

Dispute Resolution Hotline

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SUPREME COURT CLEARS THE AIR ON THE PLEDGE OF DEMATERIALIZED SHARES

On its face, invoking a pledge of demat share appears to be a simple exercise of submitting a form with the depository participant. But in practice, there are several issues that the lenders need to keep in mind when it comes to enforcement of the pledge. For instance, (a) the valuation of shares on the date of invocation of pledged dematerialised (“**demat**”) shares vis-a-vis the valuation at the time of sale; (b) manner in which the pledge needs to be invoked; (c) how to mitigate claims for losses suffered due to the lender’s actions; etc.

The Supreme Court (“**Court**”) in the recent judgment of *PTC India Financial Services Limited v. Venkateswarlu Kari & Ors.*¹ has resolved some of the issues surrounding the pledge of demat shares. The Court has held that there is no disharmony between the Depositories Act, 1996 (“**DP Act**”), SEBI (Depositories and Participants) Regulations, 1996 (“**DP Regulations**”), and the provisions of the Indian Contract Act, 1872 (“**Contract Act**”) in the context of a pledge of demat shares.² The Court clarified that the invocation of pledge of demat shares as per the DP Regulations does not amount to “actual sale”. After the invocation, the lender may, in terms of the Contract Act, either sue the borrower for the debt and retain the pledged shares as collateral or sell the shares upon giving reasonable notice of sale. There is no discharge or satisfaction of the debt upon invocation.

LAW RELATING TO PLEDGE

The Contract Act (Section 176) prescribes that upon default, a pledgee may either (a) file a suit for recovery of debt and retain the pledged property as security, or (b) sell the pledged property after giving reasonable notice of sale to the borrower.³ The pledgor continues to be liable to pay any balance if the proceeds of the sale are less than the debt. However, if the proceeds of the sale are greater than the debt, the pledgee has to pay over the surplus to the pledgor.⁴ The pledgor also has the right to redeem the pledged property until its actual sale by the pledgee.⁵

PLEDGE OF DE-MAT SHARES VIS-À-VIS PHYSICAL SHARES

The DP Act and the DP Regulations provided a separate scheme in which pledge of de-mat shares operated vis-a-vis physical shares. Regulation 58(8) of the DP Regulations provided that subject to the pledge document, the pledgee may invoke the pledge and mandated the depository to on such invocation register the pledgee as beneficial owner of such securities. Regulation 58(9) further mandated the depositories to notify the pledgor and the pledgee about the change in the beneficial ownership after the invocation. There was no requirement of prior notification in case of the de-mat shares. Thus, in case of de-mat shares, upon invocation of the pledge, the lien marked shares in the pledgor’s account are transferred to the account of the pledgee. Whereas in case of physical shares, the ownership of shares gets transferred only after the actual sale as prescribed under Section 176 of the Contract Act i.e. after signed share transfer forms are submitted to the company. Accordingly, the courts in India started taking a view that DP Regulations are in derogation to the scheme of pledge under the Contract Act. The courts held that while Section 176 requires for a notice to pledgor prior to effecting the sale, Regulation 58 provides for notice post invocation which was viewed by the courts as equivalent to sale under Section 176.⁶ It is pertinent to note that the only title in the de-mat shares under the DP Act is as beneficial owner in the records of the participant and the depository, which beneficial ownership changes on invocation of the pledge in terms of Regulation 58.

BRIEF FACTS

PTC India Financial Services Limited (“**PIFSL**”) advanced a loan of INR 1.25 billion to NSL Nagapatnam Power and Infratech Limited (“**Borrower**”). In order to secure the loan, Borrower’s promoter, Mandava Holdings Private Limited (“**MHPL**”), pledged the 31,80,678 (i.e. 26%) shares (“**Pledged Shares**”) of the NSL Energy Ventures Private Limited (“**NEVPL**”), which was a sister company of the Borrower. The shares were in de-mat form. Owing to the default by the Borrower, PIFSL on 16 January 2018 invoked the pledge on the Pledged Shares. Consequently, PIFSL became the “beneficial owner” in the records of the depository participant (“**DP**”). PIFSL had issued notices to MHPL both before and after the invocation of the pledge and reserved its right to sell the shares in accordance with the terms of the pledge agreement and Contract Act.

Meanwhile, the National Company Law Tribunal (“**NCLT**”) admitted the Borrower’s application for initiation of its corporate insolvency resolution process (“**CIRP**”) under Section 10⁷ of the Insolvency and Bankruptcy Code, 2016 (“**IBC**”). Under the CIRP, MHPL filed a claim before the Interim Resolution Professional (“**IRP**”) as a financial creditor of the Borrower. MHPL contended that since it no longer holds the title over the Pledged Shares, it has stepped into the shoes of PIFSL as creditor of the Borrower to the extent of the value of the Pledged Shares. On the other hand, PIFSL also submitted a claim before the IRP in the CIRP of the Borrower. It contended that as on date of initiation of

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CIRP approx. INR 1.69 billion was due to it from the Borrower. PIFSL did not account for or reduce the value of Pledged Shares in its claim. The IRP rejected both the claims made by MHPL and PIFSL. IRP informed MHPL and PIFSL that their claims could not be crystallised as there was no valuation provided for the Pledged Shares at the time of transfer of Pledged Shares to PIFSL. Both MHPL and PIFSL challenged this finding before the NCLT.

The NCLT held that consequent to the invocation of pledge MHPL's shareholding was reduced in NEVPL. Accordingly, MHPL became a financial creditor of the Borrower to the extent of value of Pledged Shares. The NCLT directed the IRP to appoint an independent valuer to value the Pledged Shares as of invocation date to determine the extent of debt due to PIFSL and MHPL. PIFSL challenged the finding of the NCLT before NCLAT. However, the NCLAT dismissed PIFSL's appeal on the ground that it was immaterial whether or not PIFSL further sold the shares after the invocation. The NCLAT held that once PIFSL became the owner of the Pledged Shares, it can realise its dues in part or whole by selling the shares and cannot be allowed to reclaim the full amount of debt. Aggrieved by the order of the NCLAT, PIFSL filed the appeal before the Court.

JUDGMENT

The Court allowed the appeal of PIFSL based on the following analysis:

i. *Lender has a special and not general right in the pledged property*

The Court held that in case of a pledge the Lender (or the pledgee) does not have a wider general right i.e. akin to the right of an owner. While the owner has (a) right to possession; (b) right of enjoyment; and (c) the right of disposition, a lender does not have right of ownership, but has only limited right to retain the possession till debt is discharged. Further, upon default the Lender can either (a) file a suit for recovery of debt and retain the pledged property as security, or (b) sell the pledged property after giving reasonable notice of sale to the borrower. Accordingly, the lender only has the special property right in the pledged goods. The special property rights in the pledged goods is higher than the mere right to detention but lesser than general property right.

ii. *Whether the Lender can retain the benefits accrued on the pledged shares*

The Court observed that the pledge extends to accretions and additions, and therefore, when the lender returns the pledged goods, the additions or accretions must also be returned. In the context of pledge of shares, the Court affirmed earlier judgments which held that benefits such as bonus or rights shares issued on pledged shares, dividends, or any other type of benefits received from pledged shares also constitutes a security for the debt and must be returned to the borrower upon redemption.

iii. *Notice of sale and the duty of lender to sell*

Relying on earlier judgments, the Court held that upon default the lender has the option to sell the pledged property by giving reasonable notice to the borrower. It is not required that the notice stipulates details such as date, time, and place of sale. The reasonableness of the notice prescribed under Section 176 of the Contract Act would depend upon facts of each case. In case of listed shares, even 24 hours could be a reasonable notice. But the requirement to issue notice prior to sale is mandatory and cannot be waived. This is because the borrower should be afforded all opportunities to discharge the debt and redeem the pledged property. However, the lender cannot be compelled to sell the pledged property – not even after the issuance notice of sale.

iv. *Sale of pledged property to self*

The Court held that Section 177 of the Contract Act entitles the pledgor to redeem the pledged shares till the actual sale. Thus, the Contract Act does not support the concept of sale of pledged property by the lender to itself. The Court relying upon the earlier judgments of the High Court and the provisions of the Contract Act, held that sale of pledged property by the lender to itself amounts to conversion and does not bring the pledge to an end. The Court affirmed that it is only after the sale to third parties that the pledge ends and the borrower loses the right to redeem the pledged property. Accordingly, the Court overruled the earlier decision of the High Court which held that sale to self by the lender was not void.

v. *Effect of DP Act, DP Regulation on the provisions of the Contract Act*

The Court held that under the scheme of the DP Act and DP Regulation, one can only sell the shares if he/she is registered as a "beneficial owner" in the register and index of the DP. Accordingly, Regulation 58(8) merely requires that upon invocation the lender should be registered as the "beneficial owner". This in and of itself, does not amount to "actual sale" as stipulated under Section 176 and 177 of the Contract Act. In fact, this would only enable the lender to conduct an "actual sale" in terms of the Contract Act. The Court clarified that the expression "actual sale" has to be given meaning and does not mean sale to self (which constitutes conversion). Relying upon various earlier decisions, the Court held that the expression "actual sale" means lawful sale to a third person. The Court further clarified that the borrower's right to redeem the shares under Section 177 of the Contract Act can be exercised even after the lender has acquired the status of the "beneficial owner". It is only after the sale by lender to a third party that the borrower lender loses its right to redeem the pledged shares.

The Court therefore, held that there is no disharmony between the scheme of the DP Act, Regulations and the Contract Act and the same can be read harmoniously without nullifying or altering each other. The Court observed that there was however, one exception to this. Under the Contract Act the borrower is entitled to redeem the pledged shares on the ground that reasonable notice under Section 176 was not given to the pledgor. The Court held that if this is applied to de-mat securities that have been transferred as per the DP Act and DP Regulations, it may materially impact the certitude in transactions in listed demat securities. Accordingly, borrower's right to redeem the pledged shares on grounds of failure to provide requisite notice under Section 176 is not applicable in case the demat shares were transferred in accordance with the provisions of DP Act and DP Regulations. In fact, the scheme of DP Act and DP Regulation already provides for intimation to both the borrower and the pledgor after the invocation. Thus, barring this exception the Section 176 and 177 of the Contract Act operate without hindering the scheme of the DP Act and DP Regulations.

The Court in passing the above remarks overruled various decisions of the High Courts which took the view that the provisions of the DP Act and DP Regulation are in derogation to the Contract Act in the context of the de-mat shares.

PRESENT CASE

The Court held that PIFSL's change of status as the "beneficial owner" of the Pledged Shares did not constitute a "sale". It was in fact a step required to conduct actual sale. It was still unclear whether PIFSL would be able to find a willing buyer for the Pledged Shares. PIFSL could not account for the Pledged Shares until it is sold to third party and the sale proceeds are received by the PIFSL. The debt therefore, was found to not have been discharged either in part or in full. MHPL therefore was held not to be a secured creditor of the Borrower.

ANALYSIS AND CONCLUSION

The present judgment is a welcome step in settling many of the issues clouding the enforcement of the pledge of demat shares. It is now clear that the mere invocation of the pledge under the DP Regulations would not extinguish the debt or borrower's right to redeem the pledged shares. This would occur only upon the actual sale to a third party. However, several issues continue to remain that the lenders should take into account while giving loans against pledge of shares.

1. Could the lender exercise voting rights on the shares?

The judgment indicates that the terms of the pledge agreement would govern such matters. Thus, if the pledge agreement provides, the lender could exercise voting rights on the shares during the period the lender holds the shares in its demat account.

Having said the above, in the present judgment, the Court recognised that the pledge only creates a special interest, i.e., the option to transfer the property in case of a default. The law of pledge does not recognise the general right in the pledged property. Thus, it is unclear on which basis the judgment indicates that if the pledge agreement so provides, the lender could exercise the voting rights on the shares (which is akin to exercising ownership rights, i.e., something more than just the mere right to sell). Shareholders are entitled to contractually agree upon voting matters as commonly done under shareholders' agreement. However, such a voting agreement results in the shareholder itself voting per the agreed terms. This is different from exercising voting rights as the beneficial owner of the shares. Being the beneficial owner permits the lender to cast a vote directly. In contrast, as a counterparty to a voting agreement, any vote would have to be cast through the original shareholder, i.e., the borrower. In fact, under the Companies Act, a shareholder has several rights, such as the right to inspect certain documents and the right to call for a general meeting.

From a lender's perspective, it may want to exercise the rights in order to protect the value of the security. However, this raises concerns about how long the lender can remain in the state of a mere beneficial owner (i.e., not sell the shares after invocation). The Court has indicated that the lender cannot be compelled to sell. But being in the position of a 'beneficial owner' and exercising shareholder rights for an extended period could give rise to issues that a lender needs to be cautious of.

2. At what stage do the obligations under other laws trigger, i.e., upon invocation or sale?

Several laws and regulations impose certain requirements connected to the transfer of ownership of shares. For example, prior consent of IRDA is required in case of transfer of ownership of an insurance company, or the consent of RBI is required in case of transfer of ownership of a core investment company. SEBI regulations have reporting requirements in case of transfer of a specified percentage of ownership and an obligation to make an open offer in case the thresholds under the takeover code are triggered. It remains to be seen if such obligations under other laws would trigger upon invocation or actual sale. The judgment hints that such triggers may negatively impact the creditors, and therefore, a holistic view of the lender as a "beneficial owner" who has not sold the pledged securities is necessary for the smooth functioning of the securities market. Currently, the lenders should evaluate the potential position that the regulator may take in the event the lender invokes the share pledge and, in particular, chooses to exercise shareholder rights.

3. Does the shares post-initiation of insolvency constitute assets of the corporate debtor and cannot be sold by the lender?

While not in the present case, there can be a situation where the corporate debtor itself has pledged the shares, and a CIRP is admitted against it after the invocation of the pledge. It is unclear whether the unsold pledged shares form part of the corporate debtor's assets or not post the initiation of insolvency. The present judgment allowed the lender's claim in the insolvency proceedings without any reduction towards the value of the shares sitting in the lender's account. Thus, while the lender's claim survives, the unsold shares are not within the control of the resolution professional because of prior invocation by the lender.

– **Mohammad Kamran & Ashish Kabra**

You can direct your queries or comments to the authors

¹ Civil Appeal No. 5443 of 2019 decided on May 12, 2022

² While the Court appears to have considered the provisions of the SEBI (Depositories and Participants) Regulations, 1996, SEBI has passed the new SEBI (Depositories and Participants) Regulations, 2018, which have similar provisions relating to creating and invocation of pledge. Therefore, the analysis of the Courts may well apply to provisions of the new SEBI (Depositories and Participants) Regulations, 2018.

³ Section 176 of the Contract Act

⁴ Section 176 of the Contract Act

⁵ Section 177 of the Contract Act

⁶ *JRY Investments Private Limited v. Deccan Leafine Services Ltd. and Others*, (2004) 121 Comp Cas 12; *Tendril Financial Services Pvt. Ltd. & Ors. v. Narredi Leasing & Finance Ltd. and Ors.*, 2018 SCC OnLine Del 8142.

⁷ Section 10(1) – Where a corporate debtor has committed a default, a corporate applicant thereof may file an application for initiating corporate insolvency resolution process with the Adjudicating Authority. [...]

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