

# **PLEDGE OF SHARES**

## **Law, Disclosures and Implications**

**Neha Gupta**

Vinod Kothari & Company,  
1012 Krishna,  
224 AJC Bose Road,  
Kolkata- 700017.

Ph: 91-33-22817715/ 22811276

Email: [neha@vinodkothari.com](mailto:neha@vinodkothari.com)

# Definition of Pledge

- What is a pledge:
  - Possessory security against a debt or promise
  - Liens or hypothecations are mere obligation against property without parting with possession
  - Pledge transfers possession of property also
  - Pledge is different from usufructuary mortgage:
    - In the latter, the mortgagee is allowed the right of usufruct. Pledge is merely right of possession; without right in the usufruct
- Definition of Pledge: **Section 172 of the Indian Contract Act**
  - Pledge is the delivery of goods by the pawnor to the pawnee by way of security upon a contract that they shall, when the debt is paid or the promise is performed, be returned or otherwise disposed of according to the directions of the pawnor.
  - A pledge would, therefore, create a right of possession only. The title of the pledged property remains with the pawnor.
- ***J Shelat in Lallan Prasad vs Rahmat Ali AIR 1967***– Pawn or pledge is a bailment of personal property as a security for some debt or engagement.
- Parties
  - Pawner/pledgor
  - Pawnee/pledgee
- Goods pledged - pawn

# Basic law of pledge

- As a pledge is a specie of bailment, all requirements of bailments are applicable to pledges too
  - Delivery of goods by the pawnor to pawnee
  - Delivery must be such as to put the goods effectively in the control of the pawnee, and outside the control of the pawnor
  - Agreement that the goods will be returned to pawnor when purpose satisfied
  - Goods must be movable property, ascertainable
  - Since a pledge is a mere bailment and not a hire, hence, pawnee does not get any right of using the goods

# Provisions of the Contracts Act

- Admitted purpose of a pledge is to create special property in the pawnee
  - On default, pawnee must be able to sell the pawn to realise his dues
- **Sec 176 of the Indian Contract Act, 1857:** Pawnee's rights where pawnor makes default
  - File a suit against the pawnor and may retain the goods pledged as a collateral security.
  - Sell the goods pledged after giving the pawnor a reasonable notice of the sale.
- Two distinct rights – right of retention and sue for the claim; right of sale to realise the dues
- In case pawnee exercises right to sell, he may recover from the pawnor any deficiency arising on the sale and hand over the surplus, if any, realised on the sale of the goods to the pawnor.
- Right to retain or sell are not concurrent, right to sue and sell are concurrent rights (*Haridas Mundra v. National Grindlays Bank Ltd.*)
- This right secures the debt for the pawnee up to the value of the goods pledged.
- If the pawnee has sold the goods, he cannot sue for the debt.
- When the goods are lost due to pawnee's negligence, the liability of the pawnor is reduced to the extent of value of the goods.

# Pledge of shares as a special case

- Why would pledge of shares be a special case?
  - Shares are goods in law; hence, common law rules must be applicable to shares too
- But Depositories Act pertains to shares in dematerialised form
  - In effect, a share in a demat form is beneficial interest in the shares legally held with the depository participant
- Since a demat share does not have a physical existence, is it something that can be bailed under the Contracts law?
  - In view of specific provisions in Depositories Act on pledges, it is possible to hold that save the general rules of the contract law, specific provisions of Depositories Act should apply to pledges

# Provisions in the Depositories Act

- **Sec 12 of the Depositories Act, 1996**
  - a security owned through a depository. Pledge or hypothecation of securities held in a depository
  - Beneficial owner with the previous approval of the depository creates a pledge or hypothecation in respect of
  - Every beneficial owner should give intimation of such pledge or hypothecation to the depository participant and such depository is required to make entries in its records accordingly.
  - Any entry in the records of a depository should be evidence of a pledge or hypothecation.
- Law talks about pledge or hypothecation. A CLB ruling has referred to mortgage also. Hence, 3 possibilities for demat shares
  - Pledge
  - Hypothecation
  - Mortgage
- Hypothecation seems a bit irrelevant, since once a pledge is registered with the depository participant, it creates rights similar to pledge.

# Regulation 58 of SEBI (Depositories and Participants) Regulation, 1996

## *Manner of creating pledge or hypothecation*

- Beneficial owner to make an application to the depository through the participant
- Participant after satisfaction that the securities are available for pledge shall make a note in its records and forward the application to the depository.
- Depository after confirmation from the pledgee shall within fifteen days of the receipt of the application create and record the pledge and send intimation to both the participants.
- On receipt of the intimation, the participants shall inform the pledger and the pledgee.
- If the depository does not create the pledge, it shall send along with the reasons an intimation to the participants.
- Entry of pledge may be cancelled by the depository if pledger or the pledgee makes application to the depository through its participants.

# Regulation 58 (Contd.)

**Provided that no entry of pledge shall be cancelled by the depository without** prior concurrence of the pledgee.

- Depository on cancellation of the entry of pledge informs the participant of the pledger.
- Subject to the provisions of the pledge document, the pledgee may invoke the pledge and on such invocation, the depository shall register the pledgee as beneficial owner of such securities.
- Depository immediately informs the participants of the change who in turn shall make the necessary changes in their records and inform the pledger and pledgee.
- No transfer of security in respect of which entry of pledge or hypothecation is in force shall be effected by a participant without the concurrence of the pledgee or the hypothecatee, as the case may be.

# CLB Order

- Company Law Board Order dated 7<sup>th</sup> Nov, 2001- in matter of *Maruti Udyog Limited v. Pentamedia Graphics Limited, Pentafour Products Limited and Shri V.Ramakrishnan*
  - The pawnee has right to sue for the outstanding amount, enforce the security by sale after due notice and file suit enforcing the security.
  - Only in case of mortgage of shares, the mortgagee can enjoy the shares and bring them in his name and not in the case of pledge.
  - Significant ruling on the rights of a pawnee – Contracts Act rule empowering the pawnee to sell seems established by the ruling
- The Depositories Act provision that talks about pledgee getting the beneficial ownership transferred in own name effectively seems to be from viewpoint of enabling a sale

# Case Laws

- ***Narasayamma Vs. Andhra Bank–AIR 1960 Andhra Pradesh 273 (V 47 C 85)*** -a pawnee has only the special property in the goods pledged, that is, the right of retainer of the goods as security and in case of default he must either bring a suit against the pawnor or sell the goods after giving a reasonable notice
- ***Shatzadi Begum Saheba Vs. Girdharilal Sanghi – AIR 1976 Andhra Pradesh 273*** –A pawnee does not have the right of ownership, though he has the right of possession but not the right of enjoyment; a pawnee has the right of disposition which is limited to disposition of pledgee's rights only and of a sale only after notice and subject to certain limitation.

# Case Laws

- ***Lallan Prasad Vs. Rahmat Ali – AIR 1967 Supreme Court 1322*** –a pawnee cannot maintain a suit for recovery of debt as well as retain pledged property.
- ***T.S.Kotagi Vs. Tahsildar, Gadag – AIR 1985 Karnataka 265*** –if a pawnee wants to sell articles without the intervention of the Court, he can do so only after issuing a notice of sale to the pawnor. Sale without notice is void.
- ***Ramdeyal Prasad Vs. Sayed Hasan – AIR (31) 1944 Patna 135*** -Pawnee is entitled to sell the ornaments pledged by giving a reasonable notice of the sale to the Pawnor.

# Rights and duties of Pawnee

- Where a negotiable security is taken as collateral to an existing debt, the holder may endeavor to make it available in a suit, but failing of success, he may resort to his original security without restoring that taken as collateral.
- He is bound to observe due diligence in the collection of the note, and in giving notice of non-payment, etc, and if the security be lost by his negligence, he is liable.
- He may, at any time, sue upon the debt for which it is pledged, without surrendering it, and may even attach the pawn on the very debt secured by it.
- If the pawn be lost, or tortiously converted by the pawnee to his own use, and the pawnor recover the value thereof from the pawnee, the original debt still survives, and may be sued.

# Can Pawnee sell pawn to himself?

- Upon default of the pawnor, the pawnee cannot appropriate the specific pawn, unless it be conveyed by way of mortgage, so as to pass the legal title. But he may sell it, and apply the proceeds of such sale to the liquidation of his claim. He cannot, however, become the purchaser himself.
- Where bank shares pledged to the bank in security of a loan were sold at auction upon the death of the pawnor, and the bank itself became the purchaser and claimed the balance from the borrower's administrator, it was held that no property in the shares passed to the bank by sale, but that they still held them as collateral security for their claim, although, had the sale been to a third person, it would have been perfectly valid. Until the pledge be sold, however, the pawnor may redeem it at any time after his default; for so long as it remains in the hands of the pawnee, it can only be considered as security for the original debt, and never as the property of the pawnee; and if he die, it may be redeemed from his representatives. Nor will prescription, nor the statute of limitations, run against it.
  - *Demandray v. Metcalf*, Pr. Ch. 419; 2 Vera. 691, *Jarvis v. Rogers*, 15 Mass. 389, 397

# Reasonable Notice to be given

- The pawner is required to give a reasonable notice to the pawnee about the sale. The notice is not a mere notice but reasonable notice- ***Prabhat Bank vs Babu Ram AIR 1966***
- The terms of an agreement of a loan enabled the bank to sell the securities upon default without notice. The pawnor defaulted in payment. The bank sent a reminder upon which the pawnor asked for more time. The bank sold the securities. SC held that this was bad in law. The bank is required to give a clear and specific notice of the impending sale. Pawner's request for more time cannot be interpreted as a notice of sale.

# Delay in selling immaterial

- SEBI's Directions *Against Kosha Investments Ltd In The Matter of Snowcem India Ltd*, dated 27<sup>th</sup> January 2004, Mumbai -On pledge of shares by KIL, the lenders in whose favour the shares were so pledged did not become the "owners" of the said shares and the interest of KIL in these shares continued to subsist.
- **Reasonable notice of sale given---Sale may be made at any time-Delay in selling goods immaterial.** Where there is no evidence to show that delay in affecting the sale was deliberate and mala fide or that the sales were improper in any way or much below the market rate, no inference of bad faith on the part of the Bank can be drawn.

# Important points about pledges

- Can the pawnee sell to himself:
  - As per common law/ contracts law, no.
  - But Depositories Act clearly seems to permit this
  - Mutual contract between parties may always specifically empower pawnee with right to appropriate property
  - In case of shares with transparent market price, there is effectively no difference between a pawnee selling in the market, or selling to himself
- Where pawnee sells to himself, he is seller and buyer both. Sale proceeds go to credit of the pawnor.
  - Hence, clear case of conflict between interests of the buyer and seller
- Any such must be unimpeachable and above-board
- Pawnee cannot, for instance, choose a date of sale when the price of shares is the least, thus clearly benefiting himself at the cost of the pawnor

# More points about pledges

- Strictly the procedure of the Depositories Act provides for invocation of a pledge which is transfer of beneficial interest to the pawnee
- Pawnee subsequently makes a sale of the shares in the market
- Question – who is responsible for the change in price between the date of invocation and actual sale?
- On proper construction, it appears that there is no difference under Depositories Act, as under Contracts law, between invocation and sale. Invocation is for the purpose of sale
- Pawnee may invoke pledge and cause sale directly, as beneficial owner
- If he chooses to invoke pledge, transfer beneficial interest to himself, and not sell in the market, it is a case of sale to himself
  - Hence, any change in price after the date of invocation should belong to the pawnee
- Generally, the practice of invoking pledge and not selling should be discouraged

# SEBI Takeover Code- Disclosures

- Amendments were made vide Notification no. *LAD-NRO/GN/2008-2009/33/15022* - apparently, this was triggered by the Satyam episode

## *Regulation 8A- Disclosure of Pledged Shares*

- A promoter or every person forming part of the promoter group of any company shall, within seven working days of commencement of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) (Amendment) Regulations, 2009, disclose details of shares of that company pledged by him to that company.
- A promoter or every person forming part of the promoter group of any company shall, within 7 working days from the date of creation of pledge on shares of that company held by him, inform the details of such pledge of shares to that company.
- A promoter or every person forming part of the promoter group of any company shall, within 7 working days from the date of invocation of pledge on shares of that company pledged by him, inform the details of invocation of such pledge to that company.

# SEBI Takeover Code- Disclosures

- The company shall disclose the information received to all the stock exchanges, on which the shares of company are listed, within 7 working days of the receipt thereof, if, during any quarter ending March, June, September and December of any year, :-
  - aggregate number of pledged shares of a promoter or every person forming part of promoter group taken together with shares already pledged during that quarter by such promoter or persons exceeds twenty five thousand; or
  - aggregate of total pledged shares of the promoter or every person forming part of promoter group alongwith the shares already pledged during that quarter by such promoter or persons exceeds one per cent. of total shareholding or voting rights of the company, whichever is lower

# “Satyam Killer Amendments”

- While Regulation 8A seeks disclosure of “pledged” shares, Clauses 35/41 of Listing Agreement seeks disclosure also of shares “otherwise encumbered” or “encumbered”.
- The form of reporting under Regulation 8A requires disclosure also of pledge “revoked”. But Regulation 8A does not require such disclosure.
- There is some confusion on whether the Company should report information to stock exchanges relating to pledges on a quarterly basis. The disclosure formats and clauses 35/41 later introduced compound the confusion. However, on balance, it seems that the Company should disclose the information it receives within 7 working days of receipt and not wait till the quarter is complete.

# Whether Insider Trading?



- The Economic Times reports (17th January 2009)- that SEBI is examining whether, in law, pledge of shares amounts to Insider Trading.