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Analysis



Private Credit: Supreme Court holds that ownership of pledged shares remains with pledgor despite transfer to pledgee

Key Takeaways

- SC overrules a series of prior rulings which held that pledgee becomes the owner of pledged shares upon invocation.
- SC holds that even though pledgee is recorded as beneficial owner upon invocation, pledgee only receives 'special rights' and not 'ownership' over pledged shares.
- The term 'actual sale' means sale to a third party, not to the pledgee.
- Takeover Code and other legislations may need a 'holistic review' in view of this ruling.
- Approach to regulatory filings and compliances will need to be reassessed – who holds the ownership and voting rights?

Background

Pledge of shares in dematerialised (***demat***) form has been seen as one of the most efficacious forms of security. A series of rulings beginning with ***Tendril***[1] held that pledged shares automatically stand transferred to the pledgee upon 'invocation' by the pledgee, which amounts to an 'actual sale'. Hitherto, it was believed that the Depositories Act, 1996, and rules and regulations (collectively referred to as ***DPAR***) (a) leave no room for the pledgor to continue as the owner; (b) clearly prescribe an automatic transfer of beneficial ownership from the pledgor to the pledgee upon invocation; and (c) even obviate the need for a prior 'notice of sale' to the pledgor as mandated by the Indian Contract Act, 1872 (***ICA***). This was largely based on Reg. 58(8) of the DPAR[2] which mandates that a pledgee must be recorded as the '**beneficial owner**'[3] upon mere invocation of a pledge, blurring the idea of 'actual sale'. Under the DPAR, the depository is the registered owner; the beneficial owner, whether of pledged shares or otherwise, exercises all rights.

Notwithstanding the well-reasoned order of the Delhi High Court in Tendril, there were several tax and regulatory impracticalities that came to the fore with the pledgee becoming the owner of the pledged shares as against a trustee or a bailee of the pledged property as envisaged under ICA.

The Supreme Court on May 12, 2022 in its ruling in the ***PTC case***[4], has cleared the air and held (a) actual sale means a sale to third party, not to the pledgee; (b) pledge is distinct from a mortgage, and hence upon invocation pledgee only gets a 'special right' to sell the property and enjoy the economics therefrom, but the general ownership continues with the pledgor; and (c) transfer of beneficial ownership under DPAR is only to facilitate onwards sale by the pledgee, but doesn't make him the owner. It was also held that as per S. 177 of ICA, the defaulting pledgor has a right to redeem the pledged goods and regain the beneficial ownership over them before an actual sale takes place. The event of 'actual sale' acts as an expiration of the pledgor's right to redeem the pledged goods. In effect, actual sale to a third party would crystallise the value of the pledged shares and such amount received should be applied to discharge outstanding dues, and the pledgee should return the excess, if any, to the pledgor. By natural design, even if the pledge has been invoked, until the pledged shares have been, 'actually sold' to a third party, (a) the pledgor should have the right to redeem the pledged shares, and (b) the pledgee should have the right to sue for dues.

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[1] Tendril Financial Services Pvt. Ltd. & Ors. vs. Namedi Leasing and Finance Ltd. and Ors., 2018 SCC OnLine Del 8142.
[2] Regulation 58(8) of Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018.
[3] See S. 10 of the Depositories Act, 1996.
[4] PTC India Financial Services Limited vs. Venkateswarlu Kari and Another, 2022 SCC OnLine SC.

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A brief background of the facts of the PTC case are set out in the Annexure. We have compared Tendril and PTC case as hallmarks of the evolving position under law. Our comparative analysis is captured below.

COMPARATIVE ANALYSIS

What is 'actual sale'?	
Tendril	In the case of demat shares, upon invocation the beneficial owner changes from the pledgor to the pledgee. There is no difference between 'invocation' and 'sale' under the scheme of the DPAR. The only title in demat shares, post-invocation is that of the pledgee, as beneficial owner in the records of the depository. Invocation in case of pledged demat shares is "equivalent to sale" under S. 176 of ICA. This effectively ends the pledgor's right to redeem on invocation of pledge on demat shares by the pledgee (which is otherwise granted for physical shares under S. 177 of ICA). Even if the pledgee sells the pledged shares for less than optimum price, it is "not a ground for invalidating a sale" but the pledgor can claim damages.
PTC case	The court undertook extensive discussion on 'actual sale' and its meaning. The court clarified that 'actual sale' under S. 177 of ICA means, "*the sale by the pawnee to a third person made in accordance with Depositories Act and applicable by-laws and rules"*. As per the scheme of DPAR, there is a "*limited objective and purpose*" behind Reg. 58(8), requiring the pledgee to be recorded as the 'beneficial owner' upon invocation which is that the sale of the pledged shares cannot be effected by pledgee without the status of beneficial owner. The change in beneficial ownership is to practically facilitate and empower the pledgee to effect the sale, and not to grant general ownership rights to the pledgee. The "*objective of pledge is not to purchase the security*", and a change in beneficial ownership is conversion and not sale. In effect, the pledgor can redeem the pledged shares till the sale to a third party is effected by the pledgee.

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What are the notice requirements in case of a pledge of demat shares?	
Tendril	S. 176 of ICA provides for a notice to pledgor prior to effecting sale to a third party. However, Reg. 58(8) of DPAR provides for notice post invocation, after the change in beneficial ownership of pledged shares from pledgor to pledgee-which is treated ad equivalent to a sale under S. 176. There is no place for prior notice as under the S. 176, in the scheme of Reg. 58(8). A notice under S. 176 is in derogation to Reg. 58(8). In Tendril, the Delhi High Court observed that to hold otherwise, "*would interfere with the transparency and certainty in the securities market, rendering a fatal blow to the Depositories Act, 1996 and Regulations and the object of enactment thereof*." It, therefore, held that the statutory requirement of notice wasn't applicable in case of demat shares, unless parties had contractually agreed to such notice requirements.
PTC case	The need for notice under ICA is a special statutory protection to the pledgor and parties cannot agree that the pledgee may sell the pledged goods without the notice to sell, even in the case of demat shares. The notice will be required before an 'actual sale', which has been interpreted to mean sale to a third party.
Is 'sale to self' legally valid?	
Tendril	Since the scheme of DPAR requires change in beneficial ownership upon invocation, 'actual sale' to self has already taken effect. Pledgee may then sell the shares to a third party, and the proceeds thus received are only a measure to determine the realised value or fair value of the shares. The title to the pledged shares upon invocation vests with the pledgee and is absolute. The court referred to but did not rely on ***Neikram Dobay***[5] and ***Ramdeyal Prasad***[6] which held that while 'sale to self' is void, it

[5] Neikram Dobay v. Bank of Bengal, ILR (1892) 19 Cal 322.
[6] Ramdeyal Prasad v. Sayad Hasan, AIR 1944 Pat 135.

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	does not put an end to the contract of pledge entitling the pledgee to hold the pledged goods till repayment by the pledgor or till the actual sale to third party. However, reliance was placed on ***Dhani Ram***[7] to hold 'sale to-self' to be "*unauthorized but not void*" holding the pledgee as a legal owner of the pledged goods upon invocation.
PTC case	The court highlighted that the purpose of pledge is not to purchase the pledged goods. Therefore, relying on Neikram Dobay and Ramdeyal Prasad, overruling Dhani Ram, it was held that 'sale to self' is void and mere "*unauthorized conversion*". The contract of pledge comes to an end on sale to a third party and not upon invocation. Post Tendril, the position was that pledge invocation amounted to an 'actual sale'. This may have acted as a disincentive for a pledgee to enter into a contract of pledge since depending on the terms of the contract, the risk of price fluctuations post invocation would have rested with the pledgee.
How does a pledgor's right to redeem (repay and the get the shares back) before an actual sale function?	
Tendril	Since invocation by a pledgee amounted to actual sale with respect to demat shares, a pledgor effectively forfeited his right to redemption upon invocation (by the pledgee) itself. The pledgor's right in the pledged property was then reduced to a pledgor's right to seek damages in case a pledgee exercised a 'sale to self'.
PTC case	The court has clarified the pledgor's right to redemption applies till the sale of the pledged goods to a third party. Recalling the principles in ***Madholal Sindhu***[8], the court clarified that the right to redeem may be exercisable "*till the actual sale of pledged goods*", which is a "*sale in conformity*" with S.

[7] Dhani Ram and Sons v. The Frontier Bank Ltd. and Another, AIR 1962 P&H 321.
[8] The Official Assignee of Bombay v. Madholal Sindhu & Ors., AIR 1947 Bom 217.

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	176 of ICA (i.e., with notice). This implied that if a sale is not in conformity with S. 176 (such that notice of actual sale has not been given), the right to redeem may even extend against a third party. However, the PTC case makes an exception for listed shares – it was held that the pledgor cannot exercise the right of redemption on the grounds of lack of reasonable notice, against a third-party purchaser of listed dematerialized shares, provided that the 'actual sale' was effected in accordance with the DPAR. This exception for listed demat shares has been carved out to preserve the sanctity of open market transactions.
Has DPAR overridden ICA in context of pledge of demat shares?	
Tendril	ICA does not prescribe the procedure of creation of pledge of dematerialized shares. DPAR is a "*whole and self-contained procedure*" for the creation of pledge of dematerialized shares. Pledge of such shares can only be created in accordance with DPAR. Since ownership changes on invocation, there is an inherent conflict between the ICA and DPAR, and DPAR being a more specific set of regulations shall prevail.
PTC case	DPAR and ICA are to be harmoniously interpreted as both the laws are not contradictory, and can be "*interpreted reasonably complementing each other*." S. 12 of DPAR does not define pledge or hypothecation and hence the terms must be accepted as they are defined under the ICA. The court, while overruling, observed that Tendril effected an "*entirely new jurisprudence on the law of pledge*", annulling and re-writing the well-established law of pledge, especially when the Depositories Act "*operates in addition to the existing laws and not in its derogation*."

CONCLUSION

The PTC case is very clear on one aspect, the right of a pledgee, in case of default by pledgor, is a 'special' right in the goods pledged, and not a general right of ownership (which continues to remain with the pledgor). The pledgee gets a limited right to utilise the pledged good for a very specific purpose (as security) along with the right to sell in case of default. To illustrate the comparative, the opposite of this could be a mortgage right – wherein the mortgagee gets a legal right on the title of the mortgaged goods, exercisable upon default.

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Interestingly, the court also noticed that *"takeover regulations may have its own impact and in a given case, may be a detriment and a negative factor for the creditor who wants to secure himself by a deed of pledge. The pertinent question is, should takeover regulations apply when the pawnee exercises his right to be recorded as a 'beneficial owner', while reserving his right to sell the pledge. There would be tax and accounting implications which may be detrimental and shackle financial market and deals."* In this vein, the Takeover Code already provides an exemption from mandatory takeover obligations in case of invocation of a pledge by a scheduled commercial bank or public financial institution. This specifically begs the question of whether a mandatory open offer should be triggered at the time of invocation **or** actual sale to a third party?

The Supreme Court in the PTC case also discussed this by referring to ***Liquid Holdings***[9] where invocation by the pledgee was interpreted as a transfer of rights in the shares and hence, caused a breach of the Takeover Code. Acknowledging the complications that this judgement is likely to pose, the court held that "*A holistic review of the impact of pledge viz. dematerialized securities, registration of the pawnee as the 'beneficial owner' without the pawnee enforcing the right to sell the pledge goods is required and necessary for the smooth functioning of the securities market and free flow of transactions without hindrance and to avoid uncertainty in fiscal matters*."

The very idea of the pledgee being recorded as the beneficial owner for procedural reasons while logical, is likely to open a pandora's box. This is only exacerbated by logistical factors which blur the lines further - for instance, upon invocation, since a pledgee becomes the beneficial owner of the demat shares in the depository records, all shareholder-related notices are directed to this pledgee as the beneficial owner. The PTC case has opened a deeper probe these questions. Who will exercise the voting rights on invoked shares? Who will have the ability to exercise shareholder rights associated with beneficial ownership of the shares? How will the different regulators such as IRDA[10], SEBI[11] and RERA[12] determine the ownership of invoked shares?

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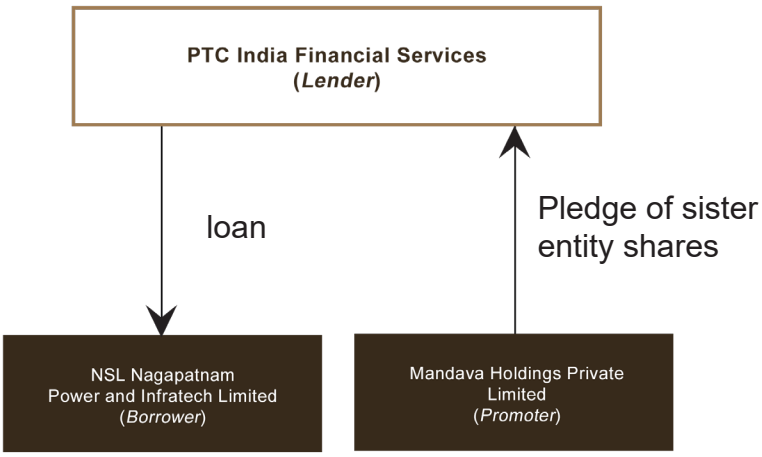
[9] Liquid Holdings Private Limited v. The Securities Exchange Board of India, (2011) SCC Online SAT 40.
[10] Insurance Regulatory and Development Authority of India.
[11] Securities and Exchange Board of India.
[12] Real Estate Regulatory Authority.

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ANNEXURE

Brief facts

PTC India Financial Services Limited (Lender) had advanced a loan to NSL Nagapatnam Power and Infratech Limited (Borrower). The promoter company, Mandava Holdings Private Limited (Promoter) of the Borrower secured this loan by pledging the demat shares of a sister company (flow chart below).



The Borrower had applied for initiation of corporate insolvency resolution process (CIRP). In the meanwhile, the Lender sought to enforce the share pledge on the Borrower's default. The Lender served a notice upon the Borrower and went on to invoke the share pledge – thus becoming the beneficial owner of the shares in the records of the depository.

On admission of the CIRP by the National Company Law Tribunal (NCLT), the Promoter sought to be classified as a financial creditor in this CIRP – arguing that since the share pledge had been invoked, the Promoter no longer had the title to those shares, and hence the Borrower was liable to treat the Promoter as a financial creditor to the extent of the pledged shares. Interestingly, when the Lender submitted a claim before the insolvency resolution professional (IRP) it quantified the amount of debt that the Borrower owed to it as a figure not reduced to adjust for the value of the pledged shares that had been invoked by the Lender. The IRP rejected both claims – by the Promoter and the Lender – concluding that since the valuation of the shares was not undertaken at the time of invocation of the share pledge – neither claim could be quantified at this point.

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extent of the pledged shares. Interestingly, when the Lender submitted a claim before the insolvency resolution professional (IRP) it quantified the amount of debt that the Borrower owed to it as a figure not reduced to adjust for the value of the pledged shares that had been invoked by the Lender. The IRP rejected both claims – by the Promoter and the Lender – concluding that since the valuation of the shares was not undertaken at the time of invocation of the share pledge – neither claim could be quantified at this point.

This finding of the IRP was challenged, and the NCLT accepted the Promoter claim recognising them as a financial creditor to the extent of the pledged shares. It was directed that the valuation as on date of invocation of the pledge be determined by an independent valuer so that the claims of the Lender and Promoter can be appropriately quantified. The Lender appealed against this order and sought relief from the National Company Law Appellate Tribunal (NCLAT). However, the NCLAT held that upon invocation the Lender had become the owner of the pledged shares, and as such, the Lender would not be entitled to characterisation as a financial creditor.

Aggrieved, PTC filed an appeal before the Supreme Court. In a division bench ruling, J. Khanna and J. Shah, ruled in favour of PTC, and in the process deep-dived into the multitude of legal questions surrounding a pledge of demat shares – most importantly clarifying on what ‘actual sale’ meant.

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