

Advanced Contracts, Tendering and Public Procurement
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Lecture No: 31: Special Contracts: Pledge

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Pledge



- **Pledge, Mortgage, and Hypothecation**
 - Pledge: Bailment of movable goods by the debtor to his creditor as security against the loan.
 - Mortgage: Turning over the interest in a particular immovable property as security against the loan.
 - Hypothecation: Fabrication of a charge on the movable possessions without giving its actual possession to the lender (**Title deeds or possession of documents**). Section 2 (n) of the Securitization and Reconstruction of Financial Assets & Enforcement of Security Interest Act, 2002 defines hypothecation.
- **Subject matter of the pledge**
 - Document in which there is the transfer of an interest or title in favor of the pawnee.
 - E.g. Shares transferred to the Bank, railway receipt, promissory notes, and Bill of exchange.
 - For shares, Regulation 58 of the SEBI lay down the manner of creating a pledge. Section 12 of the Depositories Act, 1996 lay down the provisions governing the pledge of shares in Demat form.
- **Who can pledge?**
 - As a general rule, the owner of the goods himself or any person authorized by him who holds an authority to pledge the goods.



The concept of pledge primarily revolves around the granting of loans or money. However, it is essential to distinguish between the different types of money lending businesses in India. In the informal sector, pledge is commonly referred to as pawnbroking.

Now, pawnbrokers, in most cities, are local money lenders. What they do is, if you go and give them some kind of valuable goods, usually jewelry, gold, or silver, they take it. If you need immediate liquid cash, I think they are the ones who can provide it to you. So, pledge, on the other hand, is in the more formal sector, perhaps involving banks and financial institutions. It is where they give you money or a loan advance.

What is interesting is that banks always require security before granting a loan, as there is always the risk of default. Hence, they request you to provide a valuable item as a deposit. It is important to note that pledge is typically used for movable goods, whereas mortgage is primarily utilized for immovable property. So, if you use your house and land as collateral, you enter into a mortgage agreement.

But if it is anything that is movable property, especially what we call goods because there is a distinction between movable property and goods, then you have entered a contract of pledge. Now, one of the most interesting aspects is what can be pledged, and does the government

also enter pledge contracts? They may, in certain circumstances. For example, the normal form of pledging property is shares. Shares and stocks can also be the subject matter of pledge. Banks prefer this because they hold value in terms of market conditions, require less storage space, and importantly, have a lower risk of theft compared to something like gold.

Now, when we talk about property today, tangibility was once crucial, but now we are considering immovable property under the contract of pledge as well. Intellectual property can also be pledged. Trademarks and patent rights, for instance, can be pledged, and they can be assigned a monetary value.

Third-party hypothecation, is something that the SARFAESI Act, also known as the securitization act, deals with to some extent. Hypothecation is considered a modern form of pledge. Some authors have referred to hypothecation as "in pledge" because in hypothecation, the goods can be utilized instead of being kept as a dead security with the bank. In traditional pledge, the bank retains possession of the goods, and the borrower cannot generate money or income from them, making it difficult to repay the loan. On the other hand, if the goods can be monetized while still serving as security, it becomes easier for the borrower to repay the loan. Hypothecation is commonly practiced with taxis or automobiles that are taken on loan or lease, allowing the driver or owner to utilize the vehicle while it is held as security by the bank. That is what hypothecation entails in its actual sense and meaning.

To comprehend two important points in the contract of pledge, we need to consider who can pledge and what can be the subject matter of pledge. Regarding the subject matter of pledge, it is crucial to understand that the Indian Contract Act categorizes pledge as a type of bailment.

It is bailment because in pledge, the borrower intends to keep something as security with the bank by delivering these goods for a specific purpose. And what is that purpose? The purpose is to obtain cash or a loan. In pledge, the bank simply holds the goods as security without taking any further action, which is why the Indian Contract Act grants them a general lien over those goods.

However, it is important to understand that under Section 172, there is a definition of pledge, and when we examine the chapter on pledge, we come across the fact that not only can goods be pledged, but the title to the goods can also be pledged. In India, even with the rise of

digital transactions, many goods do not have traditional title deeds. Some goods do have title deeds issued by the government or possess recognized documentation.

However, for many goods, the receipt of purchase serves as the basis for claiming the title of the goods. Traditionally, even a railway receipt is considered a document of title to goods. So, if goods are entrusted to the railways and a receipt is issued, it becomes a title deed for the goods. This concept is defined under the Sale of Goods Act, which outlines what can be considered as a document of title to goods.

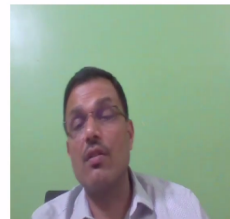
Hence, it is important to note that these types of documents of title to goods can also be pledged. The subject matter of pledge is vast, as I mentioned before, and it even includes intellectual property. Additionally, it is worth noting that there have been amendments to the Depositories Act regarding the pledging of shares. Promoters often pledge their shares to raise funds or loans for the company. Therefore, shares are commonly used as a favored subject matter of pledge, especially considering the current materialistic form of share ownership.

Furthermore, once we understand who can pledge, it is important to note that typically it is the owner of the goods who can make a pledge. However, upon reading the Indian Contract Act, we discover some interesting provisions that extend the rights to pledge beyond just the owner. An agent or a mercantile agent, acting in the ordinary course of their business, can also pledge goods. This introduces the intriguing aspect that agents can also engage in valid pledges, provided it is done within the ordinary course of their business and for business purposes."

So, pledge is a broad aspect it adds to the discussions of what we have already seen under contract of bailment.

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- **Can a mercantile agent pledge? (Section 178)**
 - Ordinarily, a mercantile agent can pledge only if;
 - He is in the possession of goods or of the documents of title with appropriate consent.
 - The pledge is undertaken in the ordinary course of business.
 - There is good faith as defined under Sec. 3(20) of the General Clauses Act, 1895.
 - In *Purshottam Das v. Union of India AIR 1967 All 549*, certain goods were delivered to a person who had forged the railway receipt. The person then later pledged it to the plaintiff. It was later claimed by the plaintiff that his pledge was good against the negligence of the railways.
 - It was held by the Court that the pledge was invalid for want of clear possession with the pawnee.
- **Pledge by a person having limited interest [sec. 179]**
 - Can a pledgee sub-pledge? There can be a sub-pledge only to the extent of the limited interest of the pledgee in the goods that are pledged. Once the payment is tendered, there arises a duty to return the goods back.



Now, when you consider mercantile agents, friends, there are certain conditions that need to be met. Firstly, the agent should be in possession of the goods or the document of title to the goods. Secondly, they should have the consent of the principal. Thirdly, the pledging should be in the ordinary course of the agency business. And lastly, it should be done in good faith. If these three conditions are fulfilled, a mercantile agent can proceed with making a pledge.

Now, when we discuss about agents and mercantile agents, we understand that a mercantile agent is someone who has the authority to engage in trade on behalf of their principal. A perfect example of a mercantile agent would be a car dealership showroom, as they act as a mercantile agent in selling vehicles on behalf of their principal. They are agents who conduct commercial transactions for their principal, and such agents also could make pledges.

Why do mercantile agents receive this recognition under Section 178? One simple reason is that in earlier times, it was necessary to appoint an agent in a location where you could not be physically present, and there may have been a lack of communication. During those days, it might have been necessary to manage the goods and have access to cash for dealing with them. Therefore, the right to pledge the goods was granted to agents, as it provided a temporary arrangement for delivering the goods in exchange for a money advance. These justifications allowed agents to have the right to pledge.

Interestingly, Section 179 also states that a person with limited interest can also make a pledge. In this context, limited interest means that the person not only has possession of the

goods but also holds a proprietary right over them. This additional right is recognized under Section 179.

However, one aspect that could be improved under Section 179 is the concept of sub-pledge, where a bank proceeds to create an interest in the pledged goods. When a pledge is created, it generates interest because money is involved. Therefore, the bank has an interest in the goods to the extent of the lent money. Consequently, under Section 179, the bank can engage in sub-pledging. Like the concept of sub-bailment in the Contract of Bailment, sub-pledging is also possible in certain cases, depending on customary practices or with the consent of the pledgor, for the purpose of the pledge.

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- **Pledge by non-owner**
- Voidable contract is when the consent is received through coercion, fraud, undue influence or misrepresentation.
 - *Philips v Brooks 2 KB 243 (In case of possession under a voidable contract- s. 178-A)*
 - **Facts:** In this case, a man named "North" who fraudulently purchased a ring through cheque from Philips (jeweler) by stating himself to be a friend of "Sir George Bulloch, ran away with the ring and pawned it to the other party Brooks Ltd, who was unaware of the status and character of North. Later when the cheque bounced, it was discovered by Philips that North was a fraudster and he thereafter sued Brooks Ltd and asked him to return the ring.
 - **Issue raised:** Is Brooks Ltd. liable to return the ring to Philips? Who is the rightful owner? Who has the title of that ring?
 - **Held:** Brooks Ltd. was not denied possession of the said ring since all the essentials of a valid contract were fulfilled in the transaction between North and Brooks Ltd.
- **Is pledgee a secured creditor?**
 - *Bank of Chittoor v. Narasimhu Naidu AIR 1966 AP 163 (Rule of priority)*
 - **Facts:** In this case, Mr. Naidu and his sons had taken a loan of Rs. 10,000/- from the Bank of Chittoor in exchange for collateral security which included camera accessories and a projector. However, the possession of the pledged security was never given to the bank since it formed a part of their running business. Sometime later, Mr. Naidu and his sons sold the pledged goods to the party who was aware of the fact that the goods sold to him were pledged goods. Bank has filed a suit against the party to whom the goods were sold.
 - **Issue raised:** Is there a valid pledge of goods by Mr. Naidu and his sons since the goods were never in possession of the bank?



Also, when you examine the concept of pledge by non-owners, one case worth considering is the Philips versus Brooks case. This case falls under Section 178A of the Indian Contract Act. Please note, friends, that this section is an additional provision and was not part of the original text. It was added later. This section stipulates that certain types of pledges can be considered valid even if they are made under a voidable contract.

in the case of Philips versus Brooks, it is a technical case that requires an understanding of the context in which the pledge becomes valid. However, it is important for us to grasp the concept that voidable contracts are deemed void either by the court or upon the parties' decision if they believe that their consent in the contract was induced by fraud, misrepresentation, undue influence, or coercion. When the option to declare the contract

voidable is exercised, the contract becomes void. However, if that option is not exercised, the contract remains valid.

Therefore, in cases where the contract is valid, despite being potentially voidable, any kind of pledge is considered valid. Time becomes a crucial element in determining the validity or invalidity of the pledge. The Philips versus Brooks case is an example worth considering. It is a complex and intriguing case that encompasses various elements, such as ownership of the contract and the significance of time in granting or denying rights to third parties. Furthermore, it sheds light on the challenges faced in pledging goods that lack proper documentation of title. Now, moving forward, let us discuss the pledge or the Pawnee, which in this case refers to the bank acting as a secured creditor.

Now, that the relationship between the creditor and the debtor is divided as follows: the debtor is the one who borrows, and the creditor is the one who lends. In the case of a bank or the pawnee, they have certain goods as security, and being a financial institution, they can be considered as secured creditors. The concept of a secured creditor is important to understand because it grants them the first rights to recover their loan.

When goods are pledged and the bank has physical possession of those goods, the party with physical possession always holds the first right over the goods, making them a secured creditor. This security is in terms of the goods kept, as well as in terms of recovering the loan and fulfilling the purpose of the loan.

In the case of Bank of Chittoor versus Narasimbhu Naidu, it was established that if there is a single good with multiple claimants, the question arises as to who should have the first right and possession of the goods. The court ruled that in a pledge, it creates a secured creditorship, and the banks should have the first right over the goods unless their loan is discharged.

Therefore, the court's decision emphasizes the importance of the banks' status as secured creditors and their priority in recovering their loan and maintaining possession of the pledged goods until the loan is repaid.

Unless the rights in the contracts are discharged, no other person can claim rights over those goods. This is how the concept of secured creditorship becomes relevant, particularly in cases of liquidation, bankruptcy, or insolvency, where the assets need to be used to repay creditors. Secured creditors hold the first right over such assets.

Understanding these aspects of contracts is crucial for commercial dealings in daily business operations, particularly when dealing with government contracts. These concepts hold significant relevance and importance in those contexts.

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- In another case, *Bank of Bihar v. state of Bihar AIR 1971*, the goods pledged with the Bank as security for debt were seized by the state lawfully and sold off. All the proceedings were also appropriated. The Bank later brought a suit for recovery of the debt.
- The Court held the State liable to reimburse the Bank. (on priority basis)
- Secured creditor has the *"first right of a claim as against the entire world"*.
- **Right to retain [Section 173-174]**
 - The pawnee holds a right to retain the pledged goods, not just for paying off the debts or performing the promise, but for the interest on the debt and all other essential/extraordinary expenses incurred by him with regard to the possession or maintenance of the goods pledged.
 - Right of Lien: A pledgee holds a right of retention as there is possession of goods and this right extends to interest, expenses, preservation of goods, recover expenses of litigation etc.
 - It is important to note that hypothecation can never create a right of lien, but a default right to sell.
 - Understanding the difference between retain and Lien.
- **Right to recover extraordinary expenses incurred. (Sec. 175)**
 - Pawnee has an express right to recover extraordinary expenses incurred by the pawnor while the goods were kept as a pledge under his supervision.
 - E.g. In the case where a horse is pledged, injury caused to the horse during that time would make the pawnor liable to compensate the pawnee with all the damages.



It is important to discuss the rights of a pawnee. The first right of the pawnee is to the right of retain. this is like a right of lien though right of retain is considered to be largely broader than right of lien and drafters have very clearly said look the pawnee has the right to hold the goods till his debts are paid off, but it is not only towards the debts that the banks can retain the goods.

It is also for the interest on the debtor. So, principal with interest and any kind of ordinary or extraordinary expenses banks have incurred in the pledge. They can hold on to the goods, they did not return the goods back unless those are actually paid off and that is where the right to retain is a broader right, it is a right of a creditor, it is the right of the pawnee and this is the legal right.

He may not hand over the goods it is an exercise of right without the intervention of the court as well. So, the pawnee offer the rights to recover extraordinary expenses of course this is something that he always has this if he takes care of the goods and naturally when you take care of the goods you may incur certain expenses of storage of preservation etc., those rights also the pawnee can exercise or he can recover it from the pawnor.

So, under the contract of pledge once can notice that the rights of the pawnee that is one who has lent the money has been secured, has been mentioned and that was the purpose of the Indian Contract Act drafter in saying in pledge now we must take care of the rights of the pawnee. If he takes care of the rights of the pawnee they will lend that is how business commerce and trade can happen.

And that is the purpose of calling this a special contract and having defining the rights and obligation of the parties in the contract of pledge.

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- **Remedies available to the Pawnee**

- Discretion to bring a suit against the pawnor for recovery of the debt.
- Retention of goods as collateral security.
- Selling off the goods after giving reasonable notice. In *Neckram v. Bank of Bengal* 1891 ILR 19, it was held by the court that the selling off the pledged shares without giving reasonable notice and other primary requirements would be regarded as a "*wrongful act*" by the bank which would make it liable to pay for the loss incurred.

- **Right to Sell**

- Before the end of the contract when default occurs
- In *Vimal Chandra Grover v. Bank of India* 2000 5 SCC 122, the pledger requested the pledgee bank to sell the pledged shares at the prevailing price of Rs. 2,400 per share. The Pledger, quite wrongly, indicated that the shares were lying at the head office of the bank. The bank later took 9 months to locate the shares and sell them at a lower price of Rs. 700 per share.
- **Issue raised:** Can the pledger claim the loss?
- **Held:** The bank held that the pledger can claim the loss since the Bank had "*defaulted*" on its part.
- Important point to note: Pawnee cannot sell the pawned property to himself as he is the seller, he cannot make himself the buyer.
- Intention of sale – Notice to be served (sec. 176)



The remedies available to the pawnee are discussed further. He has the discretion of bringing in a suit. Now please note why because you already have goods so you do not have to bring in a suit so that his entire discretion at the same time, he can retain the goods and please note this discretion is something that is completely left to the pawnee. No one can force someone to first sell the security and then bring the suit no.

The provision of the contract law of the pawnee has the entire discretion unlike the pawnor. You first sell the goods; you sell the securities from that sale if you are still having any kind of claim only then you can file a suit. This is usually a misunderstanding that lot of people have, but the contract of pledge very clearly states otherwise and it gives the entire discretion to the pawnee.

They have the option to recover the debt in any manner they choose, such as filing a lawsuit or retaining the goods. The *Vimal Chandra Grover* case is an interesting and significant case

regarding the right to sell. It is recommended to read this case as it addresses an important point. The pawnbroker has the right to sell the pledged property, but the decision to exercise this right is entirely up to the pawnbroker.

If the debtor defaults by not paying the debt or by delaying the repayment, then the pawnbroker has the right to sell the secured property. However, in cases where the bank has misplaced or lost the shares, or if they have taken a considerable amount of time to locate the shares, it may be seen as negligence in taking care of the goods as if they were their own. This relates to the principle of bailment, where the bank has a duty to return the goods once the purpose is fulfilled.

Now, if there is negligence on the bank, the borrower has every right, the debtor has every right to sue the bank for that kind of a negligence. However, he cannot insist that because of the delay his rights got affected because the share prices fell in those 9 months and that is why he wants the pawnee to be held accountable. For that he cannot sue the pawnee for, because that is a choice, that is a discretion about when he wants to sell.

Whether he want to sell or not in the first place or whether he wants to bring in a suit. Now, interestingly to bring in a suit please note there is a limitation. Under the limitation act of 1963, the ordinary limitation time to file a suit for the recovery of debt is three years from the time of default or from the three years times from the time the cost of action has arisen and if the three years get expired the creditors cannot bring in a suit that against the debtor because the limitation time has expired.

So, no suit is entertained unless probably that is what we call as Condonation of delay. So, that is one kind of a plea and a discretion that the judges can allow you to even file a suit after three years if they accept the Condonation and then accept the suit as well. However, the fact is that will not in any way touch the security that the bank has.


The bank can deal with the securities even beyond three years that is something that the banks always have a right upon and that is why we say under the limitation of law which is based on the Doctrine of Laches. The Doctrine of Laches is a Doctrine of Delay. Under this Doctrine of Laches which is the rule of delay it would exhaust your remedies, but it would never exhaust your rights that is a very popular statement that we always say.

It will exhaust your remedies vis-a-vis the fact that look you cannot file a suit and exercise your remedies. If you wish to do that you have to do that within three years beyond that you cannot. However, it does not exhaust your right, which means, towards that kind of security the bank continues to hold the security, they can sell the security at any point of time that right the goods continue to hold.


The fact remains that please note if the banks decide to sell, then law and section very clearly says that a notice must be served. Now, if the bank does not serve a notice the sale will be invalid, it would be illegal and again the borrower can have a grievance regarding the same. So, what is provided in the statute as a mandatory notice must be complied with and if the banks fail to comply with the same.


Then the borrower can say his rights under the contract of pledge has been adversely affected by the bank. This is how the contract of pledge spans between both the parties in contract and please note that these are facts that no private contract can negate, intervene, waive or diminish because these are statutory rights that are granted to contracting parties that is how the law and contract actually deals with the rights of the parties.

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- **Rights of the pawnor**
 - Right to redeem (sec. 177) Pledge can be redeemed within the lifetime of the owner. The right of the pawnor extinguishes only when the pawnee makes the actual sale of goods.
 - *State of Orissa v. Hare Krishna Mahatab AIR 1992 Ori. 284*
 - **Facts of the case:** State Government undertook the task of exporting iron ore and assigned the job of transportation to the defendants. The State gov't for certain securities also sanctioned a loan of Rs. 50,000 to the defendants for the purchase of machinery. The contractual terms stated that on termination of the contract by either party, the loan amount outstanding shall be refunded immediately and the Govt could sell the securities without approaching the court.
 - **Held by the Court:** It was held by the court that despite the contract, the gov't could approach the court for an appropriate remedy without exhausting the remedy of selling the securities
 - Muthoot Leasing Finance Ltd. V. M/s Vasudeva publicity service AIR 2003 Del. 372
 - Respondent purchased a Contessa classic car on a hire purchase basis and had claimed to clear the loan. The Finance company Ltd acquired a forcible repossession of the car without informing the hirer about the details of the installments due and also failing to serve a notice for seizing the vehicle.
 - **Held:** It was held illegal and damages of Rs. 50,000 for breach of contract was justified.





Finally, to look at what are the rights of the pawnor? The right of the pawnor is the right to redeem. Redeem means the owner, the bailor and the pawnor who wear the original owner of the goods and they have pledged these goods to get a money advance. They can redeem the property anytime before the actual sale takes place that means even after default if they wish

they can take the loan plus the interest and the extraordinary expenses whichever is there and still they can take their goods and make it their own.

The right to redeem continues to be a right for the lifetime of the owner till the actual sale takes place and even during the sale there is a possibility that you can take part in that kind of sale and purchase the goods as well which is kind of controversial in this kind of a situation because there is a right to redeem and hence before the ownership in the goods get transferred to the third party you can actually claim it to be your own. That is one of the rights of the pawnor it is called the right to redeem and that is a right that can be exercised before the bankers.