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Should the court restrain lenders from invoking share pledge?

The injunction granted by the Bombay HC has the effect of turning a secured lending transaction into an unsecured one

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The Bombay High Court’s recent decision to grant stay on sale of pledged shares, which are used as a security for loans, throws up many questions.

First, let’s look into the order itself. The stock price of the pledged shares fell below Rs 100, from the earlier Rs 350, leading to a failure in maintaining the required security cover. This caused the lenders to invoke the security and move forward with the sale of the shares.

The court, however, restrained the lenders from offloading the shares. This injunction granted by the court raises serious concerns and reflects an approach driven more by sympathy than application of global case laws on the subject and an understanding of risk allocation in a lending transaction.

What exactly is a share pledge? In simple terms, a share pledge is where a shareholder provides the shares as a security for repayment of a debt.

Now, it's easy to understand the sympathetic approach of the court towards borrowers, given the fact that businesses are down on their knees due to the COVID-19 blow. But such sympathy has completely knocked off the risk allocation that drives a lending transaction in the first place. The fundamental basis of secured lending is the lender is not party to the equity risks associated with a business and has adequate security to recover its dues.

When a business does well, the lender cannot ask for more than the fixed IRR (internal rate of returns) promised on its loan and the borrower reaps the benefits of such an upside. Similarly, when the business suffers, the lender should retain the right to recover the dues from the security on an absolute basis. So, the injunction restricting the lender from selling off the security deals a blow to this risk allocation and transfers the equity risks associated with the business to it. The lender now has to watch the value of the security diminish further and suffer harm or wait for the business to recover. In effect, the lender's risk is now completely aligned with that of the business and the security cover is no longer useful to make any recovery.

Arguably, the court is not taking away the security, but merely postponing the date of enforcement, given the fall in value of the shares. However, by suspending the exercise of a legitimate right of the lender, courts are putting them at a huge risk. The harm could be beyond repair if the economy and businesses do not quickly recover from the pandemic and the stock plummets further.

In essence, the court has looked at the whole issue from the perspective of the borrower and not the lender. The commercial decision -- if and when a share pledge should be enforced, under law or otherwise -- is for the lender to take and should be at its sole discretion. By granting the injunction, the court is stepping into this sphere of commercial decision-making. The court is making a determination that the fall in value of shares is only temporary and will last for a very short duration. This determination is not for the court to make.

Indian and global laws clearly establish that the law only requires the share sale to be conducted in an honest and proper manner. This requirement does not imply that the lender has to identify a propitious time to sell the shares. The lender is entitled to the sale at any point of time. Further, the propriety of the sale process cannot be questioned when the shares are sold on the floor of a stock exchange. Under such circumstances, there is no room for any under-hand dealing as the price discovery is done in a transparent manner.

In scenarios where the market is crashing, the lender may choose to hold on to the shares, as selling them will put the value in a downward spiral and paint the lender as unsympathetic and ruthless. Despite that, if the lender still decides to go ahead and sell shares to salvage as much as possible or due to pressure from its own investors, courts may be overstepping the boundaries of contract law and even equity by holding them back. It may so happen that lenders such as credit funds could find themselves in a deeper sinkhole. They may face litigation risks from their LPs (limited partners) if they simply watch the value of security cover diminish and not take any action.

Borrowers' claim of force majeure is also not meritorious. A force majeure clause is not included in financing transactions as the liability of the borrower is considered absolute. Even the MAC (Material Adverse Change) clauses in financing agreements are in favour of the lender and do not absolve the borrower of its obligations, particularly those related to repayment and maintaining the security cover. The absence of a force majeure provision and the construct of an MAC clause in financing agreements is like this, as in a lending transaction the repayment obligation and the lender's ability to enforce the security is considered sacrosanct and absolute.

Agreed, one may have empathy for borrowers who may be at the receiving end for no fault of theirs and are subject to the hard reality of share pledges being enforced. However, the injunctions granted by the court have the effect of turning a secured lending transaction into an unsecured one.

The borrower has the option to pledge additional collateral -- often called the 'margin' -- or repay a portion of the debt. However, if the borrower chooses to do neither, the lender is left with no choice but to sell the asset in the interest of self-preservation.

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