

Supreme Court - Pledgee not a Financial Creditor under the Insolvency & Bankruptcy Code

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1 Background

On 3 February 2021, a three-judge bench of the Supreme Court of India passed a judgment in the matter of *Phoenix ARC Private Limited v. Ketulbhai Ramubhai Patel* (**Judgement**) holding that in the absence of an express obligation upon a pledgor to repay the loan amounts secured by the pledge, the beneficiary/holder of such pledge (**Pledgee**) will not be considered as a 'financial creditor' of the pledgor under the Insolvency and Bankruptcy Code, 2016 (**IBC**).

In a landmark decision, the Supreme Court of India has held that a holder or beneficiary of pledged assets is not a 'financial creditor' in terms of the Insolvency and Bankruptcy Code, 2016.

2 Brief Facts

- a. L&T Infrastructure Finance Company Limited (**L&T**) advanced a financial facility of INR 40 crores to Doshion Limited (**Borrower**) under the facility agreement dated 12 May 2011 (**Facility Agreement**). Such facility was *inter-alia* secured by way of a pledge agreement dated 10 January 2012 (**Pledge Agreement**) whereby 40,160 shares of Gondwana Engineers Limited (**GEL**) were pledged by Doshion Veolia Water Solutions Private Limited (**Pledgor**) in favour of L&T.
- b. On 30 December 2013, L&T assigned all its rights, title and interests in the financial facility including all security interest therein in favour of Phoenix ARC Private Limited (**Phoenix ARC**) in terms of Section 5 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- c. On 31 August 2018, the National Company Law Tribunal (**NCLT**) admitted a petition filed by Bank of Baroda under Section 7 of the IBC to initiate a corporate insolvency resolution process (**CIRP**) in respect of the

- Pledgor. Pursuant to the commencement of CIRP, Phoenix ARC filed its claim as a financial creditor of the Pledgor with the Resolution Professional.
- d. The Resolution Professional rejected the claims filed by Phoenix ARC stating that the Pledgor's liability was restricted to the pledge of shares. Phoenix ARC then filed applications before the NCLT and the National Company Law Appellate Tribunal (**NCLAT**) seeking directions against the Resolution Professional to admit its claims and allow its participation in the committee of creditors (**CoC**) of the Pledgor. These applications were rejected by both the NCLT and NCLAT, pursuant to which Phoenix ARC filed the present appeal before the Supreme Court.
 - e. The key question for consideration by the Supreme Court was whether Phoenix ARC could be regarded as a '*financial creditor*' within the meaning of Section 5(8) of the IBC on the strength of the Pledge Agreement.

3 Decision of The Supreme Court

The Supreme Court observed that the Pledgor was not a party to the Facility Agreement pursuant to which the facility was extended to the Borrower. Therefore, a direct obligation on the Pledgor to pay the facilities availed by the Borrower did not exist.

Section 5(7) of the IBC defines a financial creditor as any person to whom a '*financial debt*' is owed, legally transferred or assigned. In deciding the question before it, the Supreme Court examined the definition of financial debt under the IBC. Section 5(8) of the IBC defines what constitutes a financial debt and provides that the amount of liability under any guarantee or indemnity given in respect of specific items defined as constituting financial debt under Section 5(8) (such as money borrowed on interest, amounts raised under credit facilities, liabilities in respect of hire purchase contract etc.) would also be considered as a financial debt. Further, it observed that according to Sections 124 and 126 of the Contract Act, 1872, a contract of guarantee is a contract 'to perform the promise, or discharge the liability, of a third person in case of his default'.

Considering that a promise to discharge the liability of the Borrower was absent in the underlying Pledge Agreement, the Supreme Court held that a pledge agreement is not akin to a guarantee and therefore, not covered under Section 5(8) of IBC. As the Pledgor had only extended a security by pledging certain shares of GEL without making any promise to pay any amounts to the creditor, the Supreme Court relied on its previous judgement in the matter of *Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited and others* and held that Phoenix ARC was, at best, a secured creditor qua its security but cannot be a financial creditor within the meaning of Section 5(7) and 5(8) of the IBC.

4 Analysis

- a. The Judgement is in line with the Supreme Court's earlier judgement in the matter of *Jaypee Infratech Limited (Supra)*, where it held that a person having only collateral security interest over the assets of a corporate debtor would not be covered under the definition of financial creditor under sub-section (7) and (8) of Section 5 of IBC. However, such creditor may be treated as a secured creditor under the IBC.
- b. As a result of this Judgement, if a promise to discharge the liability of a borrower is not provided in a pledge agreement, the pledgee would not be a financial creditor and consequently, would not be a member of the CoC of the pledgor. However, such pledgee would be treated as a secured creditor for the purposes of distribution of proceeds under a resolution plan or during liquidation.

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- c. In order to ensure that a pledge agreement entitles a bank/financial institution to be a member of the CoC and consequently participate in the decision making process, a bank/financial institution may, depending upon commercial feasibility, seek to include clauses similar to those in a guarantee in pledge agreements. Alternatively, a bank/financial institution may consider obtaining a corporate guarantee to ensure its participation in the CoC.

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