

When do preference shares have preference?

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LegalTalk Alert

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Introduction

The NSW Supreme Court case of *Beck v Weinstock* [2010] NSWSC 1068 recently considered the nature of redeemable preference shares. The case involved a dispute concerning shares in private companies held by various members of the Weinstock family and the administration of certain estates, but is of particular interest due to its rulings in relation to preference shares.

Ordinary shares vs. preference shares

What is an ordinary share?

Neither the *Corporations Act 2001* (Cth) (Act) nor the *Income Tax Assessment Act 1997* (ITAA 1997) defines an "ordinary share". However, ATO ID 2010/62 provides that:

- an "'ordinary share' takes its ordinary meaning, having regard to legislative context and the purpose or object..."; and
- in comparison to "preference shares", ordinary shares are shares "which have no preferential rights as to either dividends out of profits or capital on a winding up."

In simple terms, ordinary shares are those which are not preference shares (*Norman v Norman* (1990) 19 NSWLR 314).

What is a preference share?

In essence, preference shares are "shares that rank before ordinary shares."¹ This was the approach followed in *Beck v Weinstock*, where it was held that preference shares are shares which have priority to dividends or distributions in the event of winding up. "Redeemable preference shares" are "preference shares" that are issued on terms that they are

liable to be redeemed, commonly on a certain event taking place or at the discretion of the company.

Pursuant to section 245J(1) of the Act, a company may redeem redeemable preference shares only on the terms on which they are on issue. Unless a preference share may be redeemed in this way, it can only be cancelled under a reduction of capital or a share buy-back under Part 2J.1 of the Act – that is, the same rules that apply to ordinary shares in a company. These rules impose certain formalities (eg. shareholder approvals) and timing requirements (eg. meeting notice period plus an additional 14 days).

The relevance of *Beck v Weinstock*

In *Beck v Weinstock*, the only shares ever issued in the company in question were:

- "A" Class Shares (convertible preference shares);
- "C" Class Shares (redeemable preference shares); and
- "D" Class Shares (redeemable preference shares).

This case is important for a number of reasons:

1. The Court held that preference shares cannot be classified as preference shares unless there are on issue at the time of issue, shares over which they have preference (usually ordinary shares).
2. To be classified as "preference shares", the Court held that the shares can be given preference as to repayment of capital or dividends (preference as to both is not necessary).
3. The case raises questions as to whether the act of registering 'preference shares' on the ASIC Register could be considered misleading and deceptive conduct.

Were shares ever issued?

As noted above, an important aspect of the case was the affirmation that preference shares cannot be classified as preference shares unless there are on issue, at the same time, shares over which they have preference. In *Beck v Weinstock*, Hamilton AJ confirmed earlier case law that "'preference shares' can only exist by way of juxtaposition with other shares" which provides such shares with some comparative advantage.

Accordingly, the Court held that the attempt to redeem the "C" Class Shares was invalid as the shares had not been validly issued as redeemable preference shares. In other words, redeemable preference shares were never issued.

As the Court did not consider the issue in detail, ambiguity remains as to how the funds received to subscribe for invalid redeemable preference shares should be characterised. (On the facts of the case, there was no basis to grant an order for compensation.) For example, the money paid for invalidly issued shares may need to be held by the company on constructive trust, or considered to be a gift.

Debt v Equity

Quite aside from how a share is classified for corporate law purposes, shares in some instances can also be classed as a debt interest for Australian income tax purposes.

Issues may arise if a share is classed as a debt interest and is later discovered to be an equity interest as erroneously accounting for shares will have tax implications once the error becomes apparent. Similar issues may arise in circumstances when shares were invalidly issued, as occurred *Beck v Weinstock*.

For example:

- returns on debt may be deductible resulting in incorrect deductions; or

¹ ATO ID 2010/62; Australian Stock Exchange (ASX) Listing Rules Commentary, Listing Rule 6.3- Voting rights of preference shares (ASX) Listing Rules Commentary, Listing Rule 6.3- Voting rights of preference shares

- the thin capitalisation provisions of the ITAA 1997 (Division 820) may be triggered.
- In brief, a change in the classification of any interest could effect the calculation of the safe harbour amount (in general terms, a 'safe harbour' of a debt to equity ratio of 3:1 is permitted), affecting the amount of deductions available to that entity.

If an interest was erroneously determined as a debt interest, amendment of a company's income tax return would be necessary and interest may be payable.

Lessons learnt

Even if the corporate register and terms of issue refer to shares as "preference shares", the shares must in fact be preferred to another class of shares when they are issued. Companies with preference shares should review what shares they have on issue and the composition of their share capital when they issued those shares.

If "preference shares" were issued in the absence of ordinary shares, the capital raised may not in fact be equity and will need to be recharacterised, potentially affecting the company's – and the investor's – tax and accounting position. Whether it is an asset of the company (as opposed to, for example, moneys held subject to a constructive trust) will depend on the factual scenario of the capital raising.

Ambiguity remains as to whether preference shares can lose their status if all of a company's ordinary shares (to which they were preferred) are cancelled.

Further information

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