

Buchalter

“Nuts and Bolts” of Equity Pledges

Buchalter “Brown Bag” Webinar Series

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What is Equity?

What is Equity?

- Value that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debts and liabilities were paid off.
- Usually (but not necessarily) includes the right to vote on certain matters (election of directors, sale or merger)

Evidence of Equity

Evidence of Equity

- Stock or Membership Interest Certificate
- Stock Ledger
- Schedule of Members (attached to LLC Operating Agreement)

Value of Equity as Collateral to Secure a Loan Obligation

Value of Equity as Collateral to Secure a Loan Obligation

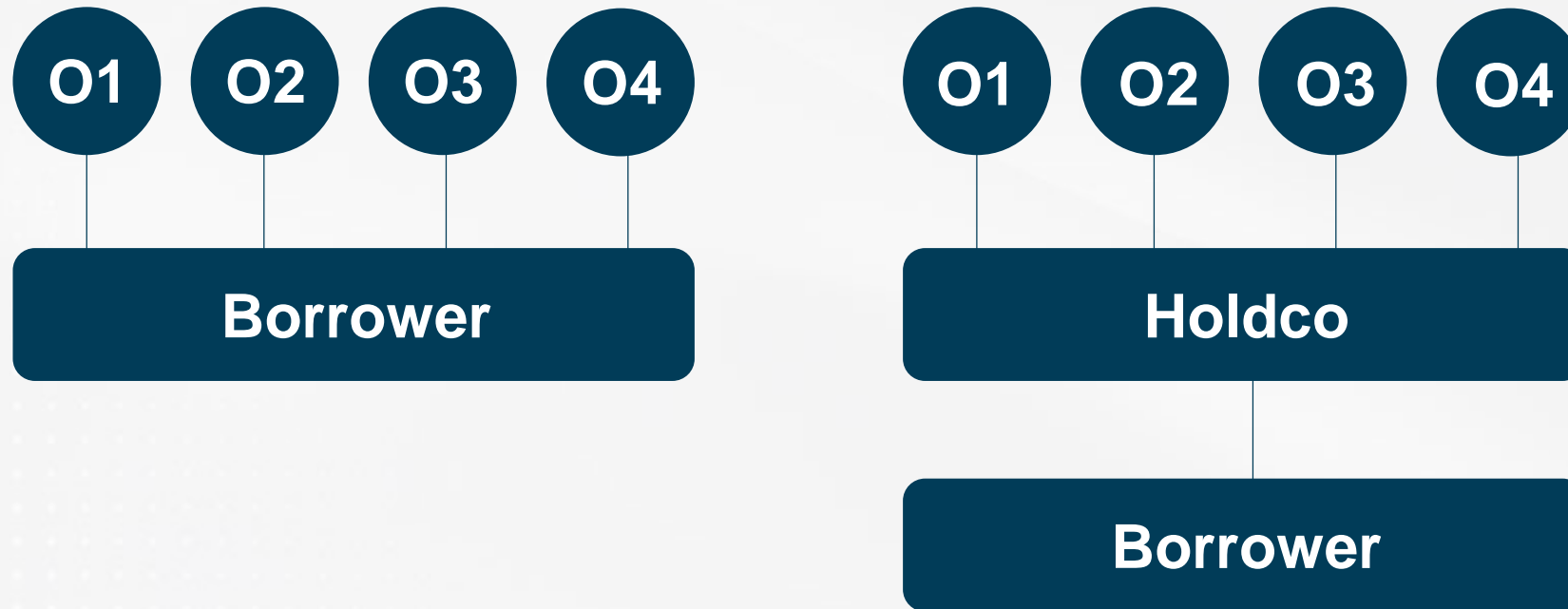
1/2

- A pledge of 100% of the equity of a company captures the going concern value, which may be greater than the value of the assets
- But note, unlike an asset sale, an equity (i.e., stock) sale carries with it the liabilities of the company
- A pledge of less than 100% of the equity of the company limits the pool of potential buyers
- Holding company structure simplifies the transaction when there are multiple owners of the borrower
 - One pledge from the holding company vs. a pledge from each owner
 - See Figure 1 on next slide
 - Eliminates the need for the beneficial equity holders to sign a pledge agreement

Value of Equity as Collateral to Secure a Loan Obligation

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Figure 1



Obtaining a Pledge of Equity as Collateral to Secure a Loan Obligation

Obtaining a Pledge of Equity as Collateral to Secure a Loan

Obligation 1/5

- “Pledge” technically means a possessory security interest although the term is often used informally to include any security interest
 - Secured party takes possession of the collateral to perfect its security interest (e.g., pawn shop).
- The UCC divides types of collateral into categories.
- A pledge or security interest in equity will be created by a security or pledge agreement signed by the debtor (i.e., the owner of the equity), that grants a security interest in the equity described in one of two ways:
 - By category
 - By specific description of the equity

Obtaining a Pledge of Equity as Collateral to Secure a Loan

Obligation 2/5

- First step in obtaining a pledge of equity is determining in which UCC category it belongs.
 - Categories include accounts, documents, equipment, inventory, general intangibles, investment property, etc.
 - “Investment property” is defined in Section 9102 of the UCC as including a security.
 - “General intangible” is defined in Section 9102 of the UCC as any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.

Obtaining a Pledge of Equity as Collateral to Secure a Loan

Obligation 3/5

- “Security” is defined in Section 8102 of the UCC as, except as otherwise provided in Section 8103 of the UCC, an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer that is all of the following:
- (A) It is represented by a security certificate in bearer or registered form, or the transfer of it may be registered upon books maintained for that purpose by or on behalf of the issuer.
 - (B) It is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.
 - (C) It is either of the following:
 - (i) It is, or is of a type, dealt in or traded on securities exchanges or securities markets.
 - (ii) It is a medium for investment and by its terms expressly provides that it is a security governed by this division.
- “Security certificate” means a certificate representing a security.
- “Uncertificated security” means a security that is not represented by a certificate.

Obtaining a Pledge of Equity as Collateral to Secure a Loan

Obligation 4/5

- A share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity is a security. Section 8103(a) of the UCC.
- An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by [Article 8 of the UCC], or it is an investment company security. Section 8103(c) of the UCC.
 - The underscored language is referred to as “opting into Article 8”

Obtaining a Pledge of Equity as Collateral to Secure a Loan Obligation 5/5

- Summary of the above:
 - Equity in a corporation is investment property
 - Equity in a partnership or limited liability company is not investment property unless its terms expressly provide that it is a security governed by Article 8 of the UCC, i.e., the issuer must “opt into” Article 8 of the UCC
 - If the equity is not investment property as defined in the UCC, it is a general intangible

Perfection and Priority of an Equity Pledge

Perfection and Priority of an Equity Pledge 1/4

- Method of perfection of the security interest differs, depending on the category of collateral
 - A security interest in general intangibles is perfected by filing a UCC-1 financing statement in the proper filing office, naming the debtor and secured party, and describing the collateral specifically or as “general intangibles”
 - A blanket or “all assets” UCC-1 includes general intangibles

Perfection and Priority of an Equity Pledge 2/4

- A security interest in investment property may be perfected by control or filing a UCC-1 financing statement per the above but describing the collateral specifically or as “investment property”
- A blanket or “all assets” UCC-1 includes investment property
 - A secured party has control of certificated investment property by taking possession of the original certificate and an endorsement (e.g. stock power) signed by the owner of the certificate
 - A secured party has control of uncertificated investment property by obtaining a control agreement (similar to a DACA) either from the issuer (in the case of privately held) or the broker (in the case of publicly-traded investment property).

Perfection and Priority of an Equity Pledge 3/4

- Priority of security interests between competing secured parties (e.g., two or more secured parties having a security interest in the same collateral).
 - Priority of security interests perfected by filing a UCC-1 financing statement is based on the first to file rule
 - A security interest held by a secured party having control of investment property ... has priority over a security interest held by a secured party that does not have control of the investment property. Section 9328 of the UCC.

Perfection and Priority of an Equity Pledge 4/4

- Summary of the above:
 - Perfection of the pledge of investment property may be by possession or filing a UCC-1
 - A secured party have a possessory security interest in the investment property will have priority over a competing secured party having a non-possessory security interest in the investment property, regardless of timing.
 - Perfection of a security interest in a general intangible is only by filing a UCC-1. Priority between competing secured parties having a non-possessory security interest in the same general intangible will be determined by the first to file rule.

Features of a Pledge Agreement

Features of a Pledge Agreement

- Granting clause
- Rights to distributions before and after an event of default
- Voting rights before and after an event of default
- After-acquired equity, e.g., stock splits, options
- Anti-dilution
- Power of Attorney and proxy to transfer ownership of the equity
- Suretyship defense waivers in the case of a third party pledge

Bankruptcy Considerations

Bankruptcy Considerations

- Bankruptcy of the company. The automatic stay that goes into effect upon the bankruptcy of the company does not apply to exercise of remedies taken by a creditor of the company against the pledgor of the equity so long as the pledgor is not also the subject of a bankruptcy proceeding.
 - Secured party can foreclose on the equity and vote the equity's claim in bankruptcy
- Bankruptcy of the pledgor. The automatic stay that goes into effect upon the bankruptcy of the pledgor will prevent exercise of remedies against the pledgor.



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Robert A. Willner is a Shareholder in the firm's Commercial Finance Practice Group. Robert provides practical, business oriented, legal advice to his clients on how to best structure, document, and manage their commercial lending transactions. Robert is an expert in a broad spectrum of middle-market, senior and second lien lending, including asset-based lending, cash flow lending, unitranche finance, acquisition financing, dividend recaps, leveraged ESOP finance, lender finance, fund finance (including capital call and subscription facilities, and NAV and hybrid loans), aircraft finance, tech finance, healthcare finance, cross-border transactions, equipment leasing, debtor-in-possession financing, trade finance, and factoring. Robert is also expert in problem loan workouts and restructurings, liquidations and foreclosures. His clients include commercial banks, alternative lenders, commercial finance companies, equipment leasing companies, factors, and other financial institutions.