

ENFORCEMENT OF PLEDGE

AMBIT OF REASONABLE NOTICE

Courts typically assess the reasonableness of notice on the basis of the nature of the security and other underlying factual circumstances





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Creation of a pledge over shares, especially over the shareholding of the promoter group in the borrower entity or a related entity controlled by the promoter group is one of the common mechanisms for security creation in commercial lending transactions. It is widely believed that lenders typically prefer security in the form of pledged shares owing to the ease of enforcement by way of disposal, particularly in the case of shares of listed entities. Additionally, the prospect of the lender enforcing its pledge rights and selling such shares in the market also results in the promoter group's own control over the relevant entity being diluted, which usually ensures better compliance and discipline on part of borrowers in honoring their repayment obligations.

While the jurisprudence on this has evolved, the process of enforcing a pledge continues to be governed by the provisions of Sections 176 and 177 of the Indian Contract Act, 1872. Section 176 provides the pledgee with following remedies upon default by the pledgor, namely, suing the pledgor for the secured debt, retaining the security as collateral, or selling the pledged security upon giving the pledgor reasonable notice of sale.

Suing the pledgor for secured debt has its own challenges, especially if the pledge is from a third party and there is no covenant to pay. Additionally, appropriating pledged shares without sale process and reducing the loan exposure is not permitted either. For enforcement then, the only viable option is of sale, with 'reasonable notice'.

Under law, a 'reasonable notice' of sale is a mandatory element of the enforcement process, with the pledgor having the right to redeem the pledged security within such 'reasonable' period of time, and at any point until the actual sale of the security.¹ The requirement to provide a reasonable notice of sale cannot be waived under contract, with Section 176 not containing any non obstante clause rendering the said requirement subject to any contract to the contrary.² The notice contemplated under Section 176 is required to be clear and specific in its language, and must set out the intention of the pledgee to dispose of the pledged security. The language of the notice cannot be vague³ or be limited to indicating an intention to arrange for a sale.⁴

The other relevant aspect is determining the sufficiency of the notice period. In drafting pledge documents, lending institutions follow either of the two approaches, i.e. (i) prescribing a notice period that both parties deem reasonable; or (ii) the documentation remaining silent on the duration of the notice period. The latter approach has been commonly adopted with lenders seeking to retain the leeway to enforce a pledge over security (particularly over listed shares) after providing a notice period of even two or three days. In each specific instance, the courts have assessed the reasonableness of the notice on the basis of the nature of the security and the underlying factual circumstances including the conduct of the borrower/pledgor.

1. Kunj Behari Lal v. Bhargava Commercial Bank, AIR 1918 All 363(2)
2. Hulas Kanwar v. Allahabad Bank, AIR 1958 Cal 644; Co-operative Hindustan Bank Ltd v. Surendra Nath Dey, AIR 1932 Cal 524; Official Assignee v. Madholal Sindhu, AIR 1947 Bom 217
3. Bharat Bank Ltd. v. Sheoji Prasad, AIR 1955 Pat 288
4. Co-operative Hindustan Bank Ltd v. Surendra Nath Dey, AIR 1932 Cal 524

In this regard, the approach adopted by a single judge of the Hon'ble Calcutta High Court in a recent judgment in the matter of *Manav Investment and Trading Company Limited v. DBS Bank India*⁵ assumes significance. In the said case, the plaintiff pledgor had created a pledge over two separate sets of shares of the same borrower entity held by it in favor of the same lender. The main pledge agreement which governed both sets of pledged shares did not prescribe a notice period. However, significantly, one of the sets of pledged shares was also governed by an undertaking provided by the pledgor entity, which provided for a notice period of fifteen business days, with such document not being applicable to the other set of pledged shares.

In accordance with the underlying documentation, at the time of invoking the pledge (on the same day, for both sets of shares), the lender provided the pledgor with a notice period of fifteen business days qua the set of shares that was governed by the abovementioned undertaking, and a time period of two days for the other set of shares (which was deemed reasonable in the eyes of the lender and was in accordance with established judicial principles, especially in the absence of any prescribed time period in the underlying documentation).

In context of the above facts, the Hon'ble High Court took a view that regardless of the prescription of fifteen business days notice period being applicable under contract to only one set of shares, it would be reasonable to expect the lender to have provided the same notice period even for the other set of shares, given that the concerned shares were of the same entity, pledged by the same pledgor in favor of the same creditor and the invocation of pledge over both sets of shares had been undertaken on the same day. Accordingly, it was observed that providing varying notice periods for the two sets of shares could not be deemed as reasonable.

The argument that the documentation underlying one set of shares explicitly provided for a notice period of fifteen business days, while that for the other set of shares being silent on the same was disregarded on

the basis that Section 176 was in either case not dependent upon a contract between parties and the reasonableness of the notice would therefore have to be construed independently of the specific contractual arrangement between the parties.

The abovementioned judgment carries significant connotations for lenders from the perspective enforcing a pledge, at the stage of drafting of the pledge documentation. One should also be mindful of such principle being extended to companies belonging to the same group. Particularly in the case of larger borrowers, involving multiple levels of security (and even creation of fresh security during the tenor of the facility, in case of a restructuring etc.), it is essential that security documentation be aligned at an overarching level to ensure that there is no inconsistency or material divergence within the same which may be utilized by borrowers/third party security providers to create hurdles in the enforcement of such security by lenders. After all, a pledge of shares is intended to be a security interest which is easily enforceable!

5. G.A. No. 1 in C.S. No. 138 of 2021, dated February 16, 2022

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