

## Reinforcement of pledge over dematerialised shares: A fillip for financial markets

Loans against shares (LAS) have been a time-tested financing tool available in the markets. Pledge of demat shares has been the subject of certain judicial decisions, which have treated “invocation” of pledge (and transfer of the dematerialised shares to the depository account of the pledgee) same as “sale” of the pledged shares, resulting in grave legal uncertainty.

Delivering a landmark judgment in **PTC India Financial Services Limited v. Venkateswarlu Kari and Others<sup>1</sup>** (the **PTC Case**), the Supreme Court has reiterated that the legal principles relating to enforcement of pledge of dematerialised shares are no different than pledge of any other movable assets (including physical shares). The SC also held that such pledges will continue to be governed by the relevant provisions of the Indian Contract Act, 1872 (**Contract Act**) and the Contract Act, the Depositories Act, 1996 (**Depositories Act**); and alongside, the SEBI (Depositories and Participants) Regulations, 1996 (**DP Regulations**) have to be construed harmoniously. Further, in order to boost open market transactions and provide certainty in the enforcement of pledge of listed shares, the Supreme Court while overruling judgments of various High Courts, has also directed the SEBI to re-examine the interplay of the provisions of the Depositories Act and the Takeover Regulations by undertaking a holistic review of the impact of pledge of listed shares and its invocation.

### Issue before the Supreme Court in the PTC Case

PTC India Financial Services Limited had granted loan to a borrower, which was, amongst others, secured by pledge of dematerialised shares by the borrower's holding company's. On account of defaults committed by the



corporate debtor, PTC invoked the pledge, pursuant to which it was recorded as beneficial owner of the shares in view of Regulation 58(8). After the invocation, the resolution professional of the borrower refused to admit PTC as a financial creditor of the corporate debtor on the ground that its debt had been discharged on account of the invocation.

Regulation 58(8) of the DP Regulations provides that **“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 and amend its records accordingly.”** (Emphasis supplied).

Per Regulation 58(8), prior to “actual sale” (i.e. sale by the pledgee to a third party) of the dematerialised shares by the pledgee, an intermediate step of transfer of the

<sup>1</sup> Civil Appeal No. 5443 of 2019 decided on May 12, 2022.

pledged shares to the demat account of the pledgee was involved, which resulted in the pledgee being reflected as “beneficial owner” of the pledged shares.

Basis the aforesaid provision, the National Company Law Tribunal, Hyderabad as well as the NCLAT (placing reliance on certain judgments of High Courts, etc.) had held that the step of “invocation” of pledge by the pledgee will tantamount to “sale” of the shares by the pledgee to itself. Accordingly, it was held that the debt owed under the pledge was discharged upon pledgee becoming “beneficial owner” and the pledgee was liable to account for the value of the shares.

## Supreme Court’s ruling in the PTC Case

In reiterating and reinforcing the settled principles of law relating to pledge of dematerialised shares, the Supreme Court held as follows:

- i. A pledgee’s prior notice, requiring declaration of its/his intention or proposal to sell the shares, need not specify the date, time and place of sale nor is the pledgee obligated to provide these details to the pledgor. The legislative intent underlining the requirement of the prior notice to the pledgor is only to inform the pledgor of the proposed sale of the pledged assets to enable the pledgor to exercise its statutory right of redemption prior to consummation of the “actual sale” of the pledged assets to a third party;
- ii. A pledgee cannot “sell” the pledged shares to itself and any such “sale” will amount to conversion, which is not a right granted to the pledgee under the provisions of the Contract Act. Pledged assets (including shares) can only be “sold” to the “third parties” and until such a sale is concluded, the pledgor is allowed to exercise its right of redemption;
- iii. The purpose of Regulation 58(8) of the DP Regulations is limited to the extent of ensure compliance with the manner in which dematerialised securities can be sold on the depository (through a participant) i.e. the seller of such securities (in case of such pledges, the pledgee) must appear as the “beneficial owner” of such shares, which necessitates the pledgee invoking the pledge and transferring the pledged shares to its depository account and recording itself as the beneficial owner before selling such dematerialised shares to “third parties”;

iv. If the terms of the pledge agreement pertaining to dematerialised shares violate the requirement of Regulation 58(8), the pledge will not be rendered void or illegal. Only the enforcement of the pledge will become unattainable. Further, in such cases, rights of third-party transferees of demat shares by the pledgor will not be affected in the absence of any injunction by a court prior to the conclusion of the sale.

- v. The rule allowing a pledgor the right to redemption against third parties in the absence of a reasonable notice under Section 176 of the Contract Act, would not apply to listed dematerialised securities which are sold by the pledgee in accordance with the provisions of the Depositories Act, bye-laws and rules. This is to ensure certainty in open market transactions. The Supreme Court has held that the provisions of Regulation 58(8), which imposes a pre-condition of the pledgee to become beneficial owner before effecting any “actual sale” to third parties is sufficient notice to the pledgor.
- vi. Normally a court would not grant interim injunction on the prayer of a pledgor alleging non-compliance of Section 176 of the Act. The purpose of giving reasonable notice is to enable the pledgor to redeem the shares before the “actual sale”. The requirement of giving reasonable notice would be satisfied once the pledgor is made aware of and has knowledge of the pledgee’s desire / intent to sell, including when the pledgee appears in any legal proceedings and takes a clear position in its written statement.

## Positive impact for creditors and financial markets

This judgment has settled issues relating to enforcement of pledge of dematerialised shares, which is likely to bring to an end and discourage legal proceedings where pledgors have argued that invocation of the pledges itself (and consequent transfer of the pledged shares to the depository account of the pledgee) amounts to discharge of pledged debt owed to the creditors.

The judgment is also likely to provide a fresh impetus to share-backed financing transactions as the Supreme Court has clarified that courts should normally not grant interim injunctions against enforcement of pledge by creditors – this of course is predicated on the fact that the creditors will have complied with the contractual terms governing the pledge enforcement.

## Contributors:

**L Viswanathan**  
Partner and Chair – Finance,  
Projects and Insolvency  
[Lviswanathan@cyrilshroff.com](mailto:Lviswanathan@cyrilshroff.com)

**Madhav Kanoria**  
Partner  
[madhav.kanoria@cyrilshroff.com](mailto:madhav.kanoria@cyrilshroff.com)

**Abhijeet Das**  
Partner  
[abhijeet.das@cyrilshroff.com](mailto:abhijeet.das@cyrilshroff.com)

### Disclaimer

All information given in this alert has been compiled from credible, reliable sources. Although reasonable care has been taken to ensure that the information contained in this alert is true and accurate, such information is provided 'as is', without any warranty, express or implied as to the accuracy or completeness of any such information.

Cyril Amarchand Mangaldas shall not be liable for any losses incurred by any person from any use of this publication or its contents. This alert does not constitute legal or any other form of advice from Cyril Amarchand Mangaldas.

Should you have any queries in relation to the alert or on other areas of law, please feel free to contact us on [cam.publications@cyrilshroff.com](mailto:cam.publications@cyrilshroff.com)

**Cyril Amarchand Mangaldas**  
Advocates & Solicitors

**100** years of legacy

**850+** Lawyers

**Over 160** Partners

Peninsula Chambers, Peninsula Corporate Park, GK Marg, Lower Parel, Mumbai 400 013, India  
T +91 22 2496 4455 F +91 22 2496 3666 E [cam.mumbai@cyrilshroff.com](mailto:cam.mumbai@cyrilshroff.com) W [www.cyrilshroff.com](http://www.cyrilshroff.com)  
Presence also in Delhi-NCR | Bengaluru | Ahmedabad | Hyderabad | Chennai | GIFT City | Singapore