

PITFALLS IN REDEEMABLE CONVERTIBLE PREFERENCE SHARES (RCPS) INVESTMENTS: DEFENSIVE STRATEGIES FOR INVESTOR PROTECTION

Introduction

Redeemable Convertible Preference Shares (“**RCPS**”) are a hybrid financial instrument, blending characteristics of both equity and debt. They offer fixed dividends and the potential for conversion into ordinary shares. While RCPS can provide stability and growth, they also present unique risks and legal challenges. This article aims to identify common pitfalls in RCPS investments and outlines defensive strategies to protect investors' interests.

Overview of Preference Shares in the Malaysian Context

In Malaysia, preference shares are primarily regulated under the Companies Act 2016. A company with share capital may issue preference shares, including RCPS, provided that such issuance is expressly authorised by its constitution.[1] Consequently, a company intending to issue RCPS must ensure that it has a constitution in place.

Should the constitution lack provisions enabling the issuance of RCPS, the company is required to amend its constitution accordingly. Furthermore, the conversion of any existing shares into preference shares is prohibited unless explicitly authorised by the constitution.[2]

Key Features of RCPS

(a) Redeemable

RCPS may be repurchased by the issuing company at a predetermined price or upon meeting specific conditions.

(b) Convertible

Holders can convert their RCPS into ordinary shares at a specified conversion rate.

These features make RCPS attractive but also introduce risks that require careful management.

Common Pitfalls in RCPS Investments

(a) Conversion Risk

The conversion feature of RCPS grants holders the right to convert their preference shares into ordinary shares, often at a predetermined or beneficial conversion rate. However, if the financial performance of the company deteriorates, the market value of the ordinary shares may decrease, thus negatively affecting the value of the RCPS upon conversion. This creates a significant risk for investors, as the return on their investment could be materially impacted by fluctuations in the company's share price.

Defensive Strategy: It is imperative for investors to meticulously review and negotiate the conversion terms stipulated in the RCPS agreement to mitigate risks associated with conversion. The investors must ensure clarity on key aspects of the conversion, including but not limited to:

(i) Conversion Period or Events

The investors should ascertain the specific period during which the conversion right may be exercised or the events that trigger the conversion. This may include scheduled dates or certain financial events such as an Initial Public Offering, merger or acquisition.

(ii) Conversion Price and Valuation Method

The conversion price (the price at which preference shares are converted into ordinary shares) and the valuation method used to determine this price must be clearly defined. The investor should seek to ensure that the price is fair and reflective of the company's current and future value, thereby avoiding scenarios where the conversion price is set too high or is subject to unfair valuation mechanisms.

(iii) Conversion Ratio

The conversion ratio, which determines how many ordinary shares the investor will receive for each RCPS converted, should be precisely outlined. This ratio can significantly influence the value realised upon conversion and the investor should negotiate terms that are beneficial.

Additionally, the investor may propose the inclusion of anti-dilution provisions. Such provisions are designed to protect the investor from the dilution of their shareholding in the event the company issues additional shares at a lower price than the original conversion price. An anti-dilution clause can adjust the conversion ratio to ensure that the investor's ownership stake remains proportionate, even if subsequent share issuances or other dilutive actions occur.

(b) Redemption Risks

RCPS are structured to be redeemable, giving the issuing company the right, but not necessarily the obligation, to repurchase or redeem the shares at a pre-determined price, either on a fixed date or upon the occurrence of specific events. However, the ability of the company to fulfil its redemption obligations may be compromised if it encounters liquidity issues or financial distress. In such cases, the company may either delay or default on the redemption, potentially leaving the investor with limited recourse. Moreover, the terms for redemption must comply with Section 72 of the Act 2016, which governs the issuance and redemption of preference shares. This provision ensures that redemptions are only made out of distributable profits, the proceeds of a fresh issue of shares or the capital of the company. The investor to note that the redemption of the RCPS shall not be taken as reducing the amount of share capital of the company.[3]

To adequately protect the investor, it is crucial that the redemption terms are clearly defined and expressly incorporated into the RCPS agreement. This includes critical elements such as the redemption price, which should be set at a fair and justifiable value and the class of shares being redeemed. Additionally, the agreement should specify the redemption periods and conditions under which redemption may be exercised. These terms provide certainty and help avoid disputes or misinterpretation at the point of redemption.

Defensive Strategy: The investor should ensure that the RCPS agreement incorporates a clear and unambiguous redemption schedule, setting out specific dates or timeframes within which redemption must occur. The following defensive measures should be considered:

(i) Redemption Schedule

The agreement should clearly stipulate whether redemption will occur on a fixed date or through a series of predetermined redemption dates. This creates transparency and ensures that both parties are aligned on the timeframe for redemption.

(ii) Redemption Price

The redemption price, which is the amount the company will pay to redeem the RCPS, must be precisely defined. It should reflect the fair value of the shares and account for any accrued dividends up to the date of redemption.

(iii) Redemption Conditions

The conditions for redemption should be explicitly set out. This includes defining whether redemption is mandatory or discretionary, and under what circumstances redemption may be accelerated (e.g., upon a change of control, insolvency or other material financial events). The investor may also consider including provisions that require the company to redeem RCPS under specific financial conditions or after the occurrence of certain events.

(iv) Redemption Guarantees

The investor may negotiate for the inclusion of redemption guarantees. Such guarantees ensure that the company remains obligated to redeem the RCPS even in the event of financial difficulties, subject to compliance with the Act.

(v) Early Redemption Provisions

The agreement may also include provisions allowing for early redemption in the event of significant financial events, such as a corporate restructuring, merger or acquisition. Early redemption clauses provide the investor with flexibility to exit their investment under favourable conditions, while still protecting their financial interests.

(c) Priority in Liquidation

In the event of the liquidation of a company, RCPS holders generally hold a priority claim over ordinary shareholders in relation to the distribution of the company's assets. However, their claims remain subordinate to those of secured and unsecured debt holders. This means that in a liquidation scenario, debt holders, such as creditors and lenders, will be paid first from the proceeds of the company's assets, and only after those claims are satisfied will RCPS holders receive any remaining assets.

Defensive Strategy: To protect their interests in the event of liquidation, RCPS investors must ensure that the RCPS investment agreements explicitly outline the priority of claims. Clarity in this area is essential for the investor to understand the likelihood of recovering their investment in a liquidation scenario. Key considerations should include:

(i) Clear Definition of Priority Ranking

The RCPS agreement must clearly specify the position of RCPS holders in the liquidation hierarchy. The investor should ensure that the agreement confirms their priority over ordinary shareholders but acknowledges their subordination to debt holders. This hierarchy of claims determines the order in which the company's remaining assets will be distributed in the event of liquidation.

(ii) Redemption and Distribution of Proceeds

The agreement should clearly outline how liquidation proceeds will be distributed to RCPS holders. In some instances, RCPS holders may be entitled to a specific redemption amount or liquidation preference (a fixed amount per share) before any assets are distributed to ordinary shareholders. This liquidation preference acts as a safety net, providing RCPS holders with a predetermined payout in case of liquidation.

(iii) Subordination to Debt Holders

It is crucial for RCPS holders to understand that their claims are subordinate to both secured and unsecured creditors. The investor should carefully review the company's debt obligations and financial position to assess how much is likely to remain for distribution after debt claims are settled. The RCPS agreement should acknowledge this

subordination, but the investor can negotiate terms that ensure they receive their liquidation preference before any distributions are made to ordinary shareholders.

(iv) Contingency Planning in Case of Insolvency

The investor should include provisions in the RCPS agreement that anticipate insolvency or liquidation. This may involve detailing specific steps to be taken in the event of insolvency, including immediate notification to RCPS holders, detailed accounting of the company's assets and liabilities, and clear guidelines on how proceeds will be distributed.

Other Defensive Strategies for Investor Protection

(a) Comprehensive Investment Agreements

When investing in RCPS, it is essential for the investor to ensure that the RCPS agreements are meticulously drafted to address all potential risks and provide a robust framework for investor protection. These agreements serve as the legal backbone governing the rights and obligations of both the issuing company and the investor, and thus must be comprehensive in nature. A well-drafted RCPS agreement not only minimizes the risk of future disputes but also clarifies the investor's entitlements, rights, and protections in various scenarios, including dividend payments, conversion, redemption, and liquidation. The features of the RCPS must be incorporated in the company's constitution.[4]

(b) Thorough Due Diligence

Conducting thorough due diligence is essential for assessing the risks associated with RCPS investments. This involves evaluating the issuing company's financial health, management team, business prospects, and historical performance. Regularly reviewing the company's financial statements and performance reports can help identify potential risks early. Among the key areas to investigate are the financial health, management team and business prospects of the company.

(c) Diversification

Diversifying investments can help mitigate the risks associated with RCPS. By spreading investments across different companies and financial instruments, the investor can reduce their exposure to the failure of any single investment. Diversification also helps manage overall portfolio risk. The diversification strategies that can be undertaken by the investor are as follows:

- (i) invest in a variety of industries and sectors;
- (ii) allocate investments across different asset classes to balance risk; and
- (iii) mix high-risk and low-risk investments to manage overall risk.

(d) Active Monitoring and Engagement

The investor should actively monitor their RCPS investments and engage with the issuing company's management. Building a strong relationship with the company can provide valuable insights into its operations and financial health, helping investors respond to potential issues more effectively. Examples of monitoring practices are as follows:

- (i) financial Performance – regularly review financial performance reports and updates;
- (ii) management engagement – schedule meetings with company management to discuss performance and strategy; and
- (iii) market trends – stay informed about industry trends and market conditions that may affect the investment.

Conclusion

RCPS investments offer a blend of security and growth potential but come with specific risks that need careful management. Understanding these pitfalls and implementing defensive strategies can significantly enhance investor protection. By focusing on detailed investment agreements, conducting thorough due diligence, ensuring regulatory compliance, diversifying investments, and actively monitoring investments, the investor can better navigate the complexities of RCPS and safeguard their financial interests in the Malaysian market.

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- 1. Section 72(1) of the Companies Act 2016.
 - 2. Section 72(1) of the Companies Act 2016.
 - 3. Section 72(3) of the Companies Act 2016.
 - 4. Section 90(4) of the Companies Act.

Written by:



Umar Izat Nubli
Senior Associate
umar.izat@azmilaw.com

Corporate Communications
Azmi & Associates
28 October 2024