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BANKING AND FINANCE

PAWNEE CAN NOT SELL THE PLEDGED GOODS TO ONE OWN SELF UNDER THE CONTRACT ACT: Supreme Court

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Supreme Court bench comprising Justices MR Shah and Sanjiv Khanna held in a recent judgment[1] that under Section 177 of the Contract Act, 1872 ("Contract Act"), in case of default by the pawnor, the pawnee cannot sell the good to itself but only bring a suit or sell the pledged items to third parties by giving the pawnor reasonable notice of the sale. The Court held that the pawnor has the right to redeem the pledged goods till the 'actual sale' to third party.

Facts of the Case

The respondent company pledged certain shares in favour of the appellant company as a guarantee of a loan obtained by another debtor company. Later, when the debt remained unpaid, as per the request of the appellant company, the depository registered the appellant as the beneficial owner of the pledged shares in accordance with the Depositor Act, 1996.

The issue was raised during the insolvency proceedings of the debtor company. The appellant company filed a claim as a financial debtor. The respondent company, which pledged the shares, objected that the appellant company having been conferred status of 'beneficial owner' became the owner of the pledged shares. Consequently, the respondent company, being the guarantor, stepped into the shoes of the appellant company and became the financial creditor of the debtor company.

Observations of the Court

The Court analysed Section 176 and 178 of the Contract Act to conclude that the pawnee cannot sell the property to itself.

As per Section 176 Contract Act, when a pawnor makes a default in payment of debt or performance of a promise, the pawnee may bring a suit against the pawnor upon such debt or promise and retain the goods pledged as collateral security, or he may sell the goods pledged upon giving the pawnor reasonable notice of the sale. If the pledged goods are sold, and the proceeds of such sale are less than the amount due in respect of the debt or promise, the pawnor is still liable to pay the balance amount to the pawnee. If the proceeds of such sale exceed the amount due, the pawnee will be liable to pay the surplus to the pawnor.

Section 177 gives statutory right to the pawnor, who is at default in payment of the debt or performance of the promise, to redeem the pledged goods at any time before 'actual sale' by the pawnee. However, in such cases, the pawnor must pay in addition the expenses that have arisen from his default.

The Court stated that *"the Contract Act does not conceive of sale of the pawn to self and consequently, the pawnor's right to redemption in terms of Section 177 of the Contract Act survives till 'actual sale'."* The Court observed that sale to self will amount to conversion and not an 'actual sale' as envisaged under Section 177 of the Contract Act. Citing various judgment, the Court held that "*pawnee has a special and not general right the pledged properties*."

Considering the interplay between the Contract Act and Depositories Act, 1996, the Court observed that Section 12 of the Depositories Act is not inconsistent with pawnee and pawnor's contractual rights and obligations under the Contract Act. The Court held that "*the mere exercise of the right by the pawnee to record himself as the 'beneficial owner', which is a necessary precondition before the pawnee can exercise his right to sell, is not 'actual sale' and would not affect the rights of the pawnor of redemption under Section 177 of the Contract Act."* The expression 'actual sale' in Section 177 of the Contract Act has been interpreted to mean lawful sale to a third person and not a conversion or unlawful sale contrary to Section 176 of the Contract Act.

"*The exercise of right on the part of the pawnee and consequent action on the part of the 'depository' recording the pawnee as the 'beneficial owner' is not 'actual sale'. The pawnor's right to redemption under Section 177 of the Contract Act continues and can be exercised even after the pawnee has been registered and has acquired the status of 'beneficial owner'. The right of redemption would cease on the 'actual sale', that is when the 'beneficial owner' sells the dematerialized securities to a third person."*

Accordingly, the Court allowed the appeal.

1 PTC India Financial Services Ltd versus Venkateswarlu Kari and another