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SECURING INTEREST: VOTING RIGHT OF
PAWNEE IN SHARE -BASED COLLATERAL
AGREEMENTS

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1. INTRODUCTION

The article explores the intricate dynamics of share-based collateral agreements within the complex realm of financial securities. It discusses the balance of trust and control between lenders and borrowers, delving into the legal and practical aspects of using company shares as collateral. The common practice of using shares as collateral provides flexibility for borrowers to secure loans without selling assets, while offering lenders tangible security. However, this introduces complexity, especially in enforcing rights during defaults. The article examines the legal framework, including the Indian Contract Act, 1872 and SEBI regulations, outlining the rights of parties involved. It analyses key case laws, such as *PTC India Financial Services Limited v. Venkateswarlu Kari*¹ and *World Crest Advisors LLP v. Catalyst Trusteeship Ltd & Ors*², shaping the understanding of share-based collateral. The goal is to provide a comprehensive overview of lenders' voting rights on pledged shares and the balance with borrowers' ownership rights.

2. STATUTES AND RULES GOVERNING THE PAWNEE CONCERNING SHARE COLLATERAL

We have mentioned hereinbelow some of the key laws governing the subject matter:

- The Indian Contract Act, 1872;
- The Companies Act, 2013;
- The Depositories Act, 1996; and
- The Securities and Exchange Board of India (Depositors and Participants) Regulations, 1996.

3. RIGHTS OF PAWNEE: VOTING RIGHTS

The right to vote is a fundamental entitlement granted to the shareholders of a company. This right allows shareholders to participate in decision-making processes related to the company's governance and major corporate actions. Furthermore, The Supreme Court of India, in the case of *Vodafone International Holding BV v. Union of India and Anr.*³, established that the right to vote is inseparable from shares. However, voting agreements, including the contested pledge deeds if any, are deemed valid and enforceable, and they do not constitute a detachment of voting rights from the shares.

The pivotal inquiry concerning voting rights emerges in instances where a share is utilized as collateral for a loan or has been pledged. The question at hand pertains to the person authorized to exercise voting rights in connection with the pledged shares—whether it is the pawnee or the original shareholder.

The Depositories Act and the Indian Contract Act lay down the provisions governing the rights of the pawnee post the invocation of the pledge but it is silent on the use of pledged goods by a pawnee, post the invocation of the

¹ Civil Appeal No. 5443 of 2019.

² Interim Application (L) No. 29574 of 2021 in Commercial Suit No. 189 of 2022 (Neutral Citation No. 2023:BHC-OS:9392).

³ 6 (2012) 6 SCC 613.

pledge, but prior to sale (including by way of exercising voting rights over the pledged shares). In other words, the law is silent on voting right of the pawnee with respect to the share hold by it/him as securities.

The Supreme Court of India, in its decision on May 12, 2022, in the case of *PTC India Financial Services Limited v. Venkateswarlu Kari and Anr*, clarified the issue regarding the creation and enforcement of pledges over dematerialized securities⁴. The court determined that although a pledgee must register as a beneficial owner⁵ of the pledged shares after invoking the pledge, they do not have the right to appropriate these shares. Instead, the pledgee must sell the shares to a third party. This ruling led to questions about the rights of a pledgee during the interim period between the invocation of the pledge and the sale of the shares, particularly whether the pledgee can exercise voting rights or other rights typically held by a beneficial owner.

The Bombay High Court addressed these questions in *World Crest Advisors LLP v. Catalyst Trusteeship Limited and Ors*. The court decided on June 23, 2022, that if the pledge agreement grants the pledgee the right to exercise voting rights and appoint a nominee after invoking the pledge, then the pledgee is entitled to those rights. This decision indicates that the Supreme Court's judgment does not diminish such rights.

In this case, World Crest Advisors LLP sought an ad-interim injunction to prevent Catalyst Trusteeship Limited from exercising voting rights in Dish TV India Limited's extraordinary general meeting after the pledge was invoked. World Crest and Dish TV argued that following the Supreme Court's judgment, a pledgee is only a beneficial owner for the limited purpose of holding the shares safely until they are sold or redeemed. They contended that the pledgee does not acquire general property rights in the shares, which would include voting rights.

The Bombay High Court's ruling clarifies that the pawnee's rights, as specified in the pledge agreement, remain intact, including the right to exercise voting rights if expressly provided for in the agreement. This interpretation ensures that the pawnee's rights are protected and that the contractual terms of the pledge agreement are upheld.

The Bombay High Court was not convinced by the arguments presented by World Crest and Dish TV. On the contrary, the court agreed with Yes Bank Limited's (YBL) argument that, according to the Companies Act, 2013 and the Depositories Act, 1996, the right to vote at any general meeting is exclusively granted to the beneficial owner, who is also considered a member of the company. The court emphasized that the PTC Judgment does not create a separate category of members with limited rights simply because they are pawnees.

⁴ Dematerialization is the process of converting your physical shares and securities into digital or electronic form. The basic agenda is to smoothen the process of buying, selling, transferring and holding shares and also about making it cost-effective and foolproof.

⁵ By virtue of the provisions laid down in Section 2 (55) and 2 (95) of the Companies Act, 2013 and Section 2 (1)(a) of the Depositories Act, 1996, a pawnee must be accorded the status of "beneficial owner" for the pledgee to exercise. Wherein the term "beneficial owner" pertains to a person whose name is recorded as such with a depository It also means any individual or group of individuals who, either directly or indirectly, has the power to vote or influence the transaction decisions regarding a specific security, such as shares in a company.

Additionally, the court examined Clauses 2.1 and 10.3 of the pledge agreement in question, which granted Catalyst the right to exercise voting rights and appoint a nominee for such purposes. After reviewing these clauses, the court decided not to prevent YBL (as Catalyst's nominee and effectively the beneficial owner of the pledged shares) from exercising voting rights at Dish TV India Limited's annual general meeting. The court concluded that YBL, as the beneficial owner of the pledged shares, is entitled to all associated rights, including voting rights, as per Regulation 58(8) of the SEBI (Depositories and Participants) Regulations, 1996.

In the PTC Financial case, the Supreme Court emphasized that a pawnee's rights over pledged goods are limited to "special property," while the Bombay High Court's decision in the World Crest case sheds light on the extent of these rights. The High Court's ruling suggests that barring any explicit legal or contractual limitations, the pawnee's "special property" includes a full range of rights concerning the shares, limited only by the pawnor's right to redeem the pledge and the pawnee's duty to adhere to legal requirements for selling the pledged shares, such as providing reasonable notice of sale and avoiding self-dealing.

The decision also encourages lenders to include explicit clauses in pledge agreements that allow them to exercise voting rights, particularly after a default event, which is a standard practice in the industry. Furthermore, the exercise of voting rights by the pawnee as the registered beneficial owner is consistent with the Companies Act, 2013, and SEBI regulations. When a company calls a shareholder meeting, the records will typically show the pawnee as the beneficial owner entitled to vote, without distinguishing between a beneficial owner due to a transfer and a beneficial owner due to a pledge, unless there is a specific regulatory, statutory, or judicial directive to the contrary.

4. LexSpectrum's View

The right of the pawnee to exercise voting rights over pledged shares is only acknowledged upon the formal invocation of the pledge agreement. According to the Indian Contract Act, 1872, the pawnee is permitted to retain the pledged security until settling the debt, interest, and related expenses, without being granted additional rights. Any provision in the pledge agreement granting voting rights before invocation would surpass the pawnee's statutory entitlements. Section 47 of the Companies Act, 2013, exclusively reserves voting rights for shareholders registered in the company's Register of Members, making any clause granting voting rights to the pawnee before pledge invocation inconsistent with statutory provisions.

The Bombay High Court's judgment in the World-Crest case confirms that the market practice of granting the pawnee the authority to attend and vote at general meetings post-pledge invocation remains lawful and enforceable. The court clarified that, despite the Supreme Court's requirement for the sale of pledged shares to third parties, the pawnee retains the right, under Section 10(3) of the Depositories Act, 1996, and pledge agreements, to exercise all rights related to the pledged shares. This includes the right to vote between the time the pawnee is recorded as the beneficial owner and when the shares are sold to third parties. Additionally, the court noted that after invoking the pledge, the pawnee is not obligated to immediately sell the security; it can

choose to sell it or initiate legal proceedings for dues recovery. This judgment provides crucial clarity on the rights of the pawnee.

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