VI. SHARE PLEDGING: EXAMINING THE POSITION OF SECURED CREDITORS UNDER THE IBC AND THE VALIDITY OF NON-DISPOSAL UNDERTAKINGS

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ABSTRACT

Share pledging is a method used by the promoters to secure loans, wherein shares are used as collateral and pledged with banks and Non-Banking Financial Companies. In the event of default by the promoters to repay the borrowed amount, such institutes may invoke the pledge and sell these shares. The paper is divided into 2 parts concerning share pledging. Part 1 deals with a general discussion on the position of secured creditors under Insolvency and Bankruptcy Code 2016 ("IBC"). It attempts to identify the extent of eligibility of a pledge-holder to fall under a particular class of creditors, under the application of the Insolvency and Bankruptcy Code, 2016. Furthermore, this part deals with existing studies on this subject and suggests changes that may be brought in to deal with the identified loopholes. Part 2 analyses the newly held position of pledge-holders as secured creditors and their chances to realise their securities through IBC. It examines the implications and the legal validity of restrictions on share pledging through Non-Disposal Undertakings ("NDUs"), in light of the concept of not transferring the beneficial ownership to the lender, being contrary to the Articles of Association ("AoA") of a Company. It further analyses the consequences of such invalidity on the promoters and the company, and on secured creditors qua IBC and general suits.

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I. INTRODUCTION

A. Concept Of Share Pledging

Pledging of goods as a concept essentially emanates as an arrangement under the Indian Contract Act, 1872, appertaining to a form of securing financing[1] by way of securitization of the transaction. The Indian Contracts Act, 1872 defines pledge as, "the bailment of goods as security for payment of a debt or performance of a promise,"[2] entailing a special kind of bailment that enables the pawnor/pledgor (bailor) to obtain a credit facility while furnishing collateral for obtaining a loan from the pawnee/pledgee (bailee). Share pledging also works to that effect.

Such an arrangement generally takes place when a person who holds shares in a company pledges the same with a lender and secures a loan. Share pledging is one of the alternatives used by company promoters to secure loans to satisfy the requirements of working capital, personal needs and finance other projects or investments.[3] A promoter's shareholding in a

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[1] Kai-hong Patrick Yung, *Pledge by Constructive Delivery in Hong Kong*, 24 ICCLR 273.
[2] Indian Contract Act, 1872, § 172.
[3] *Definition of Share Pledge,* THE ECONOMIC TIMES, https://economictimes.indiatimes.com/definition/share pledge#:~:text=Definition%3A%20Pledging%20of%20shares%20is,fund%20other%20vent

firm is often used to secure a loan as collateral. Promoters maintain their ownership while pledging shares. Loan to value (**"LTV"**) ratio of 50 per cent is to be sustained at all times while lending based on the stock pledge, as per the RBI regulations.[4] For instance, for a planned loan sum of around 100 crores, the promoters would have to commit at least 200 crores worth of shares with the bank.

B. Invocation Of Pledged Shares

The market value of the shares tends to fluctuate and thus if the market value of those pledged shares decreases below the minimum collateral value as agreed in the Share Pledge Agreement, additional collateral, cash or more shares will have to be given by the pledgor. In the event of non-compliance, however, the bank could be forced to invoke the pledged shares.

If the market value of these securities falls below the amount decided by the lenders and the promoters in the Share Pledge Agreement, the lenders are entitled to sell the shares pledged if the company's promoters do not obtain sufficient collateral within a specified period. This method of selling the lenders' pledged securities is known as the invocation of pledged shares.

In the case of *Hulas Kunwar v. Allahabad Bank Ltd.*,[5] a Division Bench of the Calcutta High Court noted that the Bank is within its right to sell the shares at any point in the future after giving the Pledger sufficient

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ures%20or%20acquisitions.&text=In%20case%20promoters%20fail%20to,market%20to%20recover%20the%20money.

[4] Reserve Bank of India, *NBFCs- Lending against Shares – Clarification*, DNBR (PD).CC.No.028/03.10.001/2014-15 (April 10, 2015)

[5] Hulas Kunwar v. Allahabad Bank Ltd, [1958] MANU WB 0159.

notice. In the instant case, the Bank was within its rights to sell the shares "as and when opportunities are presented", which essentially meant- as and when the most desirable business conditions present themselves.

However, akin to the rights assigned to a pledge-owner, wherein the goods may be sold by said pledge-holder upon default of the loan, the sale of pledged shares also becomes impending upon default of repayment on the part of the debtor. When the lenders invoke the pledged shares, it is not a favourable outcome for the company. Consequences, inter-alia, may include shifting in the established shareholding structure of the firm, reduction in promoter's shareholding, promoter's authority over the company might reduce or valuation of the shares could also plummet.

Under Insolvency and Bankruptcy Code 2016 (**"IBC"**), a "secured creditor" is defined as "a creditor in favour of whom security interest is created". As explained above, the promoters may also pledge their shares as a security to obtain loans from banks and financial institutions, which would make such lenders fall under the definition of secured creditors. Additionally, the promoters may also enter into a Non-Disposal Undertaking (**"NDU"**) which would restrict the lender (banks and financial institutions) to invoke pledge at the time of default. In an attempt to discuss the position of secured creditors, according to the statute as well as contractually, having security interest on shares of promoters, the paper is divided into 2 parts, concerning the pledging of shares and secured creditors- *firstly*, with respect to a general discussion of the shaken position under IBC post the recent judgement of *Phoenix ARC (P.) Ltd. v. Ketulbhai Ramubhai Patel*[6], and *secondly*, taking a specific case of NDUs, and to deliberate upon the impact of NDUs on secured creditors and the problems it poses for the secured creditors to claim its interest, especially banks and financial institutions on the occasion of them being valid as well as invalid. This allows the reader to deliberate upon the concept of share pledging and secured creditors, and the nature of rights, both restrictive and positive, that become assigned/transferred to the pledge-holder upon such invocation.

Part 1 of the paper deals with the scope of the qualification of a pledge-holder, as under the specific class of creditors as the person may qualify to fall, under the application of the Insolvency and Bankruptcy Code, 2016. Furthermore, the part deals with existing literature on the subject and proposes amendments that may be brought in to deal with the identified lacunas.

Part 2 of the paper analyses the particular case of secured creditors, having a security interest over the shares and have a Non-Disposal Undertaking drawn against it. It examines the validity of Non-Disposal Undertakings with respect to restriction on transferring of beneficial ownership under the same, when signed with existing shareholders at the time of pledging, when such restriction tends to go contrary to the Articles of Association of the company. The discussion is carried forward with recognizing the issues for such secured creditors, in the event the NDU is valid and the CIRP is initiated against the borrowers. It further examines the consequences of such invalidity on the company and the promoters.

[6] Phoenix ARC (P.) Ltd. v. KetulbhaiRamubhai Patel [2021] 124 taxmann.com 90 (SC).

PART 1

II. SHARE PLEDGING AND INSOLVENCY

Having established the groundwork for what constitutes a share-pledging arrangement, we shall now consider its effect with regards to the authority of the pledge holder as being part of a certain class of creditors in an event of insolvency, wherein the pledge agreement forms a part of the claims of another such creditor, and in particular, the regime under the Insolvency and Bankruptcy Code, 2016.

One of the most pressing concerns under the umbrella of share-pledging, is the promoters pledging a hefty amount of their shares, and then defaulting on the subsequent repayments, essentially encumbering the security in question. This could result in a possible fluctuation of huge amounts in the share prices of the entity against whom the pledge has been made. Such fluctuations could eventually result in the amounts of the shares being held by the pledge-holder being open to dispute should events like CIRP be initiated. Resultantly, the disputes arising out of the contested values could lead to the estate of the Corporate Debtor/Pledgor being wrongly valued.

Essentially, a pledge holder under a pledge-agreement, assumes the authority of a secured creditor holding subsequent assignment and selling-off rights pertaining to the shares in question. Regulation 58[7] of SEBI (Depositories & Participants) Regulation, 1996, defines the process for the pledge of shares by a beneficial owner and the procedures thereto. More often than not, such pledge holders are banking institutions acting as secured creditors,[8] limited by the application of the Banking Regulation Act, 1949,[9] these institutions generally make it a priority to accept such pledge of shares that carry hefty controlling share.[10]

A. Triggering The Insolvency And Bankruptcy Code, 2016

The Insolvency and Bankruptcy Code, 2016 (**"the Code"**) allows for the restructuring and insolvency resolution of stressed entities in a 'creditor-in-control' manner promoting a maximisation of asset value, recovery of creditor's interests and revival of the corporate entity. Under the scheme of the Code, the triggering of insolvency of the entity can be done by creditors that conform to the definitions of Operational Creditors,[11] i.e., creditors to the effect of having a claim with respect to provision of goods or services, including employment or statutory dues, or Financial Creditors,[12] i.e., creditors owning debt to the effect of time value of money or having a commercial effect of money. Moreover, the Code even provides for the company itself, or the Corporate Debtor,[13] to initiate the Corporate Insolvency Resolution Process (**"CIRP"**).

The process under the Code entails that the resolution of insolvency shall be carried out by a Resolution Professional who shall collate the claims of the other miscellaneous creditors in order to form an information memorandum, containing all the prospective details of the entity in question.

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[7] SEBI (Depositories and Participants) Regulations 1996, Reg 58.
[8] Securities and Exchange Board India, Recording of Non Disposal Undertaking (NDU) in the Depository System, CIR/MRD/DP/ 56 /2017 (June 14, 2017).
[9] The Banking Regulation Act 1949, § 19(2).
[10] Vikas Gupta, *All About Pledging of Shares,* TAXGURU (May 26, 2016) https://taxguru.in/sebi/pledging-shares.html
[11] Insolvency and Bankruptcy Code 2016, §9 [hereinafter, IBC] .

B. Analysis

The recently evolved position of law, emerging in the case of *Phoenix ARC (P.) Ltd. v. Ketulbhai Ramubhai Patel,*[14] (**"Phoenix case"**), delineates the rights of a share-pledge holder as being similar to a secured creditor's; but not to the extent of a financial creditor's, so as to be able to push the organisation in question into insolvency. The case involved the shares of Gondwana Engineering Ltd. (subsidiary company) being pledged by Doshion Veolia Water Solutions Pvt. Ltd. (promoter/borrower company) in furtherance of securing a credit facility from L&T Infrastructure Ltd. (lender company). Subsequently, the pledge was assigned to Phoenix ARC by the lender company, which led to Bank of Baroda filing a section 7 petition in NCLT Mumbai, upon the default on the part of the borrower company, resulting which, the hereinabove mentioned CIRP was initiated.

The appellant alleged the nature of the contract as being similar to that of a guarantee, as the liability of the corporate debtor would be co-extensive to that of the parent company of the Corporate Debtor. However, the particular arrangement in question did not contain any provisions for providing for 'time value of money' as under the definition of *'financial debt,'*[15]*,* which essentially means a debt extended along with interest for the time value of the money or must have a commercial effect of a borrowing.

[12] Insolvency and Bankruptcy Code 2016, §7

[13] Insolvency and Bankruptcy Code 2016, §10

[14] Phoenix ARC (P.) Ltd. v. Ketulbhai Ramubhai Patel [2021] 124 taxmann.com 90 (SC).

[15] Insolvency and Bankruptcy Code 2016, §5(8)

C. The Judicial Pronouncements Governing Nature of Creditors

In the above case, the Supreme Court pointed out that the nature of the credit facility advanced was of a secured debt and not a financial debt, whereby, the rights of the pledge-holder were of a secured creditor's, within the meaning of the Code, and not of a financial creditor.

This rationale was also adopted by the Apex Court in *Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited,*[16] wherein the Supreme Court has opined that even if a creditor holds a security interest in the collateral advanced by the Corporate Debtor, at best, the creditor in question shall be considered a secured creditor *qua* the corporate debtor and not a financial creditor, as section 5(8) of the Code.

In a subsequent case, *SREI Infrastructure Ltd. v. Amrit Jal Ventures Pvt. Ltd.*,[17] NCLT Hyderabad considered and deliberated on a case where the creditor had invoked the pledge of shares, becoming a shareholder to the extent of their holding, i.e. approximately 44%, which could only mean that the debt in question did not become payable, as the invocation of the same had resulted in the pledge holder having become a shareholder to that effect.

Here, the consideration rests upon the fact that when a credit facility arrangement is entered into in the form of a share-pledging agreement, then any disbursal of such credit, if bereft of a repayment structure, and should it be invoked in furtherance of recovery, would render the pledge holder in question, merely as a secured creditor or a shareholder. However, the

[16] Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited [2020] 8 SCC 401.
[17] [2019] 104 taxmann.com 273.

question is that if there is an adequate structure for repayment of such loan which subsequently qualifies to become a financial debt due and payable in law, would the same entitle the pledge-holder in question to assume rights concordant to a financial creditor's.

The lacuna around such consideration needs to be expounded upon and in the absence of one, the rational individual assumes that the nature of the credit facility be taken at face value and ipso facto, the position of the creditor herein should be tantamount to that of a pledgee; however, the same requires to be expounded upon.

Eligibility of any creditor, i.e., whether such creditor is allowed to be a part of the CoC in the insolvency resolution process of the corporate entity, and the rights thereto of the creditor qua the security in question are of utmost relevance to such creditor. Especially when the security in question could be the difference between such creditor having voting rights allotted to such rights, return from such security, and dissolution of control from such rights, however, the area remains ever so dimly explored. Such mechanism should serve to identify the extent of liability and rights assigned to the parties to an NDU backed pledge of shares. A step in the right direction has already been taken by the SEBI having deliberated a mechanism for the recording of NDU-backed share pledges by a depository.[18]

D. Future Prospects

Concerning IBC and share pledging, a novel consideration rests upon the notification of such pledge being invoked, and whether or not such notice

[18] Securities and Exchange Board India, Recording of Non Disposal Undertaking (NDU) in the Depository System, CIR/MRD/DP/ 56 /2017 (June 14, 2017).

is to be rendered serviceable to the debtor under the scheme of the Code. The Indian Contract Act, 1872 governs a contract of pledging goods, and its subsequent sale, by envisaging provisions for: a) the delivery of such physical goods over de facto possession; and b) a notice of such sale, so as to provide the debtor with adequate chance to reclaim the goods.[19]

However, since shares pledged in a physical matter differ significantly from dematerialised securities, section 176 of the Indian Contracts Act, cannot be said to have force over such transactions. The Bombay High Court has also opined upon the same, in *Pushpanjali Tie Up Pvt. Ltd v. RenudeviChoudhary,*[20] in favour of the aforementioned rationale.

While deliberating a similar question in *Central Bank of India v. Sri Adhikari Brothers Television Network,*[21] the NCLT Mumbai has definitively laid down that should there be no inordinate delays in selling such shares, and should they be in a dematerialised form, no notice for the sale of such shares is necessary to be provided for the same to the debtor. Essentially, a no-notice sale of the pledged shares would render the debtor with no alternative to reclaim the said securities, provided that they must be first allowed to have reclaimed them through a notice of delays in repayment. However, it is also pertinent to consider that the legislations governing the pledging of both physical and dematerialised shares do not envisage clear definitions and differences between 'invocation' and 'sale' of such shares and thus, through judicial interpretation, these terms have been defined. Where invocation of the shares would mean the shares becoming the

[19] Indian Contract Act, 1872, §176.
[20] Pushpanjali Tie Up Pvt. Ltd v. RenudeviChoudhary [2015] AIRBom 1.
[21] Central Bank of India v. Sri Adhikari Brothers Televsion Network [2020] 114 taxmann.com 465.

property of the pledge holder, a sale to that effect would entail an arrangement made for the adjustment for the amount of money, should there not be an agreement between the pledgee and the pledger to the contrary.

Moreover, the sale of such shares in a severely adverse situation, wherein the security in question has fallen in value so despicably as to cripple the debtor, has also been considered in *Rural Fairprice Wholesale Limited & Anr. v. IDBI Trusteeship Services Limited & Ors,*[22] wherein the Bombay High Court has stayed the sale of pledged shares, whose value had fallen to almost a fourth of its original value, in furtherance of securing the debtors' interests as well, since the capital markets had been affected quite adversely due to the pandemic.

PART 2

III. ARE NON-DISPOSAL UNDERTAKINGS ON PLEDGING VALID?

A. Non-Disposal Undertakings and The Secured Creditors

The Phoenix case has laid down that whenever the shares are pledged with the banks and other financial institutions for raising a loan, such shares act as a security interest in favour of the banks, making them secured creditors.[23] While pledging, promoters often sign a Non-Disposal Undertaking ("**NDU**") with the lender. NDUs are undertakings given by a shareholder to another person (lender/creditor), undertaking not to transfer or

[22] Rural Fairprice Wholesale Limited & Anr. vs. IDBI Trusteeship Services Limited &Ors [2020] MANU MH 0524.
[23] Phoenix ARC (P.) Ltd. v. Ketulbhai Ramubhai Patel [2021] 124 taxmann.com 90 (SC).

otherwise alienate the securities held by such shareholder in a company.[24] Importantly, the beneficial ownership on the shares, doesn't change and remains with the promoter, and at the same time the new entity (the lender) can't dispose-off (sell) the shares.[25] NDUs are not any statute-provided agreements; rather, it is a leeway recognised by the lawyers, advising their clients to enter into such contracts.[26] Being a contract, its legal validity cannot be questioned upon in general, but questions arise when NDUs are signed by an existing shareholder.

In the context of IBC, this would mean that being secured creditors, pledge-holders may take the recourse of realising their securities under IBC, but with an NDU in-effect simultaneously, there may be an issue with respect to beneficial ownership of the shares. This part analyses the specific case of NDUs in share-pledging, and how its existence and non-existence affects the rights of the secured creditors under IBC.

B. Are NDUs Valid?

The preliminary question of validity of NDUs is important as NDUs essentially restrict the transfer of beneficial ownership on shares. Thus, the answer to this will either provides a leeway to secured creditors, or will have them face uncertainties and issues with respect to claiming their security interest. Both of the situations have been discussed in the third section of this Part.

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[24] Securities and Exchange Board India, Recording of Non Disposal Undertaking (NDU) in the Depository System, CIR/MRD/DP/ 56 /2017 (June 14, 2017).
[25] *SEBI Plugs Loopholes In Share-Pledging Disclosures*, BUSINESS STANDARD (November 23, 2013) https://www.business-standard.com/article/markets/sebi-plugs-loopholes-in-share-pledging-disclosures-113112300537_1.html
[26] *Id.*

As discussed, NDUs are not any statute-provided agreements; rather, a private agreement. It is a well-established principle that shareholders of a company will not be bound by any restrictions imposed contrary to the Articles of Associations ("**AOA/articles**"),[27] which means that restrictions, if any, have to be in consonance with the AOA to be legally valid.

Considering a situation where a bank is an existing shareholder in a company, and the promoter of the company pledges its shares with the same bank. However, the promoter decides to pledge its shares after entering into an NDU. Resultantly, the NDU would restrict the transfer of 'beneficial ownership' of those shares to the bank, and the same would lie with the promoters. On the other hand, the AOA of that company mandates the transfer of beneficial ownership at the time of transfer of shares. The question arises that if any private agreement being contrary to the AOA is invalid, can NDUs be held valid if the same is drawn against existing shareholders, when AOA mandates transfer of beneficial ownership?

Section 44 of the Companies Act 2013 ("**the Act**") talking about the nature of shares or debentures, holds that "the shares or debentures or other interest of any member in a company shall be movable property transferable in the manner provided by the articles of the company".[28] These provisions of the Act make it clear that the AOA are the rules of the corporation binding on the company and shareholders, and that the shares are a movable property and their transfer is governed by the Articles of the company. The position is also maintained in *V.B. Rangaraj v. V.B. Gopalakrishnan and Ors*, (**"V.B.**

[27] V.B. Rangaraj v. V.B. Gopalakrishnan and Ors (1992) MANU SC 0076. [hereinafter, "V.B. Rangaraj case"]; Vodafone International Holdings BV v. Union of India, (2012)6 SCC 613

[28] Companies Act, 2013, §44.

Rangaraj") where on the question of whether shareholders can enter into an agreement among themselves, terms of which are contrary to the AOA of the company, it was held that the shareholders and the company will not be bound by any such restrictions imposed contrary to the Articles of Associations.[29] While the 2012 case of *Vodafone International Holdings BV v. Union of India* (**"Vodafone case"**) partially overrules V.B. Rangaraj on the issue of AOA being silent on any restriction, it upholds the position that the terms of the private agreement between shareholders must not be *contrary* to the Articles.[30] This gives into effect that if a private contract incorporates restriction contrary to the provisions of the AOA , then the same would not be binding on the shareholders being a party to any such restriction.

Applying it to the present case, in case there exists a provision in AOA which provides for beneficial ownership to be transferred with the transfer of shares, then the existence of NDU (which restricts transferring of beneficial ownership with shares) would be invalidated on account of going against the articles of the company. Thus, the lender, on default by the promoter, would not be constrained to not invoke pledge and sell the shares in the open market. Hence, the provision of transfer of beneficial ownership being a restriction, has to be in line with the provisions of the AOA if at all the NDUs have to be used while pledging shares with a shareholder of the same company.

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[29] V.B. Rangaraj case.

[30] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC.

C. Effect of Invalidity of NDU on the Promoters, The Company And The Secured Creditors

1. The Promoters And The Company

Pledging of shares in a down market may become problematic because the falling share value lowers the collateral value, forcing the lenders to either claim additional margins or invoke the pledge and sell the shares in the open market to cover their interests.[31] Both these activities may hurt asset markets, reducing investors' savings.[32] In either options, there exists a risk of losing the management control and voting power of the company to lending banks and routine investors, which are essentially the secured creditors.[33] For instance, if out of its 52% stake, a promoter pledges 20% and the lender decided to invoke the pledge, then the promoter will be left with only 32% shares and will lose control over the company. At the same time, the company will be risked at a position of loose decision-making as Section 59(3) of the Act would entitle such pledge-holders to voting rights.[34]

If the shares are sold in the open market, the investor may take up the path of creeping acquisition and acquire additional 5% shares. This will make the secured creditor a holder of 25% stake in the company allowing them to initiate a takeover of the company by making a mandatory open

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[31] AmanAsija&Vijaya B. Marisetty, *Do Insider Who Pledge Their Shares Manipulate Report Earnings?,* 10 (Working Paper for NSE-NYU Stern School of Business Initiative for the Study of the Indian Capital Markets).

[32] *SEBI Issues New Mandate For Pledged Shares*, BUSINESS TODAY (June 28, 2019) https://www.businesstoday.in/current/policy/what-is-sebi-new-mandate-for-pledged-shares/story/359725.html

[33] Guntur A. Raju & KanakSapra, *Convenience to Curse: Pledging of Promoter Shareholding in India Under Scanner,* 12 J. WEALTH MGT SPR'G 12, 2010.

offer under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.[35]

Furthermore, concerns for the promoters and the company would also arise when the scenario is connected with the 2015 RBI Rules on Strategic Corporate Debt Restructuring. Under the scheme, a bank can convert the debt it had provided to the company into equity shares, subject to Regulation 19(2) of Banking Regulations Act 1949, if the company distresses and defaults in payment. Such banks can form a Joint Lending Forum (**"JLF"**), and if together they reach a threshold of 51% equity shares, the JLF can acquire the company and change the management.[36] Interestingly, while calculating the equity stake of a bank in the company, the shares pledged by its promoters with the bank will also be taken into account.[37]

Considering a situation where the bank in question, A, has dual holdings in a company and it is an existing shareholder of company B with 10% stake, as well as a creditor providing debt. The promoter of company B decides to pledge its 10% shares with bank A after signing an NDU. The invalidity of NDU due to such relationship being contrary to provisions expressly written in the Articles would mean that now the bank (that is, the secured creditor) has the power to treat such shares as normally pledged shares and may invoke pledge. Removing the bar of invocation on such shares would mean that the 10% pledged shares could now be clubbed up with the existing 10% shares and debt to make up to 30% holding of the

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[34] Companies Act, 2013, § 59(3).
[35] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, §6
[36] Reserve Bank of India, *Strategic Debt Restructuring Scheme*, DBR.BP.BC.No.101/21.04.132/2014-15 (June 8, 2015).
[37] Id.

bank. To sum up, such pledges based on NDUs would contribute to soon reaching the threshold of 51% equity of the defaulting company, resulting in fast managerial alteration.

To avoid such situations, prudent action on the part of promoters would be to make cautious financial decisions and investment, after calculating the percentage of already-held stakes of the creditor in the company and the percentage of shares intended to be pledged.

2. Secured Creditors

If the NDUs are valid, then as per the discussion of Part 1, due to recent judicial pronouncements, many secured creditors will not be categorized as financial creditors, and may not be able to participate in COC.[38] Now, at the time of concluding a pledge agreement, along with an NDU, the intention of the parties of retaining the beneficial interest with the borrower is restricted to the point the borrower-promoter does not make a default. Following a general understanding, at the time of default, the NDU will cease to exist and the beneficial interest of those shares would directly be transferred to the concerned lender. Thus, if the NDUs are valid, then pledge may be invoked by the lender without difficulty. The dilemma arises when the CIRP process against the borrower has been initiated by other creditors, and the claims are to be filed with the Resolution Professional.

At this point, while the pledge agreement permits transferring of beneficial interest on shares to the lender only on account of “default”, there may not have happened a default of repayment with respect to the concerned creditor-bank. Thus, since the beneficial interest on shares would not lie with the concerned secured creditor, they may neither be able to file any claim under CIRP Process, nor realise their securities as per IBC.

Section 56(1) of the Act states that "A company shall not register a transfer of securities of the company, …, other than the transfer between persons both of whose names are entered as holders of beneficial interest in the records of a depository".[39] As discussed, conceptually, NDUs restrict transfer of beneficial ownership with transfer of shares to the lender. In other words, no beneficial interest has been drawn in favour of the lender, which means that the company will not recognize the bank's right on the particular securities, and may refuse to register the same. However, the SEBI seemed to have come to the rescue of such lenders and permitted "the depositories to offer a system for capturing and recording the NDUs" in 2017 through a notification.[40]

Notably, the notification does not mandate the depositories to record NDU transactions, but only *offer* the same. This means that the decision to have the NDU recorded or not lies with the parties to the NDU. Since recording of this private agreement excludes any possibility of deception on account of beneficial ownership conundrum, the lenders would be more interested in the same than the borrowers. However, there might be chances that the parties do not avail the facility of recording with the depository.

In such cases, alternative may be found in the second part of Section 56(1) itself which says, "unless a proper instrument of transfer… executed

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[38] Phoenix ARC (P.)Ltd. v. KetulbhaiRamubhai Patel [2021] 124 taxmann.com 90 (SC).
[39] Companies Act, 2013, §56(1).
[40] Securities and Exchange Board India, *Recording of Non-Disposal Undertaking (NDU) in the Depository System*, CIR/MRD/DP/ 56 /2017 (June 14, 2017).

by or on behalf of the transferor and the transferee … has been delivered to the company by the transferor or the transferee within a period of sixty days from the date of execution,...".[41] Thus, if the parties to the NDU execute a form in accordance with this part, the lender bank may be able to invoke pledge, defying the issue of not having beneficial ownership. However, the borrower may again follow deceptive practices, and may not execute this form. To avoid this situation, the lending bank must obligate the borrower-promoter in their pledge agreement to execute such a form.

The lending-bank still may face closed doors with respect to their security interest, in such situations, they may approach the Debt Recovery Tribunal to claim their security as a secured creditor under Section 13 of the Securitisation And Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (**"SARFAESI Act"**), which lays down the procedure for enforcement of securities.[42] The procedure under Section 13 requires serving a notice to discharge in full his liabilities. Requirement of such notices may prove to be detrimental for lending-banks as they might choose this recourse after following the above alternatives. As discussed in Part 1, serving and waiting for reply of such notices, may result in depreciation of the value of shares by the time they could be claimed.

On the other hand, the invalidity of NDUs seem much in favour of the secured creditors as they will not be bound by any restriction as NDU, and may invoke pledge conveniently. The lending banks may form the JLF, and follow the recourse as mentioned above to take over the management of

[41] Companies Act, 2013, §56(1).

[42] Securitisation And Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, §13.

the borrower's company. However, as identified in Part 1, even if the concerned pledged shares carry substantial voting rights, the secured creditor would still not be able to participate in COC, due to it not being a financial creditor.

As the validity or invalidity of an NDU is not an issue sub-judice before any Court of law, it may seem rational to insert a provision in the NDU discussing the aftermaths in the event such NDU has been declared invalid. Undoubtedly, the first of them must be to transfer beneficial interest of the shares to the lender. This will not only enable them to take the Section 56(1) of the Act recourse, but also allow them to realise their securities as per IBC without any issue.

IV. CONCLUSION

The gap in such judicial interpretation exists in a plethora of avenues, a) several of the aforesaid matters have not been yet ruled on by the Supreme Court and thus, may be open for appeal, b) the service of notice to the debtor doesn't have to be provided only in case of dematerialised shares, as they are not governed by the Indian Contracts Act, 1872, but the SEBI Depositories and Participants Regulations, 2020, c) no consolidated law exists for overseeing the classification of creditors that hold such security pledges and lastly, d) a consolidated procedure for recovery and regulation of share-pledges both in the pre and post-invocation stage. The same may be corrected by according a higher interpretative authorisation to the Adjudicating Authority, when/if faced with such dilemmas, wherein the business decisions of the CoC amid-CIRP are affected by the categorisation of such creditors in a manner that facilitates resolution and does not materially challenge their superintendence over the same.

Such legislative/judicial lacunas need to be provided for, either in the above-mentioned manner, or in the superlative wisdom of the herein mentioned authorities, at the earliest so as to not render the mechanism of invocation of share-pledges defunct and otiose, and in order to provide a streamlined approach towards enforcement or relinquishment of such security interests.

Expounding upon the aforementioned points, the need for a resolution-led approach is a must, considering that the ambiguities that persist in the current share-pledging regulations are to be stopped from running rampant. Moreover, due consideration should also be paid to the inaccuracies of the nature of the notice that is to be provided before the sale of the securities should also be given special cognisance since the quantum of the shares and their value determines the holding and controlling rights tied to it.

In summation, the glaring gaps that exist between the congregations of laws involved in pledging of shares must be considered in a manner that allows both the pledgee and the pledger to exercise their rights and obligations in a well-defined and regulated manner and not in a superficial manner governed by purely judicial intent. This would further allow for a gateway to be opened for prospective developments vis-a-vis similarly complex arrangements, i.e., assignment of rights with regards to a third party, etc.

On the other hand, by categorising the pledge-holders as secured creditors, the Phoenix case has definitely provided them with a recourse to claim their interest under a CIRP or liquidation process under IBC, apart from approaching Courts and Tribunals under SARFAESI and other civil laws. However, the practice of concluding an NDU would restrict their option under IBC due to the issue of beneficial ownership.

However, shares being freely alienable property, its transfer cannot be restricted by an outside agreement between shareholders unless there is an explicit bar under the Article of Associations. In accordance with precedents like Vodafone case, the NDUs drawn against existing shareholders, being an outside agreement, should be held as invalid if the specific restriction of transfer of beneficial ownership along with shares is contrary to the AOA. This particular analysis may provide relief to these secured creditors as, if the NDU is invalidated, this means that there is no restriction on transfer of beneficial ownership to the creditor, thus the creditor may invoke pledge easily.

If NDUs are invalidated, it would have an adverse effect on the promoter and the company. Without NDUs, the secured creditors being the lending banks can invoke pledge and sell the shares in the open market, threatening voting power and management of the company. There would be a huge gap in the system and encumbrances would be required to be converted into normally pledges shares from NDU encumbrance. To overcome this, appropriate authority would need to be informed under SEBI (LODR) 2015 which would involve a heavy workload and requires more vigilance on the part of SEBI.

Further, in a case when the lending bank has dual-shareholdings in a company, on a default by the promoter, banks can form a JLF and such restricted pledged shares could help JLF touch the cap of 51% of the company faster, throwing out the existing management. This could be controlled by simply capping the limit of JLF to acquire less than 49% shares.