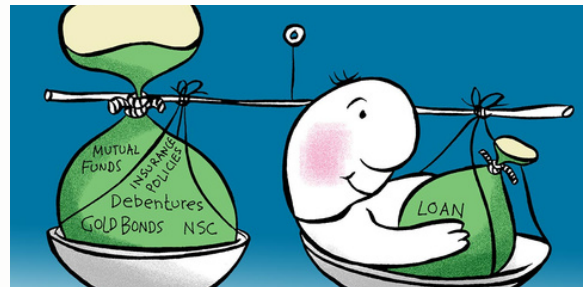


VOTING RIGHTS THE NEW ARSENAL FOR LENDERS

Authored by

Shivi Rastogi, Managing Partner,
Head-Corporate Commercial

Sonalika Ahuja, Senior Associate



In India, it is a common practice for the promoters/directors of a company to pledge their securities to secure the loans raised by such companies. Rights in relation to the pledged securities, including right to exercise voting rights over the shares, transfer the share downstream or constitute a nominee, have always been a bone of contention between the pledgor and pledgee. This has been particularly so in respect of dematerialized securities where, unlike in case of physical shares, the invocation of pledge leads to the transfer of the pledged securities into the dematerialized account of the lender, making the lender the beneficial owner of such shares.



The Supreme Court and the Bombay High Court in the cases of PTC India Financial Services Limited v. Venkateswarlu Kari & Ors^[1] (“PTC India”) and World Crest Advisors LLP vs Catalyst Trusteeship Ltd & Ors.^[2] (“World Crest”) respectively have tried to resolve some of the issues concerning the invocation of pledged securities. This write-up analyses the legal principles laid down by the Indian courts with respect to enforcement of pledge and the special rights available to a pledgee on invocation of a pledge in respect of dematerialized securities.

The Conundrum

The rights of a pledgee emanate from relevant provisions of the Indian Contract Act, 1872 (“ICA”), which is applicable irrespective of whether securities are in physical or dematerialized form. Section 176 of the ICA deals with Pawnee’s right (when pawnor makes default), inter alia, to sell the pawned property for recovery of its debt after giving the pawnor reasonable notice of sale. On the other hand Section 177 of the ICA protects the defaulting pawnor’s right to redeem^[3] the pawned property at any time prior to the actual sale by making payment of the debt and any expenses incurred by the pawnee.

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

[2] Interim Application (L) NO. 19253 of 2022.

[3] Section 177 of ICA: If a time is stipulated for the payment of the debt, of performance of the promise, for which the pledge is made, and the pawnor makes default in payment of the debt or performance of the promise at the stipulated time, he may redeem the goods pledged at any subsequent time before the actual sale of them; but he must, in that case, pay, in addition, any expenses which have arisen from his default.



In case of dematerialised shares, the pledge is also governed by the Depositories Act, 1996 (“**Depositories Act**”) and the SEBI (Depositories and Participants) Regulations, 1996 (“**DP Regulations**”). Regulation 58(8) of the DP Regulations states that subject to the provisions of the pledged documents, the pledgee may invoke the pledge, and, on such invocation, the depository shall register the pledgee as beneficial owner of such securities and amend its records accordingly. In the recent years, as pledge of shares, particularly dematerialised shares of listed companies, became a prevalent collateral, various issues arose on the applicability of provisions of the ICA, particularly on the requirement for notice of sale, in case of sale of the dematerialized shares where the lender (or a security / debenture trustee appointed for the benefit of the lender) becomes the “beneficial owner” of such shares prior to the sale of such shares for recovery of the debt. This seeming divergence between the ICA and the DP Regulations spawned other questions on the nature of rights exercisable by the lender/ trustee as a “beneficial owner”, in particular the right to vote on such shares. The recent decision by the Supreme Court in the case of **PTC India Financial Services Limited v. Venkateswarlu Kari & Ors.** and the follow-on decision of the Bombay High Court in the case of **World Crest Advisors LLP vs Catalyst Trusteeship Ltd & Ors.** have clarified these issues significantly.



Special Property of the Pledgee

The Supreme Court in the case of PTC India Financial Services Limited v. Venkateswarlu Kari & Ors. made extensive observations on issues

relating to invocation of pledge, resolving the interplay between the ICA and the DP Regulations by reading them harmoniously. The court, while holding that the right of pledgee in the pledged shares is a special property and not general property, declared that:

- issuance of notice before sale of pledged shares as required under Section 176 of the ICA is mandatory even in respect of dematerialized shares.
- right of pledgee to record oneself as the beneficial owner will not amount to actual sale for the purpose of Section 177 of ICA.

While the aforesaid judgement clarified that the pledgor, despite becoming the “beneficial owner” of the pledged shares, continues to have only special property in such shares, left ambiguous the scope of what constitutes “special property” of pledgee pursuant to invocation of the pledge. The Supreme Court in the said case, did not delve into the extent of rights available to a pledgee upon invocation of pledge i.e. what is encompassed in the special property of the pledgee and what is excluded from that. In fact, it raised the question of whether voting rights were excluded from the scope of the pledgee’s special property.





Voting Rights of the Pledgee

The division bench of Bombay High Court, in the case of World Crest Advisors LLP vs Catalyst Trusteeship Ltd & Ors. has examined this aspect and shed some light on the scope of the pledgee's special property.

As per the facts of the case, Yes Bank Ltd (“YBL”) advanced loan to certain borrowers. The repayment of the said loan was secured by pledge of shares of Dish TV India Limited (“Dish TV”) held by World Crest Advisors (“World Crest”) in favor of security trustee, Catalyst Trusteeship Limited (“Catalyst”). It was agreed between the parties under the contract of pledge that Catalyst can transfer the pledged share to itself on an event of default. On the event of default, Catalyst transferred the security in its favor and registered itself as ‘beneficial owner’ as per regulation 58(8) of DP Regulations. Thereafter, Catalyst further transferred the shares to YBL.

The main point of contention was whether YBL, registered as a beneficial owner (as a nominee of Catalyst), can exercise voting rights over the pledged shares or does it merely hold those shares in its name until it sells the shares to a third-party purchaser after necessary notice or World Crest redeems the pledge.



Relying upon the provisions of ICA and PTC Judgement, the applicant Pledgor, while seeking restraint on exercise of voting rights by YBL, contented that:

- Catalyst can transfer the pledged shares in its name only for limited purpose of holding it safely until they are redeemed, sold or are held as collateral in a recovery suit;
- The transfer of all rights of general property by the Pledgee to itself is sale to self and prohibited under ICA; and
- the pledgee can exercise its contractual rights only in a manner not inconsistent with the law declared by the Supreme Court regarding pledges.

The Bombay High Court held as below:

- PTC India restates long-standing law on pledges and does not re-write it;
- The proposition that the recording of Catalyst's name under Regulation 58(8) as the beneficial owner results in it having some severely curtailed rights as beneficial owner was not acceptable, particularly as the pledgor could bring those rights to an end in one stroke by exercising its right of redemption.



- No inference can be made from PTC to state that conferment of voting rights amounts to ‘the general property’ in shares and the contract or pledged document could not provide so.
- Eventually, the court, finding that the applicant had not been able to make an overwhelming prima facie case and on equitable considerations, dismissed the application.

CONCLUSION

In our view, while in the PTC Financial case the Supreme Court reiterated that the pledgee only holds special property in the pledged goods, the Bombay High Court’s decision provides some guidance for understanding the boundaries of such “special property”. It provides ground for the argument that in the absence of any clear statutory or contractual restrictions, the special property of the pledgee encompasses the entire fullness of rights in relation to the shares, circumscribed only by the pledgor’s right of redemption of pledge and the pledgee’s obligation to follow the process prescribed under law for the sale of pledged shares, including giving reasonable notice of sale and prohibition on sale to self. It also provides ripe ground for lenders to seek express provisions in the pledge documents enabling them to exercise voting rights especially on occurrence of an event of default (which is a common industry practice). It may be noted that the exercise of voting rights by the pledgee as registered beneficial owner also aligns with the provisions of the



Companies Act, 2013 and other SEBI regulations, as the records of the company calling a meeting for a shareholders vote, would, in absence of any specific regulatory, statutory or judicial order, reflect the pledgee as the beneficial owner entitled to vote and not make any distinction between a beneficial owner pursuant to a transfer and a beneficial owner.

Reach out to the authors:
shivi@amicusservices.in
sonalika.ahuja@amicusservices.in

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Delhi: I-1, Jangpura Extension, New Delhi 110 014, INDIA

Noida: 620, Tower B, Advant Business Park, Greater Noida Expressway, Sector 142, Noida 201305, INDIA