

Insolvency and Bankruptcy Hotline

July 24, 2023

FROM PROMISE TO PERIL- EXPLORING THE HURDLES OF SHARE PLEDGE ENFORCEMENT FOR INVESTORS IN INSOLVENCY CASES

WHAT IS A PLEDGE?

'Pledging of shares' is a contractual arrangement whereby the 'pledgor' transfers possession of shares to the 'pledgee' as collateral security for a loan. Under the Indian Contracts Act, 1872, a pledge has been defined as, 'the bailment of goods as security for payment of a debt or performance of a promise'.¹ The term bailment simply denotes that the pledgee can retain the shares till the time of repayment of the loan. It is when the pledgee defaults on the repayment of the loan that the pledgor's right to sell the shares accrues by which it can recover the outstanding amount. Thus, pledged shares act as a security for the loan granted.

Therefore, one of the most popular components of a security package availed by creditors (as pledgee) is a pledge of shares of a sister concern or one of the group companies of the principal borrower (as pledgor). It is an attractive option due to the ease and speed of enforceability of the collateral, wherein the first step is to merely intimate the depository participant of the invocation of the pledge, upon which the shares are transferred to the creditor. Shares as an asset are also one of the easiest to monetize, as compared to other forms of collateral.

JURISPRUDENCE ON POSITION OF PLEDGEE UNDER IBC

However, one of the major drawbacks of this form of security is the position the creditors/pledgees occupy upon the admission of the pledgor into the corporate insolvency resolution process ("CIRP") under the Insolvency and Bankruptcy Code, 2016 ("IBC"). The Supreme Court in the judgments of Anuj Jain² and Phoenix ARC,³ held that pledgees will not be regarded as "financial creditors"⁴ and instead shall only qualify as "secured creditors"⁵ if (a) the pledgor is not the principal borrower and (b) no amount has been disbursed directly to the pledgor. This takes away the rights of the pledgee to initiate any proceedings against the pledgor. If a pledgee is not a financial creditor then it cannot be a member of the committee of creditors ("CoC") thereby losing its ability to participate in important decisions pertaining to the CIRP.

However, the Supreme Court has recently in the case of Vistra ITCL (India) and Others vs. Mr. Dinkar Venkatasubramanian and Another⁶, recognized that the present statutory framework suffers from certain lacunae in terms of rights of pledgees qua the pledged shares, upon admission of the pledgor to CIRP.

Further, this judgment has brought into focus the following difficulties faced by pledgees when the pledgor is declared as insolvent:

- a pledgee cannot seek initiation of proceedings under the IBC against the pledgor;
- a pledgee cannot be part of the CoC and participate in the decision-making process;
- a pledgee cannot file a claim as a financial or operational creditor thereby not receiving statutory safeguards on minimum pay-outs provided to such categories of creditors; and
- a pledgee will have to file its claim as an 'other creditor' which falls at the bottom of the distribution waterfall as provided under section 53 of the IBC.

Thus, a close analysis of the aforesaid judgment is essential to understand the effectiveness of pledging shares as a security from the IBC perspective. In particular, the peculiar situation which arose in the instant case, whereby, the resolution plan approved by the adjudicating authority had the effect of extinguishing the pledge agreement without providing any payment to the pledgees. Consequently, the pledgees as secured creditors were left in a position far worse than other creditors (such as operational creditors and dissenting financial creditors).

ANALYSIS OF VISTRA ITCL (INDIA) CASE

In the instant case the pledgor/corporate debtor was not the principal borrower, therefore, no money was advanced to the pledgor by the pledgee/lender. Post initiation of CIRP of the pledgor, the pledgee unsuccessfully tried to register its claim with the resolution professional of the pledgor. The resolution professional contended that the pledgee did not qualify as a financial creditor of the corporate debtor. Subsequently, the pledgee challenged the decision of the resolution professional first before the NCLT and then the NCLAT, both of which upheld the decision of the resolution professional. Pending these proceedings, a resolution plan was approved which did not provide for any payment to the pledgee as the pledgee was not included in the list of creditors. Consequently, the pledgee did not receive any payment as a part of the resolution process and the security, i.e. pledged shares were sold to the resolution applicant.⁷

Research Papers

FAQs on Setting Up of Offices in India

December 13, 2024

FAQs on Downstream Investment

December 13, 2024

Gaming Law 2024

December 12, 2024

Research Articles

The Revolution Realized: Bitcoin's Triumph

December 05, 2024

The Bitcoin Effect

November 14, 2024

Acquirers Beware: Indian Merger Control Regime Revamped!

September 15, 2024

Audio

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FI8 event in Riyadh

October 31, 2024

Analysing SEBI's Consultation Paper on Simplification of registration for FPIs

- a pledgee has a right of payment from the pledgor to the extent of the value of the pledged assets;
- a pledgee cannot seek repayment of the entire debt obligation of the principal borrower under the pledge agreement;
- a pledgee cannot ask the pledgor to discharge the obligation of the principal borrower;
- a pledge is different from guarantee or indemnity and therefore would not fall within the definition of a "financial debt" under the IBC;
- a pledgee is a creditor to the corporate debtor without any statutory safeguard as provided to other categories of creditors like operational creditors and dissenting financial creditors;
- a pledgee cannot initiate fresh legal proceedings against the corporate debtor post completion of the CIRP due to the "clean slate" doctrine; and
- the assets of the corporate debtor charged to the pledgee would be sold as a part of the CIRP therefore it is necessary that the pledgee be provided a repayment of its dues.

To provide protection to the rights of a pledgee under IBC, the Supreme Court has envisaged two solutions, depending on the stage of the process:

- **When the CIRP is ongoing:** treat the pledgees as a financial creditor of the principal debtor to the extent of the estimated value of the pledged shares on the date of commencement of the CIRP; or
- **In the event the CIRP has been completed:** either the pledged shares are to be transferred to the pledgee or proceeds from the sale of the pledged assets should be transferred to the pledgee.

Solution (1) is extremely integral as it safeguards pledgees during the CIRP process as compared to the present situation where they do not have such rights. Essentially, pledgees would be a member of the CoC and have voting rights equivalent to the value of the pledged shares. They can also make a claim against the debtor as a financial creditor and receive statutory safeguards like a minimum payment threshold in case they are dissenting against the approval of a resolution plan. It is a positive step in the right direction, and ensures the pledgees have a say in the manner in which their security interest is being dealt with. However, it is to be noted that this may require referral to a larger bench as it reconsiders the dictum of Anuj Jain and Phoenix ARC.

Solution (2) is what the court opted for as the CIRP had concluded in the present case. This protects the rights of the pledgees upon liquidation, as they are entitled to retain the security proceeds upon the sale of the pledged shares. Hence, they can either relinquish their security interest and receive the proceeds from sale of the assets by the liquidator, or they can realize their security interest by removing the pledged shares from the asset pool in the liquidation estate.

Although it commendable for the Supreme Court to try and provide a practical and commercial solution for a situation which is not envisaged under the IBC, there are certain concerns with the solutions as proposed by the Supreme Court:

- For the purpose of ascertaining the extent of debt payable to the pledgee one would have to carry out a valuation of the pledged assets. Would this valuation be as on the date of commencement of the CIRP or as on the date of creation of the pledge? This will have a major impact on the extent of the claim that can be made by a pledgee.
- During CIRP there is no distinction between secured and unsecured creditors, neither is there any distinction between the priority of charge over the same security. Therefore, even if a financial creditor holds exclusive charge over an asset, the sale proceeds from such an asset will be divided amongst all the creditors in proportion to their claim amount. However, in the instant case the pledged shares will be sold for the sole benefit of the security holder and the benefit will not be passed on to all the creditors. This creates discrepancies within the IBC and as such requires further evaluation.
- An act of balancing interests of the pledgee in relation to other creditors needs to be undertaken as all creditors of the corporate debtor will not be able to recover their dues without incurring heavy cuts below the liquidation value but the pledgee will be paid 100% of the liquidation value. Such a differential treatment of a pledgee cannot be justified without sufficient grounds.
- Finally, the resolution applicant had proposed a consolidated amount for the corporate debtor as a going concern which includes all the assets of the corporate debtor, including the pledged shares. In pursuance to the ruling in the instant case, the pledged shares will be either transferred to the pledgee or sale proceeds will be transferred to the pledgee. Therefore, the resolution applicant should be allowed to proportionately reduce the purchase consideration.

While the abovementioned judgment provides much needed respite for private equity/venture capital players as well as institutional investors who have availed of pledge as a security, the specific fact scenario of the case (due to the provisions of the pledge agreement) meant that the amount received by the pledgee was capped at the amount realized pursuant to the enforcement of the security interest in the pledged shares. The security gains its value from the market, and upon admission of the pledgor into CIRP the value of the shares would fall, thus eroding the value of the collateral of the creditor. Hence, certain contractual provisions should be built into the pledge agreement in order to safeguard against such eventualities.

For example, the agreement can be modified to make the pledge a hybrid instrument by increasing the liability of the pledgor to the entire debt amount rather than capping the value of the security, thus strengthening the position of the pledgee so they can make a claim which is not capped to the value of the pledged shares in the event of admission to CIRP. The method of determining this claim can also be captured in the agreement for clarity. Further, a clause can also be added detailing the procedure if the pledged shares fall in value- for example, if they fall in value the number of shares pledged have to be proportionately increased to bridge the resulting gap (the valuation methodology should also be specified). The fall in value can also be captured as an event of default, thus triggering an option of the pledgee to require mandatory prepayment of the loan by the principal debtor. Alternatively, a clause can be

inserted to make the pledgor liable to repay the principal debt upon the trigger event, or to bridge the gap created due to the value drop of the pledged shares as another method.

Although the aforementioned judgment adds another layer of protection to one of the most used forms of security, the final position of law is yet to be ascertained as there may be a reference to a larger bench.

– Sach Chabria, Faiza Khanum & Arjun Gupta

You can direct your queries or comments to the authors.

¹172 of the Indian Contract Act,1872

²Anuj Jain Interim Resolution Professional for Jaypee Infratech Limited vs. Axis Bank Limited (2020) 8 SCC 401.

³Phoenix ARC Private Limited vs. Ketulbhai Ramubhai Patel (2021) 2 SCC 799.

⁴"Financial Creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to.

⁵"Secured Creditor" means a creditor in favour of whom security interest is created.

⁶Civil Appeal No. 3606 of 2020

⁷Section 5(25) of IBC

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.