The Pledge – Taking Security Over Shares

In our experience, the taking of security for repayment of a debt by way of a pledge of shares subject to English law is fairly commonplace in certain of the emerging economies, particularly Russia, and we have seen the use of this instrument in a number of emerging market transactions with cross-jurisdictional elements in which we have been involved.

In the more established economies the pledge is and has for some time been a little used form of security which has largely been superseded by more sophisticated forms of security such as (broadly) charges and mortgages and certain types of quasi-security. However, in the emerging economies, the pledge retains a relatively greater significance as a means of taking security and it is perhaps the very ‘physical’ nature of how the pledge is created and perfected coupled with its simplicity and transparency – involving as it does the physical possession of an asset by the pledgee – that goes some way to explaining its relative popularity in these emerging economies.

Under English law a pledge is effectively the delivery of possession of an asset by one party (the pledgor) to the creditor (the pledgee) by way of security but with ownership of the asset remaining with the pledgor. In this article we focus in particular on the pledge in the context of a pledge of shares to secure a loan or a deferred payment (e.g. in the context of a shares acquisition) but it should be borne in mind that any items of property capable of delivery (including documents of title to property, tangible or intangible) may be pledged. Furthermore, delivery of the asset in question may be actual or constructive – e.g. handing over the keys to a warehouse where the pledged goods are located. As we say, in practice the pledge is rarely used in the more established economies as an instrument of security but in specialised transactions or in different
jurisdictions (particularly emerging markets) it may have an important role to play.

Under the common law of England and Wales, the creditor (or pledgee) can sell the pledged asset if the pledgor defaults on making payment, provided the pledgee gives due notice to the pledgor. As the length of notice will depend on the circumstances prevailing at the relevant time it is advisable that the pledgor and the pledgee enter into a letter of pledge or memorandum of deposit setting out the pledgee’s rights in respect of the pledged assets and dealing in particular with the length of notice to be given by the pledgee. Similarly, in the context of a pledge of shares, a share pledge agreement is usually executed between the registered owner of the pledged shares (the pledgor) and the individual or legal entity in whose favour the pledge is executed (the pledgee).

A share pledge agreement is signed by the pledgor and the pledgee and usually provides that, in order to perfect the security created under the pledge, certain documents, as follows, will be delivered to the pledgee at the same time as that agreement is signed:

- the original share certificate(s) representing the pledged shares;
- an undated blank instrument of transfer of the shares duly signed by the pledgor in favour of the pledgee;
- an irrevocable proxy and power of attorney in respect of the pledged shares from the pledgor;
- undated, signed letters of resignation from the company secretary and each director;
- a certified copy of a resolution from the board of directors of the company approving the pledge of the shares under the share pledge agreement and the transfer of the shares to the pledgee (in the event that the pledge is enforced); and
- a letter of authority and undertaking from the company secretary and each director.

The share pledge agreement should impose an obligation on the pledgor to procure that immediately upon the company’s receipt of a notice from the pledgee giving notice of the pledge evidenced by the share pledge agreement and attaching a certified copy of the said agreement, the company will insert a memorandum of pledge in its register of members.
against the pledged shares. This memorandum effectively serves as a safeguard in the event of any unauthorized or fraudulent execution of the blank instrument of transfer of the pledged shares, since the company secretary is aware of the share pledge agreement and should be in possession of the said documentation.

In order to ensure the enforceability and legality of the security created pursuant to the share pledge agreement it may be necessary in certain jurisdictions to register the security interest created under the share pledge agreement with the registrar of companies or equivalent within a prescribed period of time following the creation of the security interest. Failure to do so may render the security void against a liquidator, administrator or company creditor.

The circumstances in which a pledge may be terminated should be set out explicitly in the share pledge agreement and these usually include the following:

- on the date of discharge by the pledgor of the secured obligations in accordance with the share pledge agreement;
- on the date on which the parties’ mutual written agreement to terminate the share pledge agreement is executed and delivered by all parties;
- on the date on which the pledgee serves a written termination notice on the pledgor (in the event that the pledgee chooses in its sole discretion not to enforce the share pledge agreement); or
- upon enforcement of the pledge by the pledgee in the event of default by the pledgor under the share pledge agreement.

In the event of termination of the pledge, the pledgee will return the share certificate representing the pledged shares and any other documents provided to the pledgee under the terms of the share pledge agreement, and execute and submit (or procure the execution and submission of) any documents or instruments as may be necessary to remove the security interest in favour of the pledgee attaching to the pledged shares.

Any registration of the security interest created by the pledge to the registrar of companies or equivalent is usually cancelled by filing an appropriate cancellation notice. An appropriate notification must also be
sent to the company secretary in order to remove the memorandum of pledge that was made in the company’s register of members against the pledged shares.

In the event that the pledgor is in default under and in accordance with the term of the share pledge agreement the terms of that agreement will usually provide for the pledgee to enforce its security by transferring the pledged shares into its own name. This transfer takes place by dating the instrument of transfer which was originally deposited with the pledgee and thereby transferring the pledged shares into either the name of the pledgee or the name of a third party nominee as nominated by the pledgee. An appropriate notification is given to the company secretary in these circumstances who will record this transfer in the company’s register of members, cancel the previous share certificates and issue new share certificates in accordance with the pledgee’s instructions.

In the event that the pledgor defaults under the share pledge agreement there is usually no statutory requirement in common law jurisdictions for the public sale of the pledged shares. However, such a requirement may be stated in the share pledge agreement. Furthermore, if the pledgee proceeds and sells the pledged shares in these circumstances, it usually has a common law obligation to obtain a reasonable market price for the shares at the relevant time.

It is also important for the pledgee to ensure that:

- the articles of association of the company whose shares are to be pledged allow the granting of such a security and there are no specific restrictions;
- all appropriate corporate approvals and board resolutions have been obtained;
- there are no other charges or encumbrances registered against the pledged shares; and
- the pledged shares are fully paid up at the time of taking the security.

If you have any questions or for further information, please feel free to contact Michael Thompson at +44 (0)20 7367 8070; Mike Fox at +44 (0)20 7367 8064.