

Dispute Resolution Hotline

April 15, 2020

COURT RESTRAINS LENDERS FROM SELLING LISTED PLEDGED SHARES AMIDST DIMINISHING SECURITY COVER OWING TO COVID-19

- Major risk to lenders lending against listed equity shares
- Lender was restrained by court despite clear breach of security cover covenant
- Must a lender wait until actual payment default, even as security cover diminishes beyond agreed limits?
- Does the lender have duty to maximize value of the pledged shares, or just a duty to ensure reasonable care?

Amidst the outbreak of COVID-19, the Bombay High Court ("Court") in the recent case of *Future Group Wholesale Limited & Anr. ("Plaintiffs") v. IDBI Trusteeship Services Limited & Ors. ("Defendants")*,¹ granted an ad-interim relief to Future Group, restraining their lenders from selling the shares pledged to them. The shares, when pledged, were listed at close to INR 350 per share and fell to below INR 100 thereby severely breaching the security cover agreed with the lender causing the lender to invoke and sell the pledged shares, which has been, at least temporarily, been restrained by the order of the court.

BACKGROUND AND ORDER

- Facts:** Pursuant to Debenture Trust Deed dated January 12, 2018 and April 4, 2019 ("Debenture Trust Deed"), Future Group Wholesale Limited ("Borrower") had borrowed a sum of about INR 6.1 billion from IDBI Bank and UBS AG London Branch ("Lenders") by issuing debentures. Future Corporate Resources Private Limited ("Future HoldCo"), being the promoter of Future Retail Limited ("FRL") and the Borrower, pledged the 8% equity shares of FRL ("FRL Shares") to secure the debentures.²
- Security cover breached:** At the time of Debenture Trust Deed the price of FRL Shares was INR 350 per share. Owing to the outbreak of COVID-19 the share market collapsed FRL Shares traded below INR 100³, which breached the agreed upon security cover in the DTD. As the price of FRL Shares fell, the Lenders through their debenture trustee, issued notices of default to FCRPL and Future Group because of latter's inability to maintain the minimum-security cover stipulated in the Debenture Trust Deeds.⁴
- Covid19 caused the security cover breach:** In view of above, the Borrower and Future HoldCo filed an application before the Court seeking to restrain the Lenders from selling FRL Shares in the market. The Borrower argued the collapse in the share market was due to the present COVID-19 situation and if FRL Shares are sold in this situation, irreparable loss will be caused to the Future Group.
- Lender left exposed:** On the other hand, the Lenders argued that though they have to recover from the Borrower INR 6.1 billion, the value of FRL Shares is presently not more than INR 3.5 billion. Hence, there can be no question of granting any restraining order.
- The Court, however held that considering the present situation of market and COVID-19, ad-interim protection should be granted to the Plaintiffs till next date of hearing⁵ and restrained the Lenders from selling the FRL Shares.

ANALYSIS

- Should the pledgee (the lender in this case) wait for an actual payment default to occur, or can it sell the pledged property upon any other default:** As per S. 176 of the Indian Contract Act, 1872 ("Contract Act"), upon default or failure to perform, 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.⁶ Accordingly, so long as there is a default in performance of an obligation, a lender can choose to sell the pledged property. It is common for lenders to grant loans casting clear obligations on the borrower to maintain certain financial covenants, which includes the most imperative covenant to ensure that a security cover is met. If for any reason, such security cover is not met due to reasons whatsoever, lender retains the absolute and unfettered right to call an event of default on the lending, accelerate the payment of debt and sell the pledged property to recover the amounts outstanding.
- When can a pledgee sell the pledged property:** It is well settled law that no pledgor can decide when and how a pledgee should exercise its right to sell. Section 176 makes it clear that it is the discretion of the pledgee to sell the pledged goods (shares in this case) in case the pledgor makes default.⁷ It is in lender's interest also to maximize recovery from the security, particularly where the value of security is insufficient compared to the dues.

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However, the commercial determination of whether a recovery from security should be made in the current market or if the current situation should be allowed to further develop and unfold is a call solely for the pledgee to take.

- c. *When can a pledgor object to sale of pledged property:* Various decisions of the court hold that the pledgor's right extends only to ensure that the pledged property is sold in a fair and reasonable manner, so to say, there is no impropriety in the sale process and that the sale is honestly and properly done⁸.

The lender under English law typically owes the following duties in relation to the sale:

- (i) Duty to act in good faith;
- (ii) Duty to take reasonable precautions to obtain the true market value of the property at the date on which he decides to sell it.⁹

The lender is also not required to consult the borrower as to the time and manner of sale. He can sell by private agreement or public auction provided that he takes adequate steps to publicize the sale and bring it to the notice of a reasonable number of prospective buyers.¹⁰ The fairness of sale process assumes importance where the pledged property is illiquid in nature and the sale price can be subjective. However, in case of listed shares where price discovery happens on the floor, there can be no question of any underhand dealings and hence the scope for objections should not arise.

- d. *The lender could suffer irreparable harm:* In a listed context, a lender has to anyway tread dangerous grounds because the invocation may result in 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. Further, the future is unknown and even in the current circumstances, it unclear how long the epidemic would continue the bear run on the markets. Thus, if in future the situation does not improve and price further falls, then the lender would suffer irreparable harm. However, it appears that the Court has not considered the issue from this perspective and only looked at the immediate fall in share price from the lens of the borrower.
- e. *Defeats the very distinction between secured and unsecured lender:* The inherent premise of a secured lending transaction is that the lender is taking a very limited risk on the business and that it has a security cover to ensure it is repaid. The lender does not take a risk on recovery from the borrower and may just underwrite the borrowing the security entrusted to it. The lender does not take any equity upside in the business and hence cannot be expected to take any business risk. Grant of injunctions as in the present case, defeats the very premise of secured lending and exposes lenders to 'unsecured lending' as their ability to monetize security for recovery is taken away by the courts. This is inherently against the basic commercial principles relating to a secured lending transaction.
- f. *Force Majeure:* In crashing markets, restricting the lenders from selling the pledged shares by even a day could result in massive value erosion. It is for a reason that financing contracts typically never have Force Majeure clauses unlike a vendor contract since come what may, the financial obligations must be met by the borrower on an absolute basis. Further, borrowers cannot rely upon Section 56 of the Indian Contract Act, 1872 to shy away from their obligations. If Section 56 were to apply, it would also not assist the borrower as it leads to contract being void. A party who has received any benefit under such void contract is then liable to return the same¹¹, implying the borrower has to repay the entire loaned sum.
- g. *Material Adverse Change:* The MAC (Material Adverse Change) clauses present in lending transactions are typically such that it permits lenders to stop further financing or allows them call back the entire loan, as they do not take the business risk while lending. Thus, the MAC Clauses in financing transactions also do not come to the aid of the borrower.

CONCLUSION

It is to be noted that the present order was passed in an unprecedented situation. The Court has granted the relief only till the next hearing date. Hence, this may not be a precedent which can be commonly followed. It still remains to be seen how the Court will ultimately determine the case based on a deeper examination of the facts and law over the course of next hearings. In fact, just a few days later in another case¹², the Court recognised and affirmed the vested right of a creditor to sell the pledged shares. However, in this case, it prevented the lender from selling the pledged shares as the borrower was directed to pay the outstanding amounts in a staggered manner.

At the core of any secured lending is the security cover, which is most sacrosanct to any lender, and forms the very basis to underwrite a lending. It is for this reason that a secured lending is much cheaper than an unsecured lending. In fact, in a global economic crisis like Covid19, a lender should be allowed to immediately sell the pledged shares so that the lender can recover most of its value without being left high and dry later and grappling as an unsecured creditor with the borrower.

Lastly, if the pledged shares are not invoked and sold, then the lender may be answerable to its own stakeholders and limited partners (if it is a credit fund) as to why it did not take requisite actions and witness erosion of the collateral. We have extensively dealt with questions of whether to invoke the pledge or not in our interview with Business Standard which can be found [here](#).

While one can sympathize with the plight of the borrower and the pledgor whose factories have been shut and their stock price is now not rolling, but falling off the cliff, one must appreciate that from a pure risk allocation perspective, the risk is that of the borrower and the pledgor. If the securities were unlisted an injunction could have been palpable (though still bad law), but not when sale is happening on the floor.

— Mohammad Kamran, Ashish Kabra, Ruchir Sinha & Vyapak Desai
You can direct your queries or comments to the authors

¹ Commercial Suit (O) 307 of 2020

² As reported here <https://www.barandbench.com/news/litigation/covid19-pandemic-bombay-hc-restrains-idbi-bank-from-selling-pledged-shares-of-future-retail-ltd>, on April 2, 2020

³ Price of FRL Shares is INR 74.40 as of date of this hotline.

⁴ As reported here <https://www.barandbench.com/news/litigation/covid19-pandemic-bombay-hc-restrains-idbi-bank-from-selling-pledged-shares-of-future-retail-ltd>, on April 2, 2020

⁵ Next date: May 4, 2020

⁶ Section 176 of Contract Act; *Lallan Prasad v. Rahmat Ali and another*, AIR 1967 SC 1322; *Balkrishan Gupta v. Swadeshi Polytex Ltd.*, (1985) 2 SCC 167

⁷ *Reliance Project Ventures and Managerent Pvt. Ltd. v. ECL Finance Limited and Ors.*, Bombay High Court, Commercial Notice of Motion (L) No.401 Of 2019 in Commercial Suit (L) No.191 Of 2019, Decided on: 13.02.2019

⁸ *Supra* n. 7

⁹ *Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd.* [1971] Ch 949; *Silven Properties v. Royal Bank of Scotland, Plc*, [2004] 1 WLR 997; *Beckett Pte Ltd v Deutsche Bank AG and Another and Another Appeal*, [2009] SGCA 18

¹⁰ *Id.*

¹¹ *Muhammed Hashimv. Misri*, AIR 1922 All 6; *Babulal Agarwala v. Vijaya Stores, Firm* AIR 1955 Ori 49

¹² *Ideal Toll & Infrastructure Pvt. Ltd. & Anr. v. ICICI Bank, Commercial Suit No.LD-VC-7 OF 2020 along with Interim Application No. LD-VC-7 (IA) OF 2020 in Order dated April 7, 2020 at para 9.*

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