PRE-EMPTIVE RIGHTS IN COMPANY LAW

KARANJA NJENGA ADVOCATES 30+ YEARS

Introduction

It is said that *charity begins at home*, and no other principle could possibly explain the essence of pre-emptive rights in company law better than this. Before a company invites outsiders to partake in its ownership, it must first look to its own; that is the existing shareholders who stood by it from the outset.

Shares, in the simplest terms, are parts of a company that are bought and owned. When a person purchases shares, they acquire a form of personal property distinct from real property yet equally significant in its legal and economic value.

Buying shares in a company means having more property assigned to your name in the form of ownership rights, dividends, and voting power within the company.

And so, the doctrine of pre-emptive rights dictates that when a company issues new shares, it must first offer them to its existing shareholders.

Pre- emptive rights apply only to private companies because only public companies typically raise capital by offering shares to the public, where pre-emptive rights would unduly restrict the speed and flexibility needed for such offerings.

What the law says

The Companies Act, 2015 enshrines the doctrine of pre-emptive rights as a cornerstone of shareholder protection.

It imposes a mandatory rule that *a company shall not allot equity securities to any person unless it first makes an offer to its existing shareholders to purchase those shares on equal or better terms, in proportion to their current shareholding.*

The proportion of this offer must match, as closely as practicable, the shareholder's existing proportion in the ordinary share capital of the company. The company must then wait until either the offer has expired or each shareholder has accepted or not acepted the offer.

The offer

Where an offer is made to a shareholder and they choose to renounce the right in favour of another person, the company may validly allot the shares to that person. Similarly, if a shareholder has already been granted a right to subscribe for shares, the law does not require the pre-emptive process to apply again when those shares are later issued under that right.

In addition to that, it is important to note that treasury shares (shares the company has bought back and holds in its own name) are not considered when computing existing shareholder entitlements under pre-emptive rights. This is because **the company is not treated as a shareholder**, and such shares do not form part of the ordinary share capital for this purpose.

Period of the offer

To ensure that the pre-emptive offer is meaningful, the law provides that it must be made either in **hard copy or electronically,** and it must specify that it will remain open for a period of **not less than twenty-one days** from the date of issue.

This gives shareholders a reasonable and predictable timeframe to consider and act on the offer.

During this period, the offer must not be withdrawn.

The law also allows the prescribed 21-day period to be reduced, but not to fewer than 14 days, or increased through regulation.

The reference point for calculating this period depends on the mode of communication by post, electronic message, or publication in the Gazette.

Critically, the law does not treat these rights as soft obligations. If a company fails to comply with its duties regarding pre-emptive offers whether in making the offer, respecting the offer period, or honouring shareholders' entitlements, it and every defaulting officer are jointly and severally liable to compensate any affected shareholder for losses suffered.

This liability is enforceable through civil proceedings, which must be commenced within three years of either the registration of the allotment or, in the case of equity securities other than shares, from the date of their grant.

Exceptions to pre-emptive rights

While the default rule is strict, the law recognises several legitimate exceptions. For example, pre-emptive rights do not apply to the following:

- the issue of bonus shares, or
- to shares allotted under employee share schemes, or
- to allotments where the consideration is wholly or partly non-cash.

These carve-outs acknowledge the operational needs of businesses to reward employees, engage in asset-based transactions, or make administrative adjustments to share capital without triggering a full pre-emptive process.

The excpetions under Company's Articles

It is important to note that if a company's articles contain their own pre-emption provisions that may mirror or modify the statutory/legal framework and the company complies with those internal rules, the statutory obligation becomes ousted and therefore does not apply. However, breach of those article-based rights attracts similar liability as if the contravention was agaist the statutory provisions of the Company's Act.

The directors must make a written statement setting out the reasons for recommending the resolution, the amount to be paid for the securities, and a justification for that valuation. This statement must be circulated to members along with the proposed resolution.

If the directors fail to comply with these requirements, they commit an offence punishable by a fine.

That is to say that the directors involved are liable to compensate aggrieved shareholders, and such proceedings are subject to the same three-year limitation period.

Private companies with only one class of shares may also disapply pre-emptive rights entirely **through their articles or by passing a resolution**, effectively giving the directors flexibility to allot shares without offering them first to existing shareholders.

Similarly, directors acting under general authorisation may be empowered either by the articles or by special resolution to make specific allotments without applying the pre-emption rule, or to apply it with certain modifications.

However, these powers expire when the general authorisation expires or is revoked.

If the allotment was agreed upon before the expiration, the directors may still carry it out.

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