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Security Interests in Investment Property, Including Stock in Publicly Traded Companies

In order to secure loans to individuals or businesses, many lenders take a pledge of stock in a public or closely held corporation, a pledge of a membership interest in a limited liability company, or a pledge of a partnership interest in a general or limited partnership. This e-brief outlines the classification of such types of collateral as either securities or general intangibles, the method of creating and perfecting a security interest in such collateral, and special issues to be considered with regard to pledges of stock in publicly help companies.

1. Designation of Collateral As Either Investment Property or General Intangibles.

a. Corporate Stock - Investment Property. Generally, corporate stock is considered a security, which is encompassed within the class of collateral known as investment property under the Arkansas Uniform Commercial Code, codified at Ark. Code Ann. Section 4-1-101 et. seq. (the “UCC”). Under Article 9 of the UCC, “investment property” includes both certificated and uncertificated securities, security entitlements, securities accounts, commodity contracts and commodity accounts. The UCC defines “security” as an obligation of any issuer or a share, participation or other interest in an enterprise of an issuer that (a) is represented by a security certificate in bearer or registered form or may be registered on the books of the issuer, (ii) is one of or is divisible into a class or series of shares, participations, interest, or obligations and (iii) which either (a) is, or is of a type, dealt in or traded on a securities exchange or market or (b) is a medium for investment by and by its terms expressly provides that it is governed by Article 8 of the UCC. (8-102(15))

Typically, the Article 9 definition includes stock in corporations, but not necessarily limited liability company or partnership interests. Section 8-103(c) states that an interest in a partnership or limited liability company is not a security unless one of the following conditions is satisfied: (i) it is dealt in or traded on securities exchanges or in securities markets; (ii) its terms provide expressly provide that it is a security governed by Article 8; or (iii) it is an investment company security. For purposes of this memorandum, we will assume that we are not dealing with an investment company security.

While Article 8 of the UCC governs the method of transfer and registration of investment securities, Article 9 of the UCC governs creation, attachment, perfection and priority of security interests, including security interests in investment property.

As a general rule, we can say that an interest in a corporation, publicly held or closely held, is a security under Article 8. Interests in partnerships and limited liability companies, unless they trade on an exchange or the partnership agreement or operating agreement expressly provide otherwise, are general intangibles and thereby governed by Article 9. The only means by which to perfect an interest in a general intangible is by filing a financing statement.

b. Ownership Interests in Partnerships and Limited Liability Companies - General Intangibles. As noted above, limited liability company and partnership interests are usually considered “general intangibles” for purposes of the Article 9 rules regarding attachment, perfection, and priority of security interests. However, the issuer of a limited liability company or partnership interest may invoke certain provisions of Article 8 in order to change limited liability or partnership interests from general intangibles to “securities”, which are treated as investment property rather than as general intangibles for purposes of the Article 9 rules on attachment, perfection and priority. The designation of such interests as securities rather than general intangibles changes the method of perfection of those security interests.

Interests in limited partnerships and limited liabilities companies are not securities unless they are actually dealt in or traded on a security exchange or a securities market or by their terms are expressly stated to be governed by Article 8 of the UCC. Instead, they are generally treated as general intangibles under Article 9 of the UCC. If a limited liability company or partnership interest is a security and not a general intangible, having the interest certificated can provide benefits to the lender that are not available if the interest is a general intangible. For instance, if the lender obtains control or possession of a certificated security, no other party can obtain control of that security, and as a consequence, there can be no buyer of the security that is a protected purchaser (and therefore would take free of the lender’s security interest) and no competing lender can obtain priority by taking control or possession of the certificate. The secured party may also find it easier to obtain control of a certificated security (by taking possession of an indorsed certificate) rather than obtaining control of an uncertificated security. Control of an uncertificated security requires either registration of the security in the name of the lender (not likely to be an available means of holding a limited liability company or partnership interest) or a control agreement with the issuer of the security. While the issuer of the limited liability company or partnership interest may be willing to take the necessary steps for the interest to be a security and to issue a certificate, it may not be willing to undertake the responsibilities (and potential liability) involved in a control agreement.

2. Creation of Security Interest.

A security interest in stock or other ownership interest, including limited liability company membership interest or partnership interest, is typically granted pursuant to the terms of a security agreement, a stock pledge agreement, or another form of pledge agreement tailored to the pledge of an interest in a limited liability company or partnership.

A pledge agreement is often tailored to the specific pledge of stock (or limited liability company or partnership interest) and should require the pledging party to represent and warrant that (a) it has the power and authority to pledge the stock or interest, (b) the stock or interest is not otherwise encumbered, (c) the pledge of the stock or interest is not otherwise prohibited by contract or agreement (e.g. a shareholders’ agreement or a voting

trust agreement) and that, in the even the secured party were to execute on the stock or interest, no such agreement would prohibit transfer of full ownership rights, including voting rights, to the secured party, and (d) the ownership of the stock is registered, if required by applicable securities laws. Further, the pledge agreement should also contain negative restrictions on the pledging party that prohibit (y) further pledge or transfer of the stock or interest, and (z) entering into any shareholder or voting agreement that would limit the transferability or voting rights in the stock or interest.

3. **Perfection of Security Interests.**

a. **Investment Property.** A secured party may perfect its security interest in investment property, including securities, in any of three different ways:

i. ***Possession.*** For certificated securities only, a security interest may be perfected by delivery of possession of the certificate to the secured party or to a third party (not a secured intermediary) on behalf of the secured party (typically accompanied by a stock or transfer power executed in blank) (ARK. CODE § 4-9-313);

ii. ***UCC-1 – Financing Statement.*** For any investment property, a security interest may be perfected by the filing of a UCC-1 financing statement describing the investment property as collateral (either generally as a class or more specifically by subclass, type or item) with the applicable filing office (ARK. CODE § 4-9-312); or

iii. ***Control.*** For any investment property, a security interest may be perfected by control (ARK. CODE § 4-9-314). In general, control is generally conferred by some act sufficient to enable the secured party to sell the investment property without the further consent or cooperation of the debtor. For certificated securities, this is accomplished by delivery of the certificate to the secured party in bearer or registered form with indorsement to the secured party in blank or by registration in the name of the secured party in the books of the issuer (ARK. CODE § 4-8-106). For uncertificated investment property, control may be obtained by either becoming the entitlement holder or by a control agreement with both the securities intermediary and the debtor pursuant to which the securities intermediary agrees that it will comply with all entitlement orders given to it by the secured party without further consent from the debtor.

A security interest in investment property perfected by control will have priority over a security interest in the same collateral perfected by any other means. If two or more secured parties have perfected their security interest in the same investment property by control, those security interests will rank equally, regardless of when or how control was obtained. As to security interests perfected by any method other than control, the general rule of first to file or perfect will control. Often, a secured party will perfect its security interest by both possession or control and the filing of a UCC-1.

b. **General Intangibles.** As set forth above, the perfection of a security interest in general intangibles, which typically includes ownership interests in limited liability companies and partnerships, is accomplished by the filing of a UCC-1 financing statement describing the general intangible(s) as collateral (either generally as a class or more specifically by subclass, type or item) with the applicable filing office (ARK. CODE § 4-9-103). It does not matter if the limited liability company or partnership interest is represented by a certificate, only the filing of a UCC-

1 is effective if the interest is a general intangible. As mentioned above, the issuer may occasionally invoke Article 8 by classifying the interests as “securities”, in which event, the security interest in the limited liability company or partnership interest would be perfected in the same manner as any other investment property, including stock in a corporation. e.g. possession or control.

4. **Securities Laws Requirements – Publicly Held Companies.** The following is a summary of potential securities law issues surrounding pledges of securities issued by public companies, specifically, the various reporting requirements and liability issues that may be involved in each of three major events involved with a pledge of securities: (a) the pledge of the securities as security for the extension of the loan, (b) the declaration of default on the loan, and (c) the sale of the pledged securities by the lender.

a. Pledge of Securities

i. *Applicability of Margin Rules.* If the lender is extending credit to the pledgor for the purpose of purchasing or carrying the securities to be pledged (i.e., “purpose credit” in connection with a margin account), the loan may be subject to margin rules under Regulation U issued by the Federal Reserve Board. For example, under Regulation U, lenders may not extend credit to purchase or carry margin stock where the loan amount is more than 50% of the value of the margin stock securing the loan. Pledges of securities already owned by the pledgor and not in connection with a margin account, however, are not subject to the margin rules.

ii. *No Reporting Obligations for Lender or Pledgor.* Neither the lender nor the pledgor is required to report the pledge of securities to the Securities and Exchange Commission (“SEC”) because a pledge does not involve a change in beneficial ownership of the securities.

iii. *Potential Insider Trading Liability for Pledgor.* Where the pledgor is an “insider” (i.e., an executive officer, director, or principal shareholder) of the company that issued the stock, the pledge may have insider trading liability implications for the pledgor. For purposes of the antifraud provisions of the Securities Act of 1933 (the “**Securities Act**”) and the Securities Exchange Act of 1934 (the “**Exchange Act**”), a pledge of securities may be deemed to involve an “offer” or “sale” of securities. If the pledgor obtains a loan secured by public company securities while in possession of unfavorable material non-public information about the company and the pledgor then defaults on the loan after the value of the securities has dropped, he or she may be liable to the lender for the insufficient collateral.

b. Default on Loan Secured By Pledged Securities

i. *Section 13(d) Reporting Requirements of Lender.* A default on a loan secured by pledged securities, by itself, generally does not create SEC reporting obligations for the lender or the pledgor. Under certain circumstances, however, the lender and the pledgor may have reporting obligations under Section 13(d) of the Exchange Act. Section 13(d), and the corresponding rules issued by the SEC, require beneficial owners of 5% or more of a class of registered equity securities of a public company to file a report on Schedule 13D disclosing the number of shares owned by that beneficial owner.

If a borrower (or other obligor) has pledged securities totaling 5% or more of a class of registered equity

securities of a public company to a particular lender, the lender must determine when it becomes a beneficial owner of those pledged securities. Under the SEC rules, a person is a “beneficial owner” if such person has the power to vote or direct the voting of the securities or the power to dispose or direct the disposition of the securities. Where securities are pledged under a bona fide pledge agreement entered into in the ordinary course of business and not with the purpose or effect of changing or influencing control of the issuer, a lender that lacks the power to vote or dispose of the securities before default would not be deemed to be a beneficial owner of the securities until the lender:

- (A) has taken all formal steps necessary to declare a default, and
- (B) determines that the power to vote or direct the voting of the securities or to dispose or to direct the disposition of the securities will be exercised.

Once the lender has taken these steps with respect to pledged securities from a borrower totaling 5% or more of a class of registered equity securities of a public company, the lender will be subject to the Section 13(d) reporting requirements.

A lender that is subject to Section 13(d) reporting requirements as a result of securities pledged in the ordinary course of business and not with the purpose or effect of changing or influencing control of the company may file a short-form statement on Schedule 13G rather than the full Schedule 13D. The Schedule 13G generally must be filed within 45 days after the end of the calendar year in which the lender became subject to Section 13(d) reporting requirements. The lender does not need to file a report unless the lender is the beneficial owner of 5% or more of the company’s shares at the end of the calendar year. However, if the lender’s direct or indirect beneficial ownership interest in the subject company exceeds 10%, the lender must file the Schedule 13G within 10 days after the end of the first month in which the lender’s direct or indirect beneficial ownership exceeds 10% of the company, computed as of the last day of the month.

ii. *Section 13(d) Reporting Requirements of Pledgor.* Any pledgor subject to Section 13(d) reporting may be required to amend its most recent Schedule 13D or 13G report to reflect the pledgor’s disposition of the pledged securities as a result of the default. This could be the case even if the amount of securities pledged is less than 5% of the class of company securities. Under the SEC rules, the pledgor must promptly file an amendment to its Schedule 13D anytime there has been a material change in the information previously reported. An increase or decrease of 1% or more of the class of securities is deemed “material” for purposes of this requirement. In the case of a Schedule 13G, an amendment must be filed to reflect any changes in the information previously reported, except for a change in the percent of the class outstanding that results solely from a change in the number of shares outstanding. See Section 4(c)(ii) below for a discussion of the deadlines for filing an amendment to a Schedule 13G.

c. Sale of Pledged Securities By Lender

i. *Rule 144 Resale Requirements of Lender.* The sale of pledged securities by a lender following default may be subject to SEC Rule 144 under the Securities Act. The SEC views a lender that has accepted a pledge of securities as having stepped into the shoes of the pledgor for Rule 144 purposes. Rule 144 requires “affiliates” of the issuer and holders of “restricted securities” to comply with certain conditions in order to sell those securities

iii. *Section 13(d) Reporting Requirements of Pledgor.* See the discussion in the preceding section with respect to the pledgor's obligations under Section 13(d) following the lender's possession of the pledged securities upon the pledgor's default.

iv. *Section 16 Reporting Requirements and Liability of Pledgor.* Section 16 of the Exchange Act affects pledges of public company securities by an insider. Section 16(a) requires directors, certain officers, and beneficial owners of more than 10% of any class of registered equity securities of a public company to report their ownership and changes in their ownership of shares in that company. Section 16(b) creates "short-swing" trading liability for those directors, officers and beneficial owners if such persons profit from buying and selling or selling and buying shares of the company within a short time period. Any person subject to Section 16 must file an initial report on Form 3 stating their holdings in the issuing company's equity securities. Thereafter, the person must file a Form 4 within two business days after any acquisition or disposition of shares in the company and may be required to file an annual statement on Form 5.

Because the pledge of securities of a public company does not create a change of beneficial ownership of those securities, the pledge itself is not required to be reported under Section 16. However, if the pledgor is an insider, any sale of pledged shares by the lender after the pledgor's default must be reported by the pledgor on a Form 4 within two business days after the "execution" of the sale by the lender. In addition, the sale of the shares by the lender is attributable to the pledgor for Section 16(b) short-swing liability purposes. The circumstances surrounding the sale, including the pledgor's default, however, are not required to be disclosed.

v. *Potential Insider Trading Liability for Pledgor.* If the pledgor is an insider of the issuer of the pledged securities, the pledgor may be subject to insider trading liability where the pledgor is in possession of material nonpublic information at the time of the lender's sale of the pledged securities following the pledgor's default. Additionally, the pledgor generally cannot use the lender's sale of the pledged securities as an affirmative defense to insider trading liability because the pledgor is deemed to be in control (based on his or her ability to repay the loan or pledge additional collateral) of whether the pledged securities will be sold. The pledgor's possession of material nonpublic information is not attributable to the lender, and therefore, he or she cannot bar the lender from selling pledged securities by informing the lender that he or she is in possession of such material nonpublic information.

vi. *Disclosure in Company Proxy Statement.* Shares of common stock that have been pledged by a person who is a beneficial owner of more than 5% of a public company or by a director or executive officer of a public company should be disclosed in the beneficial ownership table of the company's proxy statement for its annual shareholder meeting as shares owned by such person as long as that person still has the power to vote or direct the voting of or to dispose or direct the disposition of the shares. The proxy statement should, however, indicate for each director and officer the amount of his or her shares that have been pledged as security.

Additionally, if a change in control of the issuing company has occurred and shares of the company are pledged as security for a loan that is used as part of the consideration for acquiring control of the issuing company, the terms of the loan or pledge obtained and the name of the lender must be disclosed in the proxy statement. However, if the loan is made in the ordinary course of business by a bank, the identity of the bank may be omitted

provided a confidentiality request has been filed with the SEC by the person(s) who acquired control.

These disclosures required in the proxy statement are the responsibility of the company (in the case of the company's proxy statement) or whomever is soliciting proxies from the company's shareholders.

d. Steps to Address Securities Law Issues Affecting Pledges of Securities in Public Companies

i. *Representations and Warranties of the Pledgor.* The lender will want to include at least some of the following representations and warranties concerning the pledged interest and the pledgor:

A. A representation as to whether the pledgor is or is not an "affiliate" (as defined in SEC Rule 144) of the issuer of the securities to be pledged.

B. A representation as to whether the securities to be pledged are or are not "restricted securities" (as defined in SEC Rule 144).

C. A representation as to whether or not the pledgor is presently subject to the reporting requirements under Section 13(d) of the Exchange Act.

D. If the pledgor is subject to Section 13(d) of the Exchange Act, a representation acknowledging that the pledgor understands that (a) if the pledgor is declared in default of the loan, the pledgor may be subject to reporting obligations under Section 13(d) of the Exchange Act and the SEC rules and regulations thereunder and (b) the lender is not responsible for the pledgor's compliance with any such obligations.

E. A representation as to whether or not the securities to be pledged represent 5% or more of the outstanding shares of a class of equity securities of the issuing company as of the date of the pledge agreement.

F. A representation as to whether the pledgor is or is not currently subject to Section 16 of the Exchange Act with respect to the issuer of the securities to be pledged and, if the pledgor is not currently subject to Section 16, that the pledgor will notify the lender if the pledgor becomes subject to Section 16 reporting requirements with respect to the issuer of the pledged securities.

G. If the pledgor is subject to Section 16 of the Exchange Act with respect to the issuer of the securities, a representation acknowledging that the pledgor understands that (a) if the lender declares the pledgor in default of the loan and sells the pledged securities, the pledgor may be subject to reporting obligations under Section 16 and the SEC rules and regulations thereunder and (b) the lender is not responsible for the pledgor's compliance with any such obligations. The lender may want to have the pledgor further acknowledge that the pledgor understands that (a) the pledgor may be subject to short-swing liability under Section 16(b) in connection with any sale of the pledged securities by the lender and (b) the lender is not required to notify the pledgor in advance of the date of its intended sale of the pledged securities or to postpone any intended sale of the pledged securities to facilitate the pledgor's compliance with Section 16(b).

H. A representation acknowledging that the pledgor understands that the pledgor is subject to antifraud liability under the federal securities laws if the pledgor is in possession of material nonpublic information at the time the securities are pledged or, if the pledgor is declared in default, at the time the securities are sold by the lender. The lender may want the pledgor to further acknowledge that the pledgor understands that, if at the time the pledgor is declared in default the pledgor informs the lender that the pledgor is in possession of material nonpublic information with respect to the pledged securities, the lender is not prevented from selling the pledged securities by its knowledge that the pledgor is in possession of material nonpublic information.

I. A representation as to whether the proceeds of the loan for which the securities are pledged will be used as consideration to acquire control of the issuer of the securities.

ii. *Additional Information From the Pledgor – Use of a Restricted Securities Statement or Closing Certificate.* As a matter of course, a lender may want to require the pledgor to complete a statement or closing certificate providing information about the pledged securities. The lender will want the pledgor to disclose and certify the date or dates upon which the pledgor acquired (according to the terms of Rule 144) the securities to be pledged. In addition, the statement will typically contain such information as the name of the issuer, the class of pledged securities and the total number of shares both owned by the pledgor and pledged by the pledgor, the date on which the securities were acquired and the manner in which they were acquired, description of any legends on the securities, whether the shares are subject to a registration statement and on what market the securities are traded, the social security number or taxpayer identification number of the pledgor, any affiliation, present or past, of the pledgor with the issuer, any contractual restriction on the pledge of the securities, including registration rights agreements shareholder agreements, etc., any shares of the issuer owned by family members or affiliates, disclosure of any other security interests pledged in the securities, and copies of any stock certificates, warrants, registration statements, Schedule 13D filings, shareholder agreements, or other material documents affecting the pledged securities.

iii. *Lending Procedures.* In addition to the above possible pledge agreement provisions, the lender should have procedures in place to determine if the lender would be subject to Section 13(d) reporting requirements upon a default by the pledgor and whether the lender would be required to file a report in such instance. The lender should also have procedures in place to ensure that any pledgor who may be subject to Section 13(d) or Section 16 reporting requirements is notified promptly upon any sale of the pledged securities.

5. **Special Considerations.**

a. **Representations and Warranties.** The lender may want to consider having the pledgor make representations and warranties that the pledged stock or interest is not only unencumbered, but that it is not subject to transfer or voting restrictions pursuant to a shareholders' agreement or a voting trust agreement, and that the pledgor will continue to refrain from encumbering the stock in a like manner.

b. **Designation of Collateral as Investment Property.** A lender with collateral consisting of limited liability company or partnership interests designated as investment property under Article 8 of the UCC (not usually the case) should take steps to keep its collateral designated as investment property. For example, the lender could have an agreement with the issuer not to "opt out" of Article 8, require that the limited liability company or partnership agreement provide that the "opt in" cannot be changed without the lender's consent, or get a proxy to

vote on an opt out. If the issuer opts out, the lender's security interest may become unperfected if the lender was relying on perfection by possession or control and may lose its priority. This is a good reason to go ahead and file a UCC-1 financing statement even if the lender's security interest has been perfected by possession or control.

c. General Intangibles. A lender with a general intangible as collateral should take steps to prevent that interest from becoming a security because transfer of possession of the security could provide the holder with priority. For example, the lender may consider an agreement with the issuer (or a provision in the limited liability company operating agreement or partnership agreement) prohibiting an opt in to Article 8 without the lender's consent or a proxy to vote on an opt in. If the issuer opts in when the lender did not plan to have securities as collateral, a buyer that qualifies as a protected purchaser would take free of the lender's interest and another lender could have priority over the first lender's security interest. A lender will also want to consider restricting mergers, consolidations or conversions by the limited liability company or partnership that could change whether the lender's security interest is a security or a general intangible and whether the security is certificated.