

NEW FRENCH LAW ON NONVOTING PREFERRED DIVIDEND SHARES

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Many firms, especially small- and medium-sized ones, wish to increase their capital in order to ensure their financial stability, but are reluctant to do so because their managers [1] fear that their power will be compromised by the appearance of new shareholders.

Also, it has been noticed, especially by large firms, that savings investors are not particularly interested in the management of companies in which they invest. Rather, they are more concerned with a return on their investment and the security and liquidity of their stock. Absenteeism at shareholders meetings is a clear reflection of this.

Existing basic law on commercial companies, Law No. 66-537 of July 24, 1966, provides for the creation of two types of stock shares, ordinary and preferred [2]. Both carry full voting privileges [3] but the preferred shares carry additional privileges, such as the rights to receive a supplemental dividend [4] or a supplemental bonus [5].

A new law, Law No. 78-741 of July 13, 1978 has created a third type of stock share, the nonvoting preferred dividend share [6]. (Hereinafter called "the nonvoting preferred share".) This share entitles its holders to a priority on payment of dividends over both ordinary and preferred shares. It does not however carry full voting privileges.

This article will examine the features of this new share; regulations governing its creation; shareholder protections; and redemption by the issuing company.

1. Features of the nonvoting preferred shares

A. *Dividends*

The amount of the nonvoting preferred dividend payment cannot be less than the greater of the following:

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- the basic dividend amount [7] allocated to ordinary shares, if such is provided for in the articles of incorporation, or that allocated to so-called “privileged” shares [8] if their basic dividend amount is higher than that of ordinary shares,
- 5% of the paid-in capital from the nonvoting preferred shares, increased by any premium paid by the shareholders when the shares were purchased.

Holders of these new shares cannot, in addition to their preferred dividend, also receive the basic dividend allocated to the ordinary or “privileged” ordinary shares [9].

The nonvoting preferred dividend can only be paid out of the disposable income for the financial year, that is, out of the net profits minus losses and payments made to the legal reserve [10], increased by profits carried forward. It is paid before any other deduction is made from the disposable income and is equal to it if there is insufficient income out of which to pay it completely.

The basic dividend on ordinary shares can only be paid once the requisite sum has been taken from the disposable income to cover the complete payment [11] of the nonvoting preferred dividend, and only to the extent of what remains after this payment. Similarly, the shareholders meeting can only transfer profits into a reserve fund (other than the legal reserve) after all payments to the holders of nonvoting preferred shares have been made. Thus, holders of nonvoting preferred shares enjoy a priority in payment over all other shareholders, even those who hold voting preferred shares which carry the right to a supplementary dividend over and above ordinary shareholders.

The new nonvoting preferred share is also partially cumulative. That is, if the profits from one year do not allow it to be paid *in toto*, the unpaid fraction is carried over to the following year, and, if necessary, over to the following two years, with priority over payment of the nonvoting preferred dividend payable for that year. It follows that if the profits for one year are only just sufficient to pay the arrears of the nonvoting preferred dividend, the shareholders have not received the nonvoting preferred dividend due for that year.

We will examine the ramifications which this feature has later on, in connection with another feature of the new type of stock share, *i.e.*, the restriction of voting rights.

It should be noted, too, that the articles of incorporation of the company can also provide for a cumulative nonvoting preferred dividend which does not have a time limit attached to its payment.

B. Reimbursement of capital contributions

In the event of liquidation of the company the new law specifies that the par value of nonvoting preferred shares must be repaid before the par value of ordinary shares [12]. This is so, even when the par value of the nonvoting preferred share has not yet been fully paid-in.

The penalty for failure of the liquidator, whose task is to supervise the liquidation process, to respect this obligation is two to six months imprisonment and/or a fine of 2,000 FF to 40,000 FF.

C. Restriction of voting rights

Offsetting the pecuniary advantages which are granted to them by the new law is the fact that holders of nonvoting preferred shares are *ipso facto* denied the right to participate in and to vote at general meetings [13]. Therefore, the quorum and majority required to validate decisions at these meetings must be calculated without inclusion of the number of nonvoting preferred shares.

There is one exception to this absence of voting rights. If the nonvoting preferred dividend due for a period of three years has not been fully paid, then the holders of these shares acquire the voting rights of normal shareholders and retain these rights over a period of three years, until their dividends, including any amounts due from previous years, have been paid in full.

The law does not specify the exact moment at which the holders of nonvoting preferred shares can exercise this voting right. Therefore, unless there is a contrary regulation in an official enactment, it would appear that this moment occurs at the end of an annual general meeting during which the stockholders noted for the third time that payment of the nonvoting preferred dividend was impossible and so would not be made.

D. Maintenance of other rights

Except for the absence of the right to participate in and to vote at general meetings, nonvoting preferred shares carry the same rights that the other types of shares carry:

- the right to additional dividends after payment is made to ordinary shareholders of the dividend allocated to them by the articles of incorporation, or, absent such allocation, a dividend payment computed as 5% of the paid-in capital from the ordinary shares;
- the right to a share of reserve funds distributed during the company's life;
- the right to a part of the liquidation bonus, provisions to the contrary notwithstanding;
- the right of access to official company documents;
- the right to take legal action against managers of the company for wilful neglect of their responsibilities;
- the right to have an expert legally designated to present a report on one or more management decisions; and
- the right to transfer their shares, and, if necessary, to have them quoted on the Stock Exchange [14].

Although the new law is not specific on this point, we think that the limitation on holders of nonvoting preferred shares to participate in and to vote at general meetings also means that they cannot exercise other rights which attach to shareholders *vis à vis* these meetings. For example:

- the right to notice of the official date of these meetings;
- the right to request that the court designate a shareholder representative to convene a general meeting, should the Board of Directors or the Supervisory Board fail to do so;
- the right to ask the directors of the company to list resolutions in the agenda of meeting.

It appears that the new law precludes holders of the nonvoting preferred shares from exerting any control over company business. Of course, the participation and voting limitation applies only to nonvoting preferred shares; any person who holds such shares and in addition holds ordinary shares may in fact participate in and vote at the meetings by virtue of his status as ordinary shareholder. Similarly, since they are shareholders, albeit nonvoting preferred shareholders, the holders of these shares could, we believe, attend meetings and vote as proxy for other ordinary and voting preferred shareholders [15].

There is some uncertainty over whether holders of nonvoting preferred shares have the right to vote when the company is being liquidated and dissolved. The new law provides that holders of such shares must be given notice of a meeting called to decide whether to liquidate and dissolve and to decide on the amount to be paid to the liquidator for his services [16]. We do not think that the new law allows them to participate in and to vote at this meeting, at least so long as they have regularly received their dividend payments, because it expressly restores such rights only in a situation of failure to be paid their nonvoting preferred dividend. So, absent a similar provision concerning the situation of the liquidation and dissolution meeting we do not think it is possible to grant holders of nonvoting preferred shares the right to take part in and to vote at this meeting.

The nonvoting preferred shareholders are not precluded however from attending the meeting as mere spectators. Perhaps the new law intends to grant these shareholders, whether they have received their dividend payments or not, the right to be informed of the final shareholders meeting and to learn, first-hand, about decisions made at that meeting.

2. Creation of nonvoting preferred shares

A. Preliminary conditions

Only those companies which have distributed at least two annual dividends during the last three fiscal years are allowed to issue the nonvoting preferred shares

[17]. Thus, it is not possible for the company to issue these shares at the time when the company is first constituted.

It should be noted too, that those companies which have already issued convertible or negotiable bonds are not allowed to issue the new type of share, since so long as such obligations exist the companies cannot modify the distribution of their profits.

B. Powers

Issuance of the nonvoting preferred shares is accomplished at an extraordinary general meeting. In the case of cash contributions, ordinary shareholders have the pre-emptive right to subscribe to new shares, a right which they may waive only by means of a special procedure [18].

The law does not indicate whether the possibility that a shareholder may in fact purchase these nonvoting preferred shares constitutes a "special advantage" which would *require* the intervention of an auditor designated by the president of the Commercial Court. If some special advantage does exist because of the priority over the basic dividend or because of the reimbursement of contributions, this advantage is greatly reduced by the restriction of voting rights. It therefore seems wise to us, so long as the courts have not decided this question, to follow the procedure for "special advantages" [19] when the right to subscribe to the nonvoting preferred shares is limited to one or more known persons. On the other hand, this procedure does not seem to us to be required if the subscription is open to all shareholders or to unspecified third parties, since, in this case, there is no "special" advantage.

C. Limits on the total value of the issue

Nonvoting preferred shares cannot represent more than one quarter of total company capital.

The penalty for disregard of this limit by the company management is two to six months imprisonment and/or a fine of 2,000 FF to 40,000 FF.

D. Restrictions as to who may own these shares

Members of the company's management are forbidden to hold any form of nonvoting preferred shares issued by that company. Non-separated spouses and unemancipated minor children of such persons are also forbidden to hold any of the shares.

The penalty for violation of this proscription is imprisonment for a period of two to six months and/or a fine in the amount of 2,000 FF to 40,000 FF.

According to the National Assembly Committee Chairman, "this measure is justified by the fact that the acceptance of a share without voting rights displays a

lack of interest in the life of the company which is incompatible with the position of a manager. Furthermore, it does not seem desirable that managers should combine the powers vested in them by their position with the advantages attached to these shares" [20].

3. Protection of holders of nonvoting preferred shares

A. Special meetings

Holders of nonvoting preferred shares have the right to be called to a special meeting pursuant to regulations to be established by administrative decree. Any clause which limits this right is invalid.

By a majority of votes cast by the shareholders present or represented (no quorum is required), this special meeting can issue a recommendation which must be brought to the attention of the ordinary shareholders at their general meeting and which must appear in the minutes of the latter. This special meeting may also designate one or (if the articles of incorporation provide for it) more spokesmen responsible for presenting this recommendation to a vote of the general shareholders meeting.

A special meeting, for which there is required a quorum and a majority vote, must give its approval before modification of the rights of nonvoting preferred shareholders will take effect. It follows from this that such approval is also needed when the company participates in a merger with another company, a division, or a so-called "merger-division" [21].

Failure to seek approval of the special meeting renders company directors liable to two to six months imprisonment and/or a fine of 2,000 FF to 40,000 FF.

B. Increase in capital

In the case of an increase in capital by cash contribution, the holders of nonvoting preferred shares (like holders of ordinary shares) enjoy a pre-emptive right to subscribe to new shares. However, after consultation with the special meeting, the extraordinary general meeting can decide that these new shares also will be nonvoting preferred shares.

Similarly, following an increase in capital by the incorporation of reserve funds, profits, or issuing premiums, distribution of any new shares must include holders of the nonvoting preferred shares. Once again, with approval of the special meeting, the extraordinary general meeting can decide that the new shares will be nonvoting preferred shares.

When the increase in capital is effected by raising the par value of the shares, the nonvoting preferred dividend must be calculated, as of the date when the increase is effective, on the basis of the new face value, to which may be added the issuing pre-

mium, if any, paid when the old shares were purchased.

If we adhere strictly to the language of the new law [22] for purposes of calculating the nonvoting preferred dividend, we would have to take into account the total issuing premium paid when the nonvoting preferred shares were purchased, even if the increase in capital was effected by the incorporation of that premium. Such an effect is, in our opinion, unintended since, to the extent of that fraction of the issuing premium used to increase the face value of the nonvoting preferred shares, it would result in the double payment of the nonvoting preferred dividend. Therefore, a sensible reading of the new law mandates that the issuing premium paid when the nonvoting preferred shares were purchased should be taken into account only after deducting that fraction which was used to increase the par value of the shares.

C. Amortization of capital [23]

So long as the nonvoting preferred shares have not been redeemed and nullified, the company is forbidden to begin amortizing its capital.

D. Reduction of capital

In the case of a reduction in capital not motivated by losses, nonvoting preferred shares must be redeemed and nullified before all other shares. Breach of this obligation results in two to six months imprisonment and/or a fine of 2,000 FF to 40,000 FF.

Practically speaking, this reduction in capital is possible once the nonvoting preferred dividends due for previous years have been paid in full.

The purchase price is fixed by an extraordinary general meeting in the same way that the price is fixed in the situation of redemption of nonvoting preferred shares (see below).

4. Redemption of nonvoting preferred shares

A. Powers

The eventuality of redeeming nonvoting preferred shares can be provided for in the articles of incorporation either at the time of issue, or thereafter; but in the latter case, amendment of the articles so as to permit redemption, must be approved by a special meeting of the nonvoting preferred shareholders.

The language of the provision of the new law [24] which relates to the time of payment of the redemption, is a source of difficulty. It refers to the nonvoting preferred dividend "due for previous years and for the current year" which, taken literally, would make it impossible to redeem nonvoting shares, since the dividend due

for the current year can clearly only be paid after the end of the year. It seems that, as far as the current year is concerned, the new law must intend that the redemption of nonvoting shares could occur only after holders of nonvoting preferred shares have been paid the dividend due that year, which is itself drawn from the profits of the prior year.

Redemption serves to reduce company capital, and therefore, is subject to approval by an extraordinary general meeting after its members have heard the auditors' report.

B. Regulations concerning redemption

Redemption must cover *all* the nonvoting preferred shares, or, if there have been several issues of such shares, *all* those belonging to the same issue. The redeemed shares must be nullified and therefore cannot be kept in portfolio by the company.

The redemption value is jointly fixed by the issuing company and a special meeting of the nonvoting preferred shareholders convening under the same conditions of quorum and majority required at extraordinary general meetings. If agreement cannot be reached, the value is set by an expert who is designated either by both parties or, if they cannot agree, by the President of the court having jurisdiction.

5. Miscellaneous provisions

Nonvoting preferred shares held by one company in another are not taken into account in determining whether the latter is a subsidiary of the former, or whether the former holds a "participation" [25] in the latter.

As a result, a company which subscribes to or acquires nonvoting preferred shares is not subject to the legal requirements of disclosure and publication involved with "participation" or creation of a subsidiary (*e.g.*, disclosure to shareholders in the management report, mention in the tables appended to the annual report, publication in the "Bulletin des Annonces Legales Obligatoires", *etc.*).

Finally, it should be noted that the tax regulations applicable to parent companies and their subsidiaries do not apply to holders of the nonvoting preferred shares [26].

Notes

[1] French law provides for two alternative systems of management for commercial companies. The traditional form divides management functions between two organs, the board of directors and the president of the board. The alternative scheme vests all management functions in one body, the executive board, while another body, the supervisory board oversees and to some extent controls the activities of the executive board. Law of July 24, 1966 (Arts. 89–150).

[2] Law of July 24, 1966 (Art. 269).

[3] Under the existing basic law on commercial companies each share, whether ordinary or voting preferred, confers upon its owner the right to at least one vote. Though there are circumstances under which voting rights may be circumscribed it is impossible under this basic law for a company to issue shares which can never confer voting rights under any circumstances. Law of July 24, 1966 (Art. 174).

[4] Law of July 24, 1966 (Art. 269).

[5] A “bonus” is that amount of money remaining after assets have been sold and liabilities have been discharged during the course of liquidation. If this amount is at least equal to the capital of the company it is distributed among all the shareholders in amounts equal to the par value of the shares they own. However, if this amount is less than the capital of the company, it is distributed first to the voting preferred shareholders. This *priority distribution* is called a “supplemental bonus”. Law of July 24, 1966 (Art. 417).

[6] Law of July 13, 1978 (Arts. 14–23). References hereinafter to the new provisions added by this law to the Law of July 24, 1966 will be cited as follows: Amendment (followed by the Article number of the 1966 Law as amended).

[7] The “basic dividend” is computed as a percentage of the “paid-in” capital of the company. This percentage is fixed by the company’s articles of incorporation.

The “paid-in” capital is that part of the par value of the share which is actually paid-in to the company. French law provides that the full par value need not be paid-in all at once; rather, the shareholder is permitted to pay-in part of the par value at the time of purchase and then pay the balance within five years. The full par value is, however, subject to call. Law of July 24, 1966 (Art. 349).

[8] So-called “privileged” shares are a class of ordinary shares which carry the right to a dividend payment which is higher than that allocated to the other classes of ordinary shares. Amendment (Art. 269-2, para. 4).

[9] Amendment (Art. 269-2, para. 2).

[10] The “legal reserve” is a device to protect creditors of commercial companies. It consists of a fund to which the company must, each year, transfer at least one twentieth of its net profits (after deduction of its previous losses, if any). The transfers may cease when the fund equals at least one tenth of the company’s total capital. Law of July 24, 1966 (Art. 345).

[11] Complete payment of the nonvoting preferred dividend includes any accumulated dividends. (See text later for a discussion concerning accumulated dividends.)

[12] The new law specifies this priority in repayment only *vis à vis* ordinary shares. It is silent as to voting preferred shares. Amendment (Art. 417-1).

[13] Amendment (Art. 177-1).

[14] Unless the articles of incorporation of the company expressly prohibit exercise of choice, the shareholders can choose to have their shares either in registered or in bearer form. Law of July 24, 1966 (Art. 263, para. 2). Cash shares, however, must be in registered form until they are fully paid-up. Law of July 24, 1966 (Art. 270).

[15] To serve as proxy for ordinary and voting preferred shareholders, one must be either a shareholder’s spouse or another shareholder. Law of July 24, 1966 (Art. 161).

[16] Amendment (Art. 397).

[17] Amendment (Art. 177-1, para. 2).

[18] Shareholders have a preferential right to subscribe for new shares which are issued for cash on an increase of capital in proportion to the par value of their existing shares, and no provision in the company's articles of incorporation to the contrary is valid. If an existing shareholder does not wish to exercise his right to subscribe for new shares personally, he can sell the right to subscribe to another person for what it will fetch. The preferential right to subscribe must be exercised by an existing shareholder within a period fixed by or under the resolution for the increase of capital. The general meeting which resolves on an increase of capital may also resolve to suppress or reduce the normal preferential right of existing shareholders to subscribe for new shares. This may only be done after considering reports on the proposed suppression or reduction of rights from the board of directors or the executive board and from the company's auditors. If the shares in question are to be offered only to certain existing shareholders, the shareholders who are to benefit do not count towards the quorum at the extraordinary general meeting on this question, nor may they vote on it. Law of July 24, 1966 (Arts. 183-188).

[19] When an increase of capital is to be accompanied by the conferment of special advantages on any persons, a court must, at the request of the president of the board of directors or of the executive board, appoint one or more appraisers whose task is to value the special advantages.

The appraiser's report is made available to the shareholders at an extraordinary general meeting. If the meeting approves the valuation and the granting of the special advantages, it will ratify the consummation of the capital increase. If the meeting reduces the valuation and the special advantages to be granted, the modification must be expressly approved by the contributors and the beneficiaries or their duly authorized agents. If their approval is not given the capital increase cannot be consummated. Law of July 24, 1966 (Art. 193).

[20] Report No. 390, p. 79.

[21] The existing basic law on commercial companies provides for three ways in which a company can transfer the whole of its assets: merger, division, and merger-division. Each results in the dissolution of the company which accomplishes the transfer.

A merger is effected by creation of a new company or by absorption into an already existing company. A division is effected when the assets of one company are divided into parts and each part is transferred to a separate new company in consideration of the issue of its share capital to the shareholders of the transferred company. A merger-division is effected when one company transfers its assets in parts to several existing companies, or when it joins with them to form new companies to which parts of the original companies' undertakings are transferred. Law of July 24, 1966 (Art. 371).

[22] Amendment (Art. 269-5, para. 3).

[23] "Amortization of capital" is the means by which the company can, while it is still a going concern, reimburse its shareholders for the amount of capital which they contributed to the company. Capital can be amortized only if the company's articles of incorporation so provide or if an extraordinary general meeting so resolves. The reimbursement of capital is made out of the profits or the reserves (other than legal reserve) and does not entail a reduction of capital. A shareholder whose capital has been wholly or partly reimbursed by amortization loses his right to be repaid the corresponding amount of the par value of his shares in the liquidation of the company, and he also loses the right to a basic dividend in respect of that amount of capital. All other rights attached to the shares remain unaffected, and so, the shareholder can cast as many votes in respect of them as before. Law of July 24, 1966 (Art. 209-210).

[24] Amendment (art. 269-8, para. 4).

[25] A "participation" exists when one company owns between 10% and 50% of the issued share capital of another company. Law of July 24, 1966 (Art. 355).

[26] For a more complete explanation of the tax implications of these shares *see* Halpern,

Taxes in France (Butterworths, London, 1976), which is an English adaptation of Gambier, *Les Impôts en France* (Ed. Francis Lefebvre, Paris, 1978).

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