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INVOCATION OF THE PLEDGE BY CREDITORS - A DEEP DIVE ANALYSIS

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The Supreme Court has recently answered the conundrum surrounding the impact of invocation of pledge vis-à-vis the actual discharge of the debt in the matter of PTC India Financial Services Limited (PFS) v. Venkateswarlu Kari and Anr¹. The said judgment of the Hon'ble Supreme Court affirmatively states that mere registration of the pawn i.e., the dematerialized shares in the said matter in favour of the creditor as a 'beneficial owner' does not have the effect of sale of shares by the pawnee. The pledge at that stage is not discharged and thus the debt remains due and payable in entirety.

BACKGROUND OF THE CASE

PFS, a non-banking finance company registered with the Reserve Bank of India, had advanced a loan of Rs. 125 crores to NSL Nagapatnam Power and Infratech Limited (NSL/Corporate Debtor). One of the conditions of the loan agreement executed inter-alia between the Corporate Debtor and PFS, was to secure the loan amount by way of pledge of shares vide pledge deed, which was executed by Mandava Holdings Private Limited (MHL), being the parent company of NSL, in favour of PFS/security trustee. On November 17, 2017, the Corporate Debtor filed a petition for voluntary insolvency under

Section 10 of the Insolvency and Bankruptcy Code, 2016 (IBC) before the National Company Law Tribunal (NCLT), Hyderabad, which was consequently admitted on January 18, 2018. On December 28, 2018, PFS served a notice to MHL, wherein it demanded MHL to discharge the debt within seven (7) days, failing which PFS would exercise its rights under the pledge deed. Since the debt remained unpaid, the Depository Participant, on the request of PFS, accorded the status of "beneficial owner" of the pledged shares to PFS. Thereafter, PFS sent a notice to MHL informing that due to the continuing default, it had invoked the pledged shares in terms of the pledge deed and now reserves the right to sell the pledged shares.

PFS had itself filed an application under section 7 of IBC against the Corporate Debtor on 17th January, 2018. However, in light of the admission Order dated 18th January, 2018, under Section 7 of the IBC, the NCLT allowed PFS to file proof of financial claim before the Interim Resolution Professional (IRP). PFS filed its proof of financial claim, wherein the amount of pledged shares had not been accounted for or reduced. Simultaneously, MHL also claimed that since PFS had already been granted the status of the "beneficial owner" of the pledged shares, MHL no longer had any title or right over the pledged shares and had accordingly, stepped into the shoes of PFS as a creditor of the Corporate Debtor to the extent of the value of the pledged shares.

The IRP found that neither PFS nor MHL's claims could be crystallized as it was not possible to ascertain the value of the pledged shares and settle the debt either in part or in whole. PFS and MHL both made applications against the rejection of their claim before the NCLT.

The NCLT disposed of the applications of PFS and MHL, stating that MHL's claim was acceptable per the Depositories Act and Regulation 58 of the 1996 Regulations². The NCLT, while approving the claims of MHL also held that PFS having exercised its right to "transfer the pledged shares" as per the pledge deed, MHL's shareholding in the Corporate Debtor had decreased by the number of pledged shares.

The said order was challenged before the Hon'ble National Company Law Appellate Tribunal (NCLAT) by PFS, arguing that the invocation of the pledge deed was not enough to count the debt as paid/discharged and that until the sale of the pledged items in accordance with Section 176 of the Indian Contract Act, 1872, the debt would not be treated as having been discharged. Irrespective of the contentions of PFS, the said challenge was disposed of by the Hon'ble NCLAT, stating that whether PFS sold the pledged shares or not would not be relevant as it was already the "beneficial owner" of the said shares. Furthermore, the Hon'ble NCLAT held that PFS had become 100% owner of the pledged shares and thereafter, could not reclaim debt under the Indian Contract Act, 1872.

RELEVANT PROVISIONS

Indian Contract Act, 1872

The provisions regarding the pledge are included under Sections 172 to 179 of the Indian Contract Act, 1872. From perusal of Sections 172 and 173, it is clear that pledge is basically a contract entered into by the

pawnor and pawnee as a form of security for payment of debt which entitles the pawnee to retain those goods pledged as security but with the liability to return the goods when payment is made. Section 176 of the Indian Contract Act, 1872, deals with the pawnee's right where the pawnor makes a default. A pawnee has the right to bring a suit against the pawnor for the debt or promise that the goods pledged for the same can be retained as a collateral security or can be sold, after giving reasonable notice to the pawnor. The pawnor has to pay the remaining debt balance to the pawnee if the proceeds received are less than the amount due and the excess has to be returned to the pawnor if the proceeds received are higher than the amount due to the pawnee.

Depositories Act, 1996 and Depositories Regulations, 2018

As per Section 2(1)(a) of the Depositories Act, 1996, "Beneficial owner" means "a person whose name is recorded as such with a depository" whereas Section 2(1)(j) defines "Registered owner" as "a depository whose name is entered as such in the register of the issuer". Regulation 79 of Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018 deals with creating pledge or hypothecation. Sub-Regulation (8) of Regulation 79 states that subject to the provisions of a pledge document, the pledgee may invoke the pledge. Upon such act, the depository shall register the pledge as the beneficial owner of the pledged securities and accordingly amend its records.

JUDGEMENT OF THE SUPREME COURT

The Apex Court observed that the pawnee has the right to sell such pledged items under Section 176 of the Indian Contract Act, 1872, and the pawnor has the right to repay the debt until the date of the said sale of

pledged goods. It was observed that while the Depositories Act, 1996, provides the difference between the “registered owner” and the “beneficial owner”, it does not have any rule contrary to Sections 176 and 177 (which provides for “defaulting pawnor’s right to redeem”) of the Indian Contract Act, 1872. Hence, these Sections will still apply to any deed of pledge and will not be diluted or overridden by the Depositories Act, 1996.

MHL cannot be said to be a secured creditor to the Corporate Debtor with respect to the pledged shares. However, PFS continues to be the financial creditor of the Corporate Debtor by right and therefore, is entitled to claim its debt in entirety without taking into consideration the value of the pledged shares of NSL.

CONCLUSION

The Hon’ble Supreme Court accordingly vide the said judgement categorically deemed that the mere invocation of pledge and attainment of the status of “beneficial owner” by the lender/ financial creditor would not mean that the debt is discharged. There should be an actual sale of the pledged securities to discharge the debt in part or in its entirety per the respective document. The said judgement being critical to any banking and financial documentation between the parties shall ultimately form part of necessary documentation to safeguard the interest of the parties to the similar transaction.

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EXECUTION OF DOCUMENTS IN INDIA: A DIGITAL OUTLOOK

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INTRODUCTION

The execution of a document means the affixation of the signatures of all the authorized persons who are required by the nature of the document to sign the said document. Such execution creates a binding effect under the law, and it is based on the principle of “consensus ad idem” – a Latin phrase meaning “meeting of the minds”, which is the guiding principle for agreements between parties, to ensure that there is clear and same understanding of the terms and conditions of the contract in each party’s mind.

In India, physical execution, that is, using wet signatures, is the most preferred mode of execution, and this preference comes down to ‘evidence’. The original physical documents that have been signed by the hand of the parties have primary evidentiary value as per the Indian Evidence Act, 1872 (“Evidence Act”), since in case the validity of the same is challenged in a court of law, the burden of proof or onus to prove that the document has not been duly executed lies on the person challenging it.

However, in the recent times, due to the COVID-19 scenario, there has been an increase in digital or electronic executions, as meeting face to face for executions is not safe.

SIGNING IN COUNTERPARTS

Contracts can be signed in counterparts wherein copies of the said contract are printed, so each party has a copy of the contract to be signed, which is treated as original contract. Another scenario is where the signing pages of the contract are printed and signed by the parties who are in various parts of the country or world, followed by the parties mailing the physically signed copies of the signing pages, which is then compiled and scanned for record purposes, hence creating both primary and secondary evidence of the execution of the contract. A contract which lacks a clause for execution in counterparts can also be signed in counterparts. However, it is advisable to include one, as it would prevent the contract from being challenged by the parties as being not enforceable or valid.

E-SIGNING OR DIGITAL SIGNING

Contrary to popular belief, the concept of e-signing or digital signing of contracts has been in existence since 2008, when an amendment was made to the Information Technology Act, 2000 (“IT Act, 2000”), to include Section 10A, which dealt with the validity of contracts formed through electronic means.

Section 10A of the IT Act, 2000 reads as follows:

“Where in a contract formation, the communication of proposals, the acceptance of proposals, the revocation of proposals and acceptances, as the case may be, are expressed in electronic form or by means of an electronic record, such contract shall not be deemed to be unenforceable solely on the ground that such electronic form or means was used for that purpose.”

There are multiple ways of signing a contract electronically or digitally, and some of the major ones are as follows:

a) Digital signature: A person can obtain digital signature certificate (“DSC”) issued by licensed certifying authorities under Section 24 and the rules under the IT Act, 2000. DSCs are a secure electronic record under the IT Act, 2000 and the Evidence Act, and are the digital equivalent of physical or paper identity records. The authenticity and integrity of a DSC is generally not questioned in a court of law, and under Section 85B of the Evidence Act, it is presumed that the DSC has not been altered since the specific point of time of its secure affixation, and that the secure digital signature is affixed by subscriber with the intention of signing or approving the electronic record. DSCs have three different levels of security – ranging from Class 1 to 3, where Class 3 is the most secure.

b) Electronic signature: It is equivalent to a signature made by hand under the IT Act, 2000 and is usually of two types, which include e-signature associated with an Aadhar identity number with e-KYC (Know Your Customer) method, and a digital signature with asymmetric crypto and hash function system stored on a USB drive. E-signature employs different technology from digital signature, and is not interchangeable with digital signature. E-signature must fulfil the following criteria to be considered as reliable: (i) the e-signature is linked only to the individual

signing the document, and not to any other person; (ii) e-signature while executing the contract was under the control of the signatory to whom it belongs; and (iii) any alteration to be made to electronic signature after affixing signature is detectable.

According to the IT Act, 2000 read with the Evidence Act, e-signature techniques using Aadhar and e-KYC method shall be considered as a valid e-signature.

STAMP DUTY IMPLICATION ON DIGITALLY SIGNED CONTRACTS

It is crucial to note that as per Section 35 of the Indian Stamp Act, 1899 (“Stamp Act”), an instrument which is chargeable with stamp duty shall be admissible as evidence only when the appropriate stamp duty has been paid on the same. Contracts that have been executed digitally shall not be exempted from the payment of stamp duty. Section 3 of the Stamp Act provides the criteria which determines if stamp duty is to be paid or not – the document attracting stamp duty must be an “instrument” and the instrument must be executed. As per Section 2(14) of the Stamp Act, “instrument” includes every document by which any right or liability is, or purports to be, created, transferred, limited, extended extinguished or recorded. Therefore, stamp duty shall be payable on all the digitally executed contracts which are enforceable before the court of law.

The Central Government allows for the online payment of stamp duty on agreements, and in certain states, such as Delhi, all stamp duty payments are made via online mode. Stock Holding Corporation of India Limited (“SHCIL”) has been appointed as the Central Record Keeping Agency for all e-stamps used in India.

Following are the most popular methods of electronic stamp duty payment:

- **E-GRAS:** It is an electronic collection of government receipts by the State Government. Anyone can use the said service to deposit any government receipts if they choose to do so. In addition to the aforementioned, many Indian state governments have made it possible to pay stamp duty utilising the E-GRAS facility.
- **E-Stamp Paper:** Another common way of paying stamp duty in India is via e-stamp paper. The amount of the stamp duty is transmitted using this method of payment to the bank account of SHCIL or any other authorised vendor of e-stamp paper. Upon receiving the required amount of stamp duty, SHCIL or the licenced e-stamp vendor will produce the e-stamp paper of the requisite amount.
- **eSBTR:** The State Government of Maharashtra, in addition to the previously mentioned methods, has made available a method to pay stamp duty, known as the Electronic Secure Bank and Treasury Receipt (eSBTR). In the eSBTR system, a person is required to visit the bank, and make the requisite payment of stamp duty to an authorised officer after filling the application form. The said designated officer, after entering the details in their database online, will issue an eSBTR which shall be a proof of payment of stamp duty akin to a stamp paper.

CONCLUSION

Digital or electronic signature has become more prevalent in recent times, owing to the COVID-19 outbreak in 2020. Signing documents face-to-face is now a risk, and digital or electronic signing is a much safer and secure option for execution of agreements. A digital signature is authentic, preserves the integrity of the

documents and cannot be repudiated.

Digital signatures which use cryptographic algorithms cannot be copied or forged, and the slightest change to any digitally signed document makes the signature invalid. Furthermore, digital execution of documents is an environment friendly option, since it eliminates the requirement of physical paper documentation and reduces paper wastage.

However, the following documents require a notarial process and/or must be registered with a Registrar or Sub-Registrar, therefore, they can only be executed using handwritten signatures to be legally enforceable:

- Negotiable instruments such as a promissory note or a bill of exchange other than a cheque;
- Powers of attorney;
- Trust deeds;
- Wills and any other testamentary disposition; and
- Real estate contracts such as leases or sales agreements, or any other document which is required to be registered under law.

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NOTABLE DEALS

1. Acted as Borrower's counsel for O2 Group:

The firm acted as borrower's counsel for O2 Group for availing financing from various financial institutions like NIIF Infrastructure Finance Limited, Aseem Infrastructure Finance Limited and L&T Finance Limited. The role of the firm was to review, vet and negotiate the transaction documents with the lenders and their legal counsels. The firm also advised the O2 Group in finalising the commercial structuring of the transaction including providing advisory on the land related matters. The team was involved in heavy negotiations with the lender and the lender's legal counsel and was able to conclude the transaction in the interest of the borrower.

2. Acted as Borrower's counsel for Hindustan Power Group:

While acting as borrower's counsel for Hindustan Group, the team negotiated the transaction documents with one of the leading public sector undertakings i.e. Power Finance Corporation Limited. The role of the firm was to review and negotiate the already settled and executed drafts considering the position of borrower group and also to modify the documents as per the current market standard practices.

3. Conducted NHB Legal Audit:

The Firm conducted extensive legal audit for National Housing Bank (NHB) for all its outstanding accounts till August, 2022 of the borrowers (viz. housing finance companies and banks) which have availed loans from NHB from time to time. The audit included detailed inspection of transaction documents, constitutional documents, authorizations, resolutions and certificates, and preparation

of comprehensive legal audit reports.

The Firm also advised on the validity and enforceability of the transaction documents and suggested corrective measures to be taken wherever possible.

4. Acted as lenders counsel to the consortium of REC Limited and IREDA

for Suzlon Group's re-financing: The Firm advised the Lenders viz. REC Limited and IREDA, on the sanction and disbursement of term loan of approx. Rs. 4,053 Crore to Suzlon Energy Limited and its subsidiaries. With the disbursement of the said facility, REC Limited and IREDA Limited substituted a consortium of sixteen lenders (led by State Bank of India). In its role as the Lenders' Legal Counsel, the firm carried out legal due diligence of the Borrower Group, drafted and negotiated the financing and security documents, and provided legal advice on crucial matters pertaining to the transaction.

5. Acted as Legal Counsel to Power Finance Corporation Limited

in connection with financial assistance of INR. 362.73 Crore granted to Clean Max Zeus Private Limited, for setting up a hybrid renewable energy project comprising of 33 MW wind capacity and 17.60 MW solar capacity, in the state of Gujarat. The scope of work as lender's legal counsel included corporate due diligence, project due diligence, land due diligence, drafting, negotiating and finalising of the financing and security documents.

Team involved Mr. Guranpreet Singh Sarna, Partner, Ms. Shikha Singh, Principal Associate, Ms. Avlokita Kanwar, Senior Associate and Ms. Aprajita Mitra, Associate.

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