

Business Standard

Pledging of shares: Do lenders need to rethink their strategy?

The laws that govern lenders and the right to invoke pledged shares

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Illustration by Ajay Mohanty

Ruchir Sinha, head of the PE and M&A practice at Nishith Desai Associates, and Mohammad Kamran, a senior member of the firm's international litigation and dispute resolution practice, explain the laws that govern lenders, right to invoke pledged shares

What is the issue regarding the pledge of shares that has come to light recently?

The issue of invocation and sale of pledged shares by lenders has been drawing the headlines, particularly in case of Essel Group and Reliance ADAG. On one hand, Essel Group thanked its lenders for reaching an 'understanding' to not sell the pledged shares until a 'speedy resolution through a strategic sale in a time-bound manner' is achieved. On the other hand, lenders to Reliance ADAG Group companies, in a largely similar scheme of things, invoked and sold large quantities of shares pledged with them collapsing the stock price. Anil Ambani called the sale 'motivated' and a spat from both sides followed. Subsequently, another group of lenders have apparently now agreed not to sell the shares of Reliance ADAG even if prices fall below the threshold limits.

What does the law prescribe on lenders right to invoke the pledge?

The question is not just about the lender's rights to invoke, but importantly its duty to invoke — under common law and governance standpoint. Under contract law, upon default, a pledgee may either (i) file a suit for recovery of debt and retain the pledged property as security, or (ii) sell the pledged property after giving reasonable notice of sale to the borrower.

The Indian Contract Act does not provide for any methodology of sale but strictly prescribes that the 'sale' (as differentiated from invocation) must happen with prior notice to the pledgor. In fact, the pledgor has the right to redeem the pledged property until its actual sale by the pledgee. The pledgee has the same duties as a bailee, which casts a duty on the pledgee to "take as much care of the goods bailed to him as a man of ordinary prudence would... take care of his own goods". Hence, so long as the notice of sale has been given, pledgee is free to sell the asset in a fair manner.

How does the invocation of pledge work in case of listed shares?

Interestingly, the Depositories Act has changed the scheme in which the pledge operated under contract law vis-à-vis physical shares. Unlike physical shares where ownership remained with the pledgor if a share pledge is invoked in case of demat shares, the lien marked shares in the pledgor's account are transferred to the account of the pledgee. Hence, invocation and sale in demat are largely simultaneous. In the case of listed shares, even a 24-hour notice could be reasonable.

Again, there is no prescribed standard for sale. It could be by way of auction, private sale or on the floor. Where the shares are not marketable, an auction may be a better option, but where the shares are frequently traded, sale on the floor of the exchange should be fair as well.

What are the challenges posed to lenders in case of invocation of the pledge?

Most lenders, and more so, non-bank lenders are nervous before enforcing a security interest despite the occurrence of a default. This is because the invocation of the pledge may result in (a) destroying the value of the stock, which apart from hurting small investors may also result in the inability of the lender to further offload the entire stock; and (b) reputational risk as the enforcing lender might be perceived as litigious.

On the other hand, if the pledged shares are not invoked and sold, then the lender may be answerable to its stakeholders and limited partners as to why it did not take requisite actions and witness the diminution of the collateral — the pledged property. A lender clearly cannot be held responsible to maintain the stock price, rather if the lender fails to sell when it has the opportunity to do so, it may be liable for the diminution in value post-invocation.

What is the general opinion on whether lenders should exercise their right to invoke?

Well, LPs of debt funds have in the past argued that a lender is not a risk participant and should not be expected to sit in judgment over the business prospects of the borrower and take a call on deferment of enforcement of security interests against the borrower. Of course, due to commercial considerations, a lender may defer enforcement — but in a situation where collateral is eroding, a safer bet would be to enforce, unless of course, the lenders believe the volumes and price have been so diminished that there is no hope for recovery by sale.