Analytical Speaking

Meaning of "encumbrance" under Takeover Code

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It has become fairly commonplace practice with promoters of large Indian companies to raise funding on the strength of their holding in their respective companies. Pledging is a common mode of raising funds; however, since the SEBI in the beginning of 2009 made it mandatory by introducing new Regulation 8A in SEBI (Substantial Acquisition and Takeover) Regulations, 1997 requiring mandatory disclosure of pledges and made similar amendments in reporting formats under Clause 35 and 41 of the Listing Agreements, requiring disclosure of pledged and encumbered shares in the quarterly financial results of companies, companies have been finding innovative ways of creating pseudo security interests on shares. In light of this, serious questions of interpretation arise as to what is the meaning of a pledge or encumbrance and whether the documentation entered into by these companies with the lenders amounts to a pledge or encumbrance.

The issue has received all the more focus with the new SEBI (Substantial Acquisition and Takeover) Regulations, 2011 ("Takeover Regulations, 2011"), Regulation 31 of which has made it mandatory for promoters of companies to disclose encumbrances also. It is to be noted that in the Takeover Regulations 1997, disclosure of pledged shares was the only requirement. The Code has inserted an inclusive definition, which, though, does not define the term, however, signals at the wider interpretation of the term "encumbrances". Not only this, if the transaction amounts to an encumbrance, for the purposes of disclosure requirements, the creditor benefiting from the encumbrance is taken as an "acquirer", requiring disclosure once again in terms of Regulation 29(4) of Takeover Regulations, 2011.

According to ET data[1], promoters of close to 1,000 companies have pledged shares worth over Rs. 1 lakh crore. The list includes most of the major names of corporate India. Promoters of close to 50 companies have pledged anywhere between 90-100% of their shareholding.

This article explores the question to develop parameters to decide whether a particular contract amounts to an encumbrance or not. The question as to what is not encumbrance is by no means new. Substantial literature exists from property law, general law of mortgages and old English legal texts which have copiously discussed the meaning of the term. We have drawn from the rich heritage of work,

[1] Source http://articles.economictimes.indiatimes.com/2011-10-06/news/30250534_1_promoters-pledge-disclosures

and we have applied this knowledge to present-day practices whereby various interesting forms of pledges or pseudo security interests have developed.

Provisions of law

Under Takeover Regulations, 2011

Disclosure of encumbered shares has been made mandatory in terms of Regulation 31 of the Regulations. Further, the term "encumbrance" has not been provided any specific meaning but
Regulation 28(3) says:

> *"For the purposes of this Chapter, the term "encumbrance" shall include a pledge, lien or any such transaction, by whatever name called"*

The definition is merely inclusive – it does not define what is an encumbrance, leaving it to interpretation. However, there cannot be a doubt that the purpose of the disclosure requirement is to bring to public notice the existence of agreements whereby there may be a possibility of attachment of shareholding of promoters in case of default. The Takeover Code is not information all about corporate governance – it is about the control of companies, and how the controlling block is leveraged. Hence, if a lender or creditor has a right to potentially attach or cause a sale of a substantial chunk of promoter holding, that should come to public domain.

Interestingly, Regulation 28(4) provides that shares taken by way of encumbrance shall be treated as an acquisition, and shares given upon release of encumbrance shall be treated as a disposal and shall require requisite disclosure in the formats specified. In this context, it is pertinent to note that an encumbrance amounts to an acquisition only for the purpose of disclosures under Regulations 29, 30 and 31 and not for the purpose of Regulation 3 and 4 requiring public announcement on triggering the specified threshold limits. However, note that if the pledgee/creditor gets voting rights also or has the right to cause the shareholder to vote as per the instructions of the creditor, the transaction would well amount to acquisition of control and hence, triggering the Regulation 3 as well.

Under Listing Agreements

Reporting requirement of shareholding pattern along with the pledged or encumbered shares as per Clause 35 and Submission of quarterly financial results

with details of pledged or encumbered shares under Clause 41 is mandatory under the Listing Agreements. Here also the word "encumbrance" has not been defined and is expected to have a wider meaning.

Since the Listing Agreement was already requiring disclosure of both encumbrances and pledges, the disclosure requirement of encumbered shares is, in fact, not new. If the transaction amounted to an encumbrance, it required disclosure even earlier in terms of the Listing Agreements. It is only that with the Takeover Regulation, 2011, the wider connotation of the word has come to fore.

Meaning of encumbrance

The simple legal dictionary meaning of the word "encumbrance" is anything that affects or limits the title of a property, such as mortgages, leases, easements, liens, trust, or restrictions. Sometimes, encumbrance is defined as a burden on property which reduces the value of the property.[2]

Dictionary Meaning

In *Wharton Law Laxion* the expression "Encumbrance" is explained as meaning *"A claim lien or liability attached to property".*

Black's Law Dictionary defines "encumbrance" as follows:

> *"Any right to, or interest in, land which may subsist in another to diminution of its value, but consistent with the passing of the fee by conveyance . . . . A claim, lien, charge, or liability attached to and binding real property; e.g. a mortgage; judgment lien; mechanics' lien; lease; security interest; easement or right of way; accrued and unpaid taxes."*

Interpretation in various rulings and texts

The Apex Court in *Omprakash Verma & Ors. Vs. State Of A.P. & Ors*. (2010) 13 SCC 158 discussing whether the transaction in the case given amounted to encumbrance or not described encumbrance as

> "…a burden or charge upon property or a claim or lien on the land. It means a legal liability on property. Thus, it constitutes a burden on the title which diminishes the value of the land. It may be a mortgage or a deed of trust or a lien of an easement. An encumbrance, thus, must be a charge on the property. It must run with the property."

[2] See *State of Himachal Pradesh v. Tarsem Singh and Others* [(2001) 8 SCC 104]

Similar views were also expressed in *Collector of Bombay v. Nusserwanji Rattanji Mistri and Ors.,* (AIR 1955 SC 298); *H.P. State Electricity Board and Ors. v. Shiv K. Sharma and Ors.*,(AIR 2005 SC 954) and *AI Champdany Industries Ltd. v. Official Liquidator and Anr.,* (2009) 4 SCC 486).

In two passages in *Salmon on Jurisprudence*, 12th Edition, at Page 241 under the sub-heading "Rights in re propria and rights in re aliena" the learned author has stated thus:

> "Rights may be divided into two kinds, distinguished by the civilians as Jura in re propria[3] and jura in re aliena[4]. The latter may also be conveniently termed encumbrances, if we use that term in its widest permissible sense. A right in re aliena or encumbrance is one which limits or derogates from some more general right belonging to some other person in respect of the same subject -matter. All other are jura in re propria"

At Page 242 the learned author has observed as follows:

> "it is essential to an encumbrance that it should in the technical language of our law, run with, the right encumbered by it. In other words, the document and the servant rights are necessarily concurrent. By time it is meant that an encumbrance must follow the encumbered right into the hands of new owners, so that a change of ownership will not free the right from the burden imposed upon it. If this is not so -- if the right is transferable free from the burden -- there is no true encumbrance".

Thus, the true test of an encumbrance is the concurrence of the right with property – that the right attaches to property and travels along with it. Salmond has discussed encumbrances elaborately and mentions 4 types of encumbrances: leases, servitudes, security interests, and trusts. A lease confers a right to use the property. Servitude is a right to the limited use of the property such as the right of way or easements. Security interests (including mortgages) are encumbrances vested in a

[3] Right over one's own property
[4] Right over someone else's property

creditor. A trust is the obligation attached to property to hold it for the benefit of another.

Justice Tulzapurkar in *National Textile Corporation vs State Of Maharashtra And Ors. (*AIR 1976 Bom 28) has discussed the meaning of "encumbrance" elaborately, and held that a notification under section 4 and 6 of the Land Acquisition Act, whereby a particular property may be notified for acquisition by the government did not amount to an encumbrance.

In the case of *Lincoln Trust Co. v Williams Building Corporation* (183 App. Div. 225, 169 N.Y.S. 1045) the Appellate Division of New York held as:

> "In my opinion the building zone resolution is not an encumbrance within the meaning of the contract. The resolution was obviously intended as a mere police regulation of business and premises. It is a police regulation such as the Tenement House Law, or Building Codes and numerous other regulations, which are never mentioned in contracts and have never been held to be encumbrances."

Encumbrance and Pledge

Citations from Salmond as above would clearly point to the magnitude of the word "encumbrance". Pledges are security interests; encumbrances need not be security interests at all. Thus, the word "encumbrance" is far wider purport than the word pledge. Pledge is a possessory security interest; encumbrance includes not just security interests but also rights of use, beneficial interests or servitudesSection 172 of Indian Contract Act, 1972 defines a pledge as:

> *"The bailment of goods as security for payment of a debt or performance of a promise is called pledge".*

This definition brings out two important features of a pledge – (a) that it is a bailment, that is, handing over of possession with the right of the owner to take back the possession at some stage; and (b) that the handing of possession is to create a security interest on the bailed asset in favour of a creditor or promisee.[5]

[5]Click here to know more on pledges http://www.india-financing.com/Presentation%20on%20Pledge%20of%20Shares.pdf

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Our analysis of the meaning of encumbrance

A mere burden on a person or obligor is not an encumbrance. Needless to say, every person who has an obligation to pay money is expected to have assets to pay the same. If all the lender is expecting is that the obligor will pay money and will have enough assets to pay the same, it is not a case of encumbrance. In case of encumbrance, the burden shifts from the person to the property – and the burden travels with the property. One of the most characteristic features of encumbrance would be that the encumbrancer will not be free to deal with the property in the way he likes. Second, the lender will have a right over the property, so as to extract money from the property if the personal obligation fails.

A mere restraint on the owner of property that he will not alienate his property cannot be said to be an encumbrance. If that were so, every obligation to pay money will amount to an encumbrance because in every obligation, the creditor expects that the debtor will not alienate property or deal with it to the detriment of the creditor.

It is also important to understand that the concept of a floating charge is an exception to the generic law of encumbrances. It is pertinent to know that floating charges are not valid except in case of companies. In case of companies, since the charge is registrable, a floating charge is recognized. An encumbrance should be on a specific property, because a generic obligation on property of the obligor is almost like a personal obligation.

The following important features of encumbrances arise from the discussion above:

- An encumbrance is a burden attached to property;
- If it is a burden for the owner, it must be a benefit for the person holding the encumbrance. This also follows from the discussion by Salmond which has taken encumbrances to be jura in re propria, that is, rights over estate of someone else. That is, the burden created by the owner must be such which can operate as a benefit in the hands of the person holding the encumbrance.
- The burden must necessarily be attached to the asset in question.
- Since the essence of attachment or concurrence of the burden is that the burden will pass on a person acquiring the property, it necessarily follows that the burden must be on an ascertainable, identifiable property.

- A mere restraint on sale or negative covenant is not an encumbrance. A leading English case law on whether a negative covenants "runs" with the property is *Tulk v Moxhay* (1848) 41 ER 1143. This classic ruling holds that a negative covenant is passable to the buyer of the property only where the parties intended the same to pass, and the burden "touches and concerns" the property. Here, a question of intent of parties will come in.

Different forms of quasi security interests on shares

Negative Lien or Negative Pledge

There is no legal definition of 'negative lien'. Lien is the right to retain goods of a borrower or pledgor for the debt. Negative Lien is used in banking parlance for a borrower to undertake not to create any charge on his property without the consent of the lender.

The borrower may sometime be having non-encumbered assets which are not charged to the bank as security. The borrower is thus free to deal with these assets and may even sell them if he so desires. To restrict this right of the borrower, bank may sometimes request him to give an undertaking to the effect that he will neither create any encumbrance on these assets nor sell them without the previous permission of the bank so long as the advance continues. This type of an undertaking obtained by the bank is known as 'Negative Lien'. Negative lien is in the form of a personal assurance or undertaking which has binding effect but confers no right on the bank to proceed against the property itself and thus creates no encumbrance or charge on the property.

A negative pledge covenant does not give the negative pledgee a security interest or, in general, any other right in the debtor's property. The security interests have generally been viewed as conveyances of an interest in the debtor's property (that is the accrual of certain rights in the property to the person in whose favour the security is given) and negative pledge covenants have not. This stems from the fact that the *vinculum juris* arises from a contractual relationship rather than a proprietary interest.

The case of *Knott* v. *Shepherdstown Manufacturing Co.* 5 S.E. 266 (W. Va. 1888) may be examined at this juncture to help bring some clarity to the issue. It was held

in *Knott* that Negative Pledgee's remedies are purely contractual and that the covenant confers no right in the property. The Court held,

> "Of course the agreement's negative pledge covenant creates no lien on or pledge of any property. It is simply negative; an agreement not to do a particular thing. The creation of a lien is an affirmative act, and the intention to do such act cannot be implied from an express negative. It seems to me that both of these clauses of the obligation that is, the negative pledge covenant and a covenant to keep the property insured are simply personal covenants, for the breach of which the remedy must be sought in a court of law. "

The generally accepted view as mentioned before is that the negative pledge does not create a proprietary or security interest and is therefore not registrable. [*Tracy Hobbs, The Negative Pledge: A Brief Guide, 8(7)* J.I.B.L.*269(1993)]*

Springing Lien

A "springing lien" refers to lien granted in the future by a debtor (borrower or lessee) in favor of its creditors whereby the right conferred on the lender springs into a full-fledged lien or pledge either on the happening of certain events, or the discretion of the person holding the pledge. The grant could occur upon certain events or occurrences such as:

- a material adverse change in a debtor's financial condition,
- a loss of an investment grade credit rating,
- a default under a credit facility,
- a delisting from a stock exchange, or
- any indicator of a forthcoming bankruptcy filing.

A lien, which is a grant of an interest in property, "springs" into effect upon the occurrence of any one or more of these events (or others limited only by the imagination of the parties). These events trigger rights that allow creditors to acquire rights in property (that is to morph from an unsecured creditor to a secured creditor) and/or to leap frog over other creditors into superior position to collect money from the debtor. In general, springing liens convert the unsecured creditors or other subordinated creditors into secured creditors or priority creditors, respectively, or both.

Whether a so-called springing lien will amount to encumbrance or security interest will depend on intent of parties. if the debtor is free to deal with the subject matter before the trigger events that transform a springing lien into full-fledged lien have taken place, it cannot be said that the lien is an obligation attached to property. Therefore, it will not amount to encumbrance. However, if the lien comes attached with restrictions on sale, it will amount to encumbrance, because the combination of restriction on sale, and automatic attachment of a right on the asset that cannot be sold, in conjunction, will amount to a passable burden on property.

Conclusion

Careful analysis of the documentation entered into by the parties is required to conclude whether the covenants amount to creation of an encumbrance or not. We have listed significant parameters to come to such conclusion. The determination of this question is quite urgent and important, as the new Takeover Code has taken effect from 22 October, 2011 and may require disclosure of encumbrances within 7 working days of creation. Though an encumbrance might have been created already, logic demands that encumbrances created in the past should be disclosed within 7 working days of the new regulations taking effect.