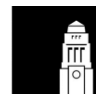

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# Taking Security over Certificated Shares in Private Companies

by Professor Duncan Sheehan

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*The article discusses the correct characterisation of the transfer of the share certificate and a blank stock transfer form to the lender where the latter takes an equitable security interest over the shares. It discusses differences in practical treatment where the share certificate is electronic or digital in form*

**Key Points**

- Handing over the share certificate to the lender typically creates an equitable mortgage over the shares
- A legal mortgage is only created if the company fulfils all the relevant formalities to transfer legal title to the shares, but this brings some practical disadvantages to the lender
- While there are practical advantages to the lender in having a blank stock transfer form, the lender must remain aware of some possible pitfalls, particularly in cases of electronic share certificates
- Digital ledger technology and smart contracts may provide an answer, but English law needs to adapt to their use.

## Introduction

An English company may issue shares in either certificated or uncertificated form. In the former case the company must issue share certificates and keep a register of its members under sections 112-121 of the Companies Act 2006. It must comply with the rules on the transfer of the shares set out in chapter 1 part 21 of the Companies Act 2006. In the latter case the company must have its shares admitted to settlement under the CREST system. This article is concerned with certificated shares, whether the certificate is electronic or hard copy in form, and puts uncertificated shares to one side.

The problem with which this short article is concerned is the clarification of the legal nature of the transfer of the share certificate to the lender in cases where the latter has taken equitable security. On the face of the matter the lender has taken possession of the document and there has been a delivery of the share certificate. Importantly this should not be construed as transferring legal title. The lender does not take title to the shares, except in the case where the shares are bearer shares where it is possible for the borrower to give the lender a common law pledge over the shares; this is rare but pledges of bearer shares were discussed in *Merlo v Duffy* [2009] EWHC 313.

**The Proper Characterisation of the Transfer of the (Paper) Share Certificate**

In many cases the company will issue a hard copy share certificate. Section 768 of the Companies Act 2006 provides that “a certificate under the common seal of the company specifying any shares held by a member is prima facie evidence of his title to the shares.” This is worth stressing. The certificate is evidence of title, but it is not title. A share certificate is not a document of title in the way that a bill of lading is a document of title to goods or a bill of exchange a document of title to money. The exception is that bearer certificates are proof of title to shares and therefore legal title can be transferred via transfer of the documents. As indicated, this is rare – not least because of the risk of fraud.

*Harrold v Plenty* [1901] 2 Ch 314 illustrates the effect of the transfer of the certificates; the attempted pledge of the shares, which were not bearer shares, was described as an equitable mortgage. Although the security is often described as an equitable charge (eg Francis Tregear and Erin Hitchens 'A calculated risk: some dangers of taking shares in private companies as collateral' (2011) 11 JIBFL 683) technically it is not. Foreclosure might for example be technically possible, although the hurdles to jump to exercise that right make it incredibly rare. The practical implications of the distinction are therefore minimal. There are two ways in which an equitable mortgage can arise. The first is that the mortgagor only has an equitable interest to mortgage. The second – of which this is an example – is where there is non-compliance with the formalities for a legal mortgage. In practice the bank takes the share certificates, along with a share transfer form in blank duly signed by the mortgagor. This enables the bank to sell the shares without further recourse to the borrower and there is an implied agreement that the mortgagee will be able to do so. Another attendant advantage of possession of the share certificate is that the absence of the share certificates should put a subsequent purchaser on notice as to the existence of the security, although this is not perfect protection.

Legal title to the shares does not, to stress, pass in this scenario. That would only occur if a legal mortgage is created. To do this, the transferee – the bank-mortgagee in this instance - must be registered as owner of the shares by the company. The company may only register the transferee’s legal title on receipt of a proper instrument of transfer (section 770) although section 771 of the Act envisages that the company may either register the transfer or explain the refusal to do so. It is possible therefore that the company or its directors may, if the articles allow for their having a discretion as to whether to register a transferee, stymie the creation of a legal mortgage. Taking title under a legal mortgage allows the bank – or more probably its nominee - to vote the share, but carries certain attendant risks and inconveniences.

- If the shareholding is a majority shareholding or comprises all the shares in the company, the lender has acquired a subsidiary (either for legal or accounting purposes) which may have tax or competition law implications or even require contributions to pension deficits.
- Even if this is not so, the lender may become entangled in unwanted associated shareholder and PSC regime requirements.

On balance an equitable mortgage is preferable.

Shares, along with other similar assets such as bonds, credit claims, “cash” in the bank etc are classed as financial collateral, which covers both directly held and intermediated securities. The key to the application of the Financial Collateral Arrangements (no 2) Regulations 2003 is the dispossession of the collateral provider through control given to the collateral taker. A

mortgagee who has the share certificate – even without having the signed transfer form – will have "possession and control" for the purpose of the regulations and any registration requirements (for the mortgage) are thereby disapplied by regulation 4 of the Financial Collateral Arrangements (no 2) Regulations 2003 (although a cautious mortgagee might choose to register anyway). The remedy of appropriation discussed below will also be available.

**Enforcement of the Equitable Mortgage**

Often this will be by sale. While the possession of the duly signed and executed share transfer form allows sale without recourse to the mortgagor it may require the cooperation of the company itself in that the directors may have a discretion to refuse to register the new owners. To avoid this the bank should insist on an amendment to the articles of association that the company will register the transferee of the shares as owner if the transfer is made by the lender. This – and an accompanying power of attorney – should also evade the general rule that an equitable mortgagee does not have the right to transfer legal title. See *Re Hodson's and Howe's Contract* (1887) 35 Ch D 668. This rule also means that an equitable mortgagee has no right to seek possession of the shares, although he does have the right to appoint a receiver.

An equitable mortgagee will also have the power to appropriate the shares if they count as financial collateral and the regulations apply and there is provision for this in the agreement (*Alfa Telecom Turkey Ltd v Cuckurova Finance International Ltd* [2009] UKPC 19). Appropriation under regulation 17 of FCARs has been compared to foreclosure – and there are similarities – although regulation 18 of FCARs requires the collateral taker to account for any surplus to the borrower and indeed if there is a shortfall the lender has an unsecured claim. In all cases the securities must be valued in a commercially reasonable manner. Effectively this is a sale to the collateral taker which is not usually permitted. Regulation 4 of the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 ensure that any equity of redemption is extinguished and no court order is required for this to occur.

**Electronic and Digital Share Certificates**

While it is conceivable that the articles of association of a company could restrict the issue of electronic documents there is no reason in principle why a share certificate could not be electronic in nature and some of the issues have been discussed by Stephan Smoktunowicz ('Where's My Share Certificate: Taking Security in an Electronic World' (2021) 9 JIBFL 629). There is no requirement for a company to have a "common seal" under section 45(1) of the Companies Act 2006 so although share certificates under the common seal are evidence of title there is no rule that the share certificate be under the common seal to be valid. There is functionality on some electronic signing platforms for electronic company seals but these will doubtless fall foul of the requirement in section 45(2) that, if the company has a common seal, the name of the company be engraved on it. However, so long as the document is executable in accordance with the company's normal procedures and signed in compliance with section 44(2) – eg by two authorised signatories – of the Companies Act 2006 it should be capable of being an electronic share certificate. Currently it is not possible to possess electronic documents, although the Law Commission proposes that certain electronic trade documents be treated as being capable of possession (Law Commission *Electronic Trade Documents* (Law

Comm no 326 2021)). Share documents are not among the documents proposed as susceptible to being possessed, and so it will not be possible even should the proposals be adopted to have electronic bearer shares. If therefore a lender takes an electronic share certificate the confusion as to whether possession of the document carries title to the shares should not arise. Stock transfer forms can now also be submitted electronically. HMRC announced in mid-2021 that temporary measures due to Covid-19 would be adopted permanently. Scanned pdf documents with electronic signatures can therefore now be emailed to HMRC for stamp duty purposes.

There are some possible pitfalls, however, to a fully electronic process which lenders should be aware of.

- How is the share certificate stored?
- Is it an original share certificate?
- Does receipt of an electronic certificate count as "possession and control" for the purposes of the Financial Collateral Arrangements (no 2) Regulations?

The storage of an electronic share certificate may be on a cloud-storage platform where it can be protected through a number of different means, including, minimally, password-protection. However, the nature of electronic documents and the fact that the document when transferred to the lender often remains behind – if I email you this article, you get a copy, but I retain a copy as well – means that it will be necessary to identify which copy is the original. We have already seen that HMRC will accept a scanned copy by email. Is that an original? An electronic share certificate may therefore be more susceptible to fraud than a hard copy certificate. Imagine if the share documents are obtained dishonestly and transferred to a bona fide purchaser with no notice of the equitable mortgage. While the possession of the hard copy share certificates provides good, although not perfect, protection against this – a fraudulent debtor might pretend to have lost the original certificate for example – the lender is more vulnerable to duplicates in the case of electronic documents.

This in turn raises another potential pitfall. If possession of the electronic share documents renders the lender more vulnerable does he have the possession and control required to dispossess the mortgagee and engage the Financial Collateral Arrangements (no 2) Regulations? The phrase is not properly defined in the Regulations, but it seems that the collateral taker must have the legal right to control the shares and to have taken practical steps to preclude the collateral provider from dealing freely with the collateral. This may be more difficult with electronic documents because of the greater ease of duplication.

A lender will need to insist on an agreement with the company, before accepting the security, as to the process by which the company treats an electronic document as an original for the purposes of validating a transfer. Can the lender, for example, send the certificate onwards to a transferee purchasing the shares after a default by the borrower and will this be accepted by the company as a valid original enabling a transfer of the shares to the buyer after a sale on default? A lender may wish to take steps to protect himself by taking control of the process. This could be by taking control of the master document, changing passwords and limiting access to trusted parties only; a lender might even print a copy out and write an agreed indorsement to identify the printed document as the original, although this seems a somewhat backward method of dealing with the issue.

It may be that smart contract and digital ledger technology will hold the key here. There is in principle no reason why a smart contract or blockchain could not hold company records. The company register could for instance be held on a permissioned digital ledger – one whereby the company acts the central administrator and enforces the rules of the system. There are some challenges to making this work under the current law; see Charles Kerrigan 'Digitalisation of Shares in an English Private Limited Company' (2020) 10 JIBFL 683. A smart contract operating on a digital ledger does, however, have the potential to provide the required functionality – it could provide for the payment of the price in given circumstances and the transfer of the shares. A smart contract can even be signed and this is so whether it is a natural language document to be performed by code or a contract consisting solely of code. If duly signed by two authorised signatories a smart contract could therefore be the electronic share certificate, protected via public key cryptography. A lender could therefore agree with the company and the borrower that on the borrower's agreement to deposit the share certificates with themselves they will be granted the private key required to enable them to initiate transactions with it and that the company will duly add a transaction to the ledger recording any sale and the identity of the new shareholder and issue a certificate – in smart contract form – to the transferee under section 776 of the Companies Act 2006. The possession of a private key should – although again it is not perfect protection – also allow the lender to demonstrate that the borrower has been dispossessed of the collateral and that the Financial Collateral Arrangements (no 2) Regulations apply which would disapply the need for the mortgage to be registered but more importantly allow for the remedy of appropriation.

**Conclusion**

There has been some confusion recently about the status of the transfer of the share certificate where a lender takes possession of the certificate and a blank signed stock transfer form. This does not create a legal mortgage, nor does title to the shares pass to the lender. The correct analysis is that there is an equitable mortgage of the shares. Possession of the share certificate helps protect the lender's priority, but also – probably – dispossesses the collateral provider to allow the bite of the financial collateral regime.

Increasingly such documents are accepted in electronic form – HMRC has made permanent its practice of accepting emailed pdf scans of stock transfer forms. This raises further issues around the possible duplication of documents and may increase the risk of fraud. These problems could be addressed by digital ledger technology, although has been noted by other articles in this journal (see Kerrigan above) English law does not make this easy and work to make it more straightforward is urgently required.