative and non-cumulative dividends, voting and priority entitlements to capital and dividends in relation to other shares or other classes of preference shares.

Any second or subsequent issue of preference shares by the company needs to be also carefully be looked at by the Company. The Corporations Act provides that an issue of preference shares is taken to be the variation of rights of previously issued shares (with the variation in turn requiring a second approval by way of special resolution of the shareholders of the company) unless the issue is authorised by the terms of the original issue of shares or the company's constitution. Therefore it is important to ensure that where preference shares are issued for the first time that the terms of the issue are carefully reviewed to take into account whether any additional

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preference shares will be raised. The terms of the issue need to be broad enough so that they are not taken to be a variation of rights. If they are taken to be a variation of rights then approval by way of special resolution of shareholders would need to be obtained which, of course, involves delays and costs.

Redeemable preference shares have special requirements under the Corporations Act. Redeemable preference shares under the Corporations Act (section 254A(3)) are shares which are issued on terms where they are liable to be redeemed at:

1. a fixed time or on the happening of a particular event; or

2. the company's option or at the shareholders option.

A company has the power to issue redeemable shares and in this regard they are treated in the same way as preference shares. Indeed the Corporations Act classes them as preference shares. Redeemable preference shares have one special and often overlooked requirement under the Corporations Act. Under section 254K the company may only redeem redeemable preference shares out of profits of the company or from the proceeds of any new issue of shares that is made for the purpose of redemption. Therefore, even if the company does have sufficient capital to enable a redemption of the shares and indeed sufficient capital that would enable a share buy back to occur under the Corporations Act, the company is not entitled to redeem the preference shares unless they are redeemed out of profits or from a new issue. This does not stop the company and the investor from entering an alternative arrangement such as through a share buy back or other means but this, of course, means that the Company and the investor will have to enter legal arrangements that are outside the terms of the redeemable preference share terms.

Concluding comments

Proprietary companies often overlook preference shares because of perceived complexities and difficulties. Though preference shares do have significant, and in some cases quite technical requirements under the Corporations Act, they can present a very attractive and advantageous form of financing for companies and investors. As the shareholding of proprietary companies is not usually widely held, these compliance and approval requirements normally do not present difficulties.

As in any commercial decision the advantages and disadvantages of the transaction need to be considered before an informed decision is made. Often poor decisions on capital structures and funding can limit a company's future potential. Fully exploring preference shares for a company seeking to attract funding is an appropriate and prudent option to consider.

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