



## **PREFERENCE SHARE CAPITAL – AN OPTION FOR PRIVATE COMPANIES**

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Preference shares are an entrenched feature of the Australian corporate landscape. The Corporations Act regulates the use of preference shares by companies and, basically, the Corporations Act will class a share as a preference share where the holder of the share is granted some right or preference that is not enjoyed by holders of shares in other classes. The typical example being a specified share dividend that is payable to any shareholder in any given year, much like interest on a loan.

Private companies are increasingly looking to preference shares as a means of raising funds. Preference shares often provide a better alternative to ordinary shares or loans.

Preference shares, of course, are not new. However, in recent times, with the increase in private capital investment and institutional and venture capital, investors have been considering carefully designed preference shares as a way to protect their interests. Companies seeking capital have also found benefits using preference shares.

### **Debt equity tax rules**

The advent of the debt equity tax rules, which came into operation on 1 July 2001, provides new structuring opportunities. The debt equity rules treat certain types of equity as debt for tax purposes. It is now possible under these new rules to have shares treated as debt for tax purposes. This allows the company seeking capital to enjoy a tax deduction for payments which would otherwise be frankable dividends. The investor, in turn, receives a dividend which is assessable to the investor in the same way as loan interest.

### **Structuring opportunities**

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. On current rates of return, preference shares in the order of 7% or 8% provide an attractive return for investors.

A preference share can be structured so that it is redeemable which means that the company can buy back preference shares at an agree time and price. In the same way, this 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 shareholder from enjoying any capital appreciation. If this presents a problem to the company and the investor, then alternatives might be considered such a giving the investor the right to any capital appreciation should that be available on a winding up.

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 family shareholdings which would otherwise be diluted when further capital is raised.

## **Converting preference shares**

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

## **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 generated 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, the directors have no choice but to place 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 requires at least 75% of the holders of all shares in the company voting in favour of 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 payment 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 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 from the happening of a particular event; or
2. at 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**

Small companies often overlook preference shares because of perceived complexities and difficulties. Though preference shares do have serious, and in some cases quite technical requirements under the Corporations Act, they present a very attractive and advantageous form of financing for companies and investors. In the case of proprietary companies where shareholdings are not 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. Fully exploring preference shares as an option is an important process and provides important some information for decision makers. Often poor decisions on capital funding are made because the decision makers are companies that do not fully understand the benefits of introducing further classes of capital such as preference shares.