

## The Company Issues Preferred Shares: Key Factors for Creating an Effective Mechanism



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**Preferred shares can serve as an instrument to motivate top management and protect minority shareholders. They allow for flexible allocation of profits and voting rights. However, the potential of this instrument has not yet been fully realized. Vladimir Levshuk, an associate in the Corporate Law and M&A practice of the *Tomashevskaya & Partners* law firm, together with a colleague, discussed the complexities and regulatory barriers. The experts analyzed how current problems can be addressed.**

Business owners can motivate key company executives using preferred shares. Management may become co-owners of the business and receive dividends, with their income becoming dependent on the company's success. At the same time, the owner does not lose control, since voting rights remain with the holders of ordinary shares.

An investor seeking guaranteed income may also acquire preferred shares. This is the main argument for those who cannot acquire ordinary shares and become a majority shareholder. Holders of preferred shares are entitled to receive dividends first – either in a pre-determined fixed amount or according to a specified formula. In the event of the company's liquidation, they enjoy priority, though they rank below bondholders. In effect, preferred shares combine characteristics of both ordinary shares and bonds.

For the preferred share mechanism to function as intended, it is essential to carefully design the structure and use precise legal wording. It is equally important to strike a balance of interests so that neither the company nor other shareholders are placed at a disadvantage – this issue will be examined in the article. The article will also consider how, in the future, the legislator may expand the functionality of preferred shares and introduce options already available in other jurisdictions. At present, preferred shares are used primarily to ensure dividend rights and priority claim on dividends.

## **Dividend Payment Procedure**

It is important to clearly specify in the charter the number of dividends payable on preferred shares – either as a fixed amount or through a formula, for example, depending on the nominal value of the shares or the profit of the company. Remember that decisions regarding the payment of dividends on such shares must be made by the company as a priority.

Preferred shares can be made cumulative. In this case, the investor is assured of receiving income even if the company cannot pay dividends during a particular period. The unpaid amounts will accumulate, and in the next period the company will pay dividends for both periods at once. If the shares are non-cumulative, future dividends cannot be claimed if the company fails to pay them when due.

A clear definition of dividend payment terms can safeguard the interests of preferred shareholders. The fact is that majority shareholders may “dilute” the stake of minority shareholders. This occurred in a case where the majority shareholder of ZMK JSC carried out an additional issue of ordinary shares, thereby diluting the stake of a minority shareholder who held only preferred shares. His stake was reduced from 2.17% to 0.1%, substantially diminishing his influence in the company.

Courts of all three instances sided with the majority shareholder. They held that the holder of preferred shares had no pre-emptive right to acquire shares through the private placement used for the additional issuance. Moreover, he was not entitled to vote on such an agenda item, as it did not affect his rights (Resolution of the Arbitrazh (Commercial) Court of the Volga district No. Φ06-1446/2025 in case No. A57-12130/2024 dated April 18, 2025)

## **Voting Rights**

Note that, by default, holders of preferred shares do not participate in the management of the company. However, the legislator has defined circumstances under which they may acquire voting rights. This can occur if the company fails to pay dividends, or in the event of a reorganization or liquidation of the company. Preferred shareholders also gain voting rights if the company is delisted or if a decision requires a vote of all shareholders.

There are certain types of preferred shares whose holders may vote only on liquidation issues. This exception applies to those who receive dividends even earlier than holders of other types of preferred shares. The rationale is that such shareholders do not receive any portion of the company’s property upon liquidation (i.e., no liquidation value).

In 2015, the legislator lifted restrictions on the scope of voting rights that may be granted on preferred shares. As a result, they became not merely “silent” investments but acquired hybrid characteristics. These additional rights can be exercised only in non-public joint-stock companies. For example, a shareholder may be allowed to vote on all or some of the issues on the agenda or be granted a pre-emptive right to acquire newly issued shares of certain categories. (Article 32 (6) of Federal Law No. 208-FZ “On Joint Stock Companies” dated 26 December 1995 (“JSC Law”))

Voting rights on preferred shares may depend on certain conditions. For example, they may become effective after a specified period, or upon the occurrence of a specific action by the company or other shareholders. Another condition might be triggered when shares are sold to third parties in violation of established procedures. It is also possible to stipulate that preferred shares become voting shares if the company’s financial indicators deteriorate by a defined margin.

### **The Legislator Limits the Use of Preferred Shares to Prevent Abuse**

The total amount of all issued preferred shares may not exceed 25 percent of the company's charter capital. In public joint stock companies, the nominal value of preferred shares must be equal to the nominal value of ordinary shares.

Previously, preferred shares could deliberately be issued at undervalue. Shareholders who already held ordinary shares would then acquire these preferred shares to subsequently pass a resolution at the shareholders' meeting to withhold dividend payments. When dividends on preferred shares are not paid, their holders automatically acquire voting rights.

In effect, a group of affiliated shareholders who issued such shares to themselves or their affiliates could obtain control of the company at minimal cost. This created a significant voting imbalance, where one ordinary share could be outweighed by 100 or even 1,000 voting preferred shares (Zakharchuk O., *Rights of Preferred Shareholders and Their Protection*, Aktsionernoe obshchestvo, 2014, No. 10).

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### **Other Additional Rights**

It is necessary to formulate which additional rights may be granted to holders of preferred shares. The legislator has not set specific limits and simply used the term "other" in the wording (Article 32 (6) of the JSC Law). This makes it possible to create flexible classes of shares: with partial management rights, investor protection mechanisms, and a functional corporate governance strategy. However, the effectiveness of such arrangements depends on the legal precision of the wording. As of the date of this article, there is no court practice on this issue, so we can only assume what additional rights can be established for holders of preferred shares. It is possible to provide the following rights:

- to redeem newly issued shares in case of a breach of issuance procedures where the charter does not contain such guarantees. This would constitute a "poison pill" right, as it would decrease the attractiveness of the company to unwanted acquirers;
- to vote on all matters within the competence if, for example, the company fails to achieve key performance indicators (KPIs) or if its debt obligations exceed specified limits;
- to elect the chief executive officer or members of the board of directors;
- to vote on amendments to the charter, approval of major transactions, and interested-party transactions;
- to gain access to the company's confidential information.

Additional rights may be granted alongside or instead of existing ones. They can serve as substitutes for standard benefits such as dividends or compensation upon the company's liquidation. For example, additional rights may be a privilege associated with a specific type of share, making them more valuable. This structure resembles the situation in a limited liability company (LLC), where certain participants may be granted more rights than those provided by law. They may receive priority in profit distribution or access to a greater volume of the company's internal documents.

### **Liquidation payment**

The company's charter should specify a fixed liquidation value for each type of preferred shares. This is the amount that a shareholder will receive after the company has settled all its debts to creditors. It

serves as a guarantee that shareholders will recover their investment in the event of the company's liquidation.

A dispute over the liquidation payment arose in Angioline JSC. The company's primary mistake was that the charter initially did not specify the liquidation value. In 2018, the company decided to establish a fixed liquidation value for preferred shares – 75 rubles per share—while only holders of ordinary shares voted on the matter.

Three court instances upheld the decision as lawful. However, the Supreme Court noted that the newly established liquidation value limited the rights of preferred shareholders, since previously no such value had been defined in the charter. Theoretically, it could have been significantly higher than 75 rubles per share. Therefore, the holders of preferred shares should have been allowed to participate in the vote (Ruling of the Supreme Court No. 304-ЭС19-11056 in case No. A45-19004/2018 dated 16 June 2021).

### **Foreign Options**

In the Anglo-American legal system, hybrid issuances – such as fixed-rate non-voting preferred shares – are popular. Companies also frequently use multiple voting preferred shares, under which the holder receives multiple votes instead of one. However, if such shares are transferred to third parties, they automatically convert into ordinary shares.

In Hong Kong, companies may issue non-voting ordinary shares, which entitle the holder only to receive dividends. Although these shares are not formally classified as preferred shares, they allow for flexible corporate governance.

Abroad, the preferred share mechanism is widely used in venture financing, given the higher risk profile of such investments. Companies issue shares with an enhanced liquidation value, as well as shares that can be converted into ordinary shares. The conversion mechanism can serve as an additional option for the investor if the company grows. This instrument can also function as a sanction if the investor fails to contribute in subsequent investment rounds. Shares may also be converted if dividends on ordinary shares significantly exceed the fixed dividend on preferred shares.