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ENFORCEMENT OF PLEDGE OVER DEMATERIALISED SHARES - SUPREME COURT PROVIDES MUCH NEEDED CLARITY

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In the recent judgement of *PTC India Financial Services Limited v Venkateswarlu Kari and Anr*, Civil Appeal No. 5443 of 2019, the Supreme Court provided clarity to the creation and enforcement of pledged securities in dematerialised form. The Supreme Court analysed the interplay between the provisions of Indian Contract Act, 1872 (**ICA**), the Depositories Act, 1996 (**DP Act**) and Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 (**DP Regulations**) (collectively, "**DP Framework**") and held that the DP Framework is **in addition to and not in derogation of the provisions of the ICA dealing with creation and enforcement of pledge over dematerialised shares**.

BACKGROUND

PTC India Financial Services Limited (**PTC**) extended a loan to NSL Nagapatnam Power and Infratech Limited (**NSL**), which was secured by pledge over the shares of NSL Energy Ventures Private Limited by Mandava Holdings Private Limited (**MHPL**). NSL defaulted and initiated proceedings under Section 10 of the Insolvency and Bankruptcy Code, 2016 (**IBC**). While NSL's insolvency proceedings were pending, PTC invoked the pledge and was recorded as the "beneficial owner". Both MHPL and PTC claimed to be "financial creditors" of NSL. The National Company Law Tribunal, Hyderabad and National Company Law Appellate Tribunal (**NCLAT**) took a view that as PTC had invoked the pledge, MHPL stepped into the shoes of PTC and was a "financial creditor". PTC challenged this before the Supreme Court.

ISSUE

Whether invocation of dematerialised pledge and the consequent recording of the pledgee as the beneficial owner amounts to "transfer" of such shares in favour of the pledgee.

OBSERVATIONS OF THE SUPREME COURT

The Supreme Court held that the ICA which is a substantive and general law relating to contracts and the DP Act which is primarily a law relating to securities, **are to be read together and interpreted harmoniously**.

The Supreme Court held that the provisions of Section 12 of the DP Act pertaining to creation of pledge over dematerialised shares is not *ex facie* inconsistent with the obligations of a pawnor and a pawnee under the ICA. The provisions of ICA governing pledge shall continue to be applicable even in the case of pledge over dematerialised shares and are not overridden or diluted by the DP Act.

In view of the above, the Supreme Court examined the issues before it by placing reliance on ICA and DP Framework.

What is the scope and extent of the powers of a pledgor and a pledgee?

- Creation of pledge involves bailment of goods by a pledgor in favour of a pledgee, which confers a special right on the pledgee. Such right is limited only to the right of retaining

possession till debt is paid or promise is performed. Further, while a pledgee has a right of disposition, the same is limited to disposition of the pledge rights only, after providing a reasonable notice of sale to the pledgor, for it to have the right of redemption.

When does "Actual Sale" take place in case of dematerialised securities?

- The Supreme Court held that under Section 176 of the ICA, a pledgee is required to give a reasonable notice of sale (**Sale Notice**) to the pledgor, so as to enable the pledgor to exercise its statutory right of redemption (ie., right to repay the debt and recover the pledged goods), which as per Section 177 of the ICA can be exercised till the date of "**actual sale**". There is no fixed form or time period for such notice and the same depends on the facts and circumstances of each case. Further, the Supreme Court held that the pledgor's right to redemption till "actual sale" in terms of Section 177 of the **ICA does not support the pledgee's sale of the pledged goods to itself**. Further, pursuant to the issuance of the Sale Notice, the pledgee has the "option" to effect the sale of pledged goods without having the "compulsion" to do so.
- Particularly, in case of dematerialised securities, Regulation 58(8) of the DP Regulations stipulates that subject to the provisions of the pledge document executed by the parties, the pledgee may invoke the pledge and, on such invocation, the depository is required to register the pledgee as beneficial owner of such securities and amend its records accordingly. Therefore, the pledgee is first required to register itself as a "beneficial owner" of the said shares before effecting a sale of the said shares to a third party under Section 176 of the ICA.
- Observing the above, the Supreme Court held that the term "actual sale" used in Section 177 of the ICA in the context of dematerialised pledged shares should be read as "**the sale by the pawnee to a third person made in accordance with the Depositories Act and applicable by-laws and rules pursuant to complying with the requirement of issuing a Sale Notice under Section 176 of the ICA.**" Accordingly, a mere exercise of the right by the pawnee to record himself as the "beneficial owner", which is a necessary precondition **before the pawnee can exercise his right to sell**, should not be construed as "actual sale" by the pledgor. *A fortiori*, it would also not affect or exhaust the rights of the pawnor of redemption under Section 177 of the ICA.

JUDGEMENT

Accordingly, NCLAT's order was overruled, and PTC was held to be a financial creditor with the right to file its claim for the entire debt due and payable to it, while MHPL was not given the status of a financial creditor.

COMMENT

With pledge over dematerialised shares being extremely common as a collateral in debt transactions, the Supreme Court's clarification is of significance in case of enforcement of pledged shares in demat form and is likely to have a far-reaching impact on lending transactions in India.

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