
November 2023

# A preference shareholder is not a financial creditor unless the preference shares become due for redemption

The National Company Law Tribunal, Kolkata Bench ("**NCLT**"), in ***EPC Constructions India Limited through its Liquidator – Abhijit Guhathkurtha v. M/s Matix Fertilizer and Chemicals Limited***[1] has ruled that preference shareholders cannot step into the shoes of a financial creditor unless their preference shares become redeemable.

## Brief Facts

1. EPC Constructions India Limited ("**EPC/Petitioner**") filed a petition under Section 7 of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") seeking to initiate corporate insolvency resolution process ("**CIRP**") against M/s Matix Fertilizer and Chemicals Limited ("**Corporate Debtor**").
2. The Petitioner had infused an amount of INR 250,00,00,000 (Indian Rupees two hundred and fifty crore) as a sub-debt into the capital of the Corporate Debtor and in lieu of such infusion, 25,00,00,000 (twenty five crore) cumulatively redeemable preference shares ("**CRPS**") were issued to the Petitioner with a face value of INR 10 (Indian Rupees ten) each, carrying cumulative dividend of 8% every year, payable at par after 3(three) years.
3. There was a default on the part of the Corporate Debtor in payment of the redemption amount of CRPS.
4. The Petitioner thus filed the above petition under Section 7 of the IBC against the Corporate Debtor on account of such default.

## Issues

1. Whether CRPS was in the nature of an investment or a financial debt having commercial effect of borrowing?
2. Whether a preference shareholder is a creditor of a company?
3. Whether an application under Section 7 of the IBC filed by a preference shareholder is maintainable?

## Findings

1. The NCLT dismissed the petition filed under Section 7 of the IBC on the ground of maintainability.
2. It discussed in detail whether a preference share is an instrument "having the commercial effect of borrowing". After examining the definition of equity and preference share capital under Section 43 of the Companies Act, 2013

[1] Company Petition (I.B.) No. 156/KB/2022

(**“Companies Act”**), it observed that a preference shareholder has a preferential right to – (a) a share in the profits of the company that are available for dividend; and (b) return of capital of the company in priority to equity shareholders in the event of the company’s liquidation.

3. The NCLT also examined Sections 2(55)[2] and 47 of the Companies Act (which defines voting rights of preference and equity shareholders) and observed that:

   a) both equity and preference shareholders are members of a company and therefore the Petitioner who was issued 25,00,00,000 (twenty five crore) CRPS too is a member of the Corporate Debtor;

   b) Preference shareholders are also entitled to enjoy voting rights in every resolution placed before the company.

4. Having arrived at the above findings, the NCLT however noted that a preference shareholder cannot step into the shoes of a creditor. In arriving at this conclusion, the NCLT examined Section 55 of the Companies Act (which defines the issue and redemption of preference shares) and observed that:

   a) Preference shares can only be redeemed out of (a) the profits of the company which would otherwise be available for dividend; or (b) the proceeds of a fresh issue of shares made for the purpose of such redemption;

   b) Preference shareholders cannot be paid unless the company fully discharges its debt obligations;

   c) Thus, non-redemption of preference shares does not result in preference shareholders becoming creditors or the carrying value of preference shares and dividends becoming a debt.

5. The NCLT then observed that CRPS are in the nature of an investment and not a debt unless it becomes redeemable, as it is not obligatory for a company to pay dividend to preference shareholders since dividend is usually a part of the profit that the company shares with its shareholders. Thus, unless the company earns profits, no dividend is payable against CRPS.

6. The NCLT also examined Sub-Sections 3 (11)[3] and (12)[4] of the IBC which define debt and default respectively, and accordingly observed that:

   a) If payment against CRPS is not due, no liability can arise; and

   b) The necessary corollary would be that unless CRPS is payable, non-payment against CRPS cannot be termed as a default.

7. Further, the NCLT observed that a perusal of the Balance Sheet of the Corporate Debtor for 2018-19 and 2020-21 manifests losses incurred by the Corporate Debtor. As such, since dividend is not payable out of losses and unless the CRPS becomes redeemable, it cannot be termed as a “debt”, much less a “financial debt”, which is the *sine qua non* for a petition under Section 7 of the IBC to be maintainable.

## Conclusion

The NCLT has summarized the fundamental difference between raising of capital through debt instruments and *via* issuance of shares. The decision is a classic example of the doctrine of literal interpretation while construing statutes. Section 55 of the Companies Act squarely covers the position that preference shares can only be redeemed out of the profits of the company available for dividend or through issuance of fresh shares. This decision removes the ambiguity surrounding the issue concerning treatment of preference shareholders, and conclusively holds that non-redemption of preference shares does not result in preference shareholders becoming creditors.

---

[2] **“member”,** in relation to a company, means—
*“(i) .....*
*(ii) .....*
*(iii) every person holding shares of the company and whose name is entered as a beneficial owner in the records of a depository”*

[3] **“debt”** – is defined to mean *“a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.”*

[4] “**default**” – is defined to mean *“non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not repaid by the debtor or the corporate debtor, as the case may be.”*

 

## Insolvency and Debt Restructuring Practice

JSA is recognized as one of the market leaders in India in the field of insolvency and debt restructuring. Our practice comprises legal professionals from the banking & finance, corporate and dispute resolution practices serving clients pan India on insolvency and debt restructuring assignments. We advise both lenders and borrowers in restructuring and refinancing their debt including through an out-of-court restructuring as per the guidelines issued by the Reserve Bank of India, asset reconstruction, one-time settlements as well as other modes of restructuring. We also regularly advise creditors, bidders (resolution applicants), resolution professionals as well as promoters in connection with corporate insolvencies and liquidation under the IBC. We have been involved in some of the largest insolvency and debt restructuring assignments in the country. Our scope of work includes formulating a strategy for debt restructuring, evaluating various options available to different stakeholders, preparing and reviewing restructuring agreements and resolution plans, advising on implementation of resolution plans and representing diverse stakeholders before various courts and tribunals. JSA's immense experience in capital markets & securities, M&A, projects & infrastructure and real estate law, combined with the requisite sectoral expertise, enables the firm to provide seamless service and in-depth legal advice and solutions on complex insolvency and restructuring matters.

**This Prism has been prepared by:**


**Sidharth Sethi**
Partner

**Kunal Saini**
Junior Associate

| | | |
|---|---|---|
| Chambers Top Ranked Asia-Pacific 2023 JSA | The Legal 500 | asialaw Outstanding Firm 2023-24 |
| 17 Practices and<br>24 Ranked Lawyers | 16 Practices and<br>11 Ranked Lawyers | 19 Practices and<br>19 Ranked Lawyers |
| IFLR 1000 Top Tier Firm 2023 | India Business Law Journal Best Overall Law Firms 2023 Law Asia | ALB Employer of Choice 2021 Thomson Reuters |
| 11 Practices and<br>39 Ranked Partners<br>**IFLR1000 APAC Rankings 2022**<br>---------<br>Banking & Finance Team of the Year<br>---------<br>Fintech Team of the Year<br>---------<br>Restructuring & Insolvency Team of the Year | Among Top 7 Best Overall Law Firms in India and<br>9 Ranked Practices<br>---------<br>11 winning Deals in IBLJ Deals of the Year<br>---------<br>10 A List Lawyers in IBLJ Top 100 Lawyer List | Banking & Financial Services Law Firm of the Year 2022<br>---------<br>Dispute Resolution Law Firm of the Year 2022<br>---------<br>Equity Market Deal of the Year (Premium) 2022<br>---------<br>Energy Law Firm of the Year 2021 |
| Benchmark Litigation | vahura | |
| 7 Practices and<br>2 Ranked Lawyers | **Ranked #1**<br>**The Vahura Best Law Firms to Work Report, 2022**<br>---------<br>Top 10 Best Law Firms for Women in 2022 | |

For more details, please contact km@jsalaw.com

www.jsalaw.com

advocates & solicitors

Ahmedabad | Bengaluru | Chennai | Gurugram | Hyderabad | Mumbai | New Delhi