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Invocation of the Pledge by Creditors - A Deep Dive Analysis

■ **Guranpreet Singh Sarna & Shikha Singh**



The Supreme Court has recently answered the conundrum surrounding the impact of invocation of pledge vis-à-vis

the actual discharge of the debt in the matter of PTC India Financial Services Limited (PFS) v. Venkateswarlu Kari and Anr¹. The said judgment of the Hon'ble Supreme Court affirmatively states that mere registration of the pawn i.e., the dematerialized shares in the said matter in favour of the creditor as a 'beneficial owner' does not have the effect of sale of shares by the pawnee. The pledge at that stage is not discharged and thus the debt remains due and payable in entirety.

BACKGROUND OF THE CASE

PFS, a non-banking finance company registered with the Reserve Bank of India, had advanced a loan of Rs. 125 crores to NSL Nagapatnam Power and Infratech Limited (NSL/Corporate Debtor). One of the conditions of the loan agreement executed inter-alia between the Corporate Debtor and PFS, was to secure the loan amount by way of pledge of shares vide pledge deed, which was executed by Mandava Holdings Private Limited (MHL), being the parent company

of NSL, in favour of PFS/security trustee.

On November 17, 2017, the Corporate Debtor filed a petition for voluntary insolvency under Section 10 of the Insolvency and Bankruptcy Code, 2016 (IBC) before the National Company Law Tribunal (NCLT), Hyderabad, which was consequently admitted on January 18, 2018. On December 28, 2018, PFS served a notice to MHL, wherein it demanded MHL to discharge the debt within seven (7) days, failing which PFS would exercise its rights under the pledge deed. Since the debt remained unpaid, the Depository Participant, on the request of PFS, accorded the status of "beneficial owner" of the pledged shares to PFS. Thereafter, PFS sent a notice to MHL informing that due to the continuing default, it had invoked the pledged shares in terms of the pledge deed and now reserves the right to sell the pledged shares.

PFS had itself filed an application under section 7 of IBC against the Corporate Debtor on 17th January, 2018. However, in light of the admission Order dated 18th January, 2018, under Section 7 of the IBC, the NCLT allowed PFS to file proof of financial claim before the Interim Resolution Professional (IRP). PFS filed its proof of financial claim, wherein the amount of pledged shares



D-55, Defence Colony
New Delhi -110 024
Tel: 91 (11) 42410000
Fax: 91 (11) 42410091
E: expertspeak@dhirassociates.com



had not been accounted for or reduced. Simultaneously, MHL also claimed that since PFS had already been granted the status of the “beneficial owner” of the pledged shares, MHL no longer had any title or right over the pledged shares and had accordingly, stepped into the shoes of PFS as a creditor of the Corporate Debtor to the extent of the value of the pledged shares.

The IRP found that neither PFS nor

MHL’s claims could be crystallized as it was not possible to ascertain the value of the pledged shares and settle the debt either in part or in whole. PFS and MHL both made applications against the rejection of their claim before the NCLT.

The NCLT disposed of the applications of PFS and MHL, stating that MHL’s claim was acceptable per the Depositories Act and Regulation 58 of the 1996 Regulations². The NCLT, while approving

the claims of MHL also held that PFS having exercised its right to “transfer the pledged shares” as per the pledge deed, MHL’s shareholding in the Corporate Debtor had decreased by the number of pledged shares.

The said order was challenged before the Hon’ble National Company Law Appellate Tribunal (NCLAT) by PFS, arguing that the invocation of the pledge deed was not enough to count the debt as paid/discharged and that until the sale of the pledged items in accordance with Section 176 of the Indian Contract Act, 1872, the debt would not be treated as having been discharged. Irrespective of the contentions of PFS, the said challenge was disposed of by the Hon’ble NCLAT, stating that whether PFS sold the pledged shares or not would not be relevant as it was already the “beneficial owner” of the said shares. Furthermore, the Hon’ble NCLAT held that PFS had become 100% owner of the pledged shares and thereafter, could not reclaim debt under the Indian Contract Act, 1872.

RELEVANT PROVISIONS

Indian Contract Act, 1872

The provisions regarding the pledge are included under Sections 172 to 179 of the Indian Contract Act, 1872. From perusal of Sections 172 and 173, it is clear that pledge is basically a contract entered into by the pawnor and pawnee as a form of security for payment of debt which entitles the pawnee to retain those goods pledged as security but with the liability to return the goods when payment is made. Section 176 of the Indian Contract Act, 1872, deals with the pawnee’s right where the pawnor makes a default. A pawnee has the right to bring a suit against the pawnor for the debt or promise that the goods pledged for

the same can be retained as a collateral security or can be sold, after giving reasonable notice to the pawnor. The pawnor has to pay the remaining debt balance to the pawnee if the proceeds received are less than the amount due and the excess has to be returned to the pawnor if the proceeds received are higher than the amount due to the pawnee.

Depositories Act, 1996 and Depositories Regulations, 2018

As per Section 2(1)(a) of the Depositories Act, 1996, “Beneficial owner” means “a person whose name is recorded as such with a depository” whereas Section 2(1)(j) defines “Registered owner” as “a depository whose name is entered as such in the register of the issuer”.

Regulation 79 of Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018 deals with creating pledge or hypothecation. Sub-Regulation (8) of Regulation 79 states that subject to the provisions of a pledge document, the pledgee may invoke the pledge. Upon such act, the depository shall register the pledgee as the beneficial owner of the pledged securities and accordingly amend its records.

JUDGEMENT OF THE SUPREME COURT

The Apex Court observed that the pawnee has the right to sell such pledged items under Section 176 of the Indian Contract Act, 1872, and the pawnor has

the right to repay the debt until the date of the said sale of pledged goods. It was observed that while the Depositories Act, 1996, provides the difference between the “registered owner” and the “beneficial owner”, it does not have any rule contrary to Sections 176 and 177 (which provides for “defaulting pawnor’s right to redeem”) of the Indian Contract Act, 1872. Hence, these Sections will still apply to any deed of pledge and will not be diluted or overridden by the Depositories Act, 1996.

MHL cannot be said to be a secured creditor to the Corporate Debtor with respect to the pledged shares. However, PFS continues to be the financial creditor of the Corporate Debtor by right and therefore, is entitled to claim its debt in entirety without taking into consideration the value of the pledged shares of NSL.

CONCLUSION

The Hon’ble Supreme Court accordingly vide the said judgement categorically deemed that the mere invocation of pledge and attainment of the status of “beneficial owner” by the lender/ financial creditor would not mean that the debt is discharged. There should be an actual sale of the pledged securities to discharge the debt in part or in its entirety per the respective document. The said judgement being critical to any banking and financial documentation between the parties shall ultimately form part of necessary documentation to safeguard the interest of the parties to the similar transaction. **W**



Guranpreet Singh Sarna is a Partner with the Firm and has more than 14 years of experience and his practice areas are Projects and Infrastructure, Project Finance and Capital Market. He is a commerce graduate, LLB and an LLM from University of Warwick. Apart from being a part of some major Infrastructure projects, he is proficient in EPC/ PPP projects. Guranpreet has closed various transactions in Project Developments, Project Financing, Real Estate, Projects and Infra, including advisory on Engineering, Procurement and Construction projects.



Shikha Singh is a Principal Associate with the firm. Her core expertise lies in project finance transactions in the renewable energy sector which includes corporate and project due diligence, land due diligence, legal documentation for financing and security creation, down selling or assignment and novation of debt etc. She is also adept in legal research for general corporate transactions and vetting legal documents for clients. She has also handled transactions related to the real estate funding including corporate due diligence, loan documents, debenture documents and security/financing documents.

¹Civil Appeal No. 5443 Of 2019 - https://main.sci.gov.in/supremecourt/2019/24185/24185_2019_14_1501_35710_Judgement_12-May-2022.pdf

²This was eventually amended and it is now Regulation 79 under the Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018.