

Possible Future Work on Security Rights in Directly Held Securities

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1. Security rights in directly held securities (*i.e.*, the non-intermediated, non-public shares of a borrower and its direct or indirect subsidiaries) play an important role in many commercial loan transactions (often involving credit facilities extended to small or medium-size companies).
2. Security rights in these shares are often required by lenders in various frequently occurring situations, such as the following:
 - a. Situation #1: The borrower's assets include the shares of one or more wholly-owned subsidiaries.
 - i. In many cases the borrower is a holding company whose only assets are the shares of its subsidiaries.
 - ii. In this situation, the lender may be willing to extend credit to the borrower based, in whole or in part, on the value of the subsidiaries by obtaining security rights in the shares of the subsidiaries.
 - iii. The lender's primary source of repayment, if the borrower defaults in the repayment of the loan, is to sell the subsidiaries as going concerns via a sale of their shares.
 - b. Situation #2: The lender also holds security rights in the borrower's receivables, inventory and other assets and requests security rights in the shares of the borrower and/or its subsidiaries to provide an alternate "exit strategy" if the borrower defaults.
 - i. Selling the business as a going concern might result in a greater, more expeditious and less costly recovery than if the lender enforced its security rights in the borrower's assets by collecting receivables and selling other assets at auction.
 - (1) A buyer may be willing to pay more for a functioning business.
 - (2) Preserving the business as a going concern could also preserve tax benefits or contractual arrangements.
 - c. Situation #3: The loan is to a corporate group that is engaged in a single business that shares managerial and other support services and assets.
 - i. The prospect of preserving the going concern value of the entire enterprise in this circumstance by means of security rights in the shares of the parent company may be essential to a lender considering a loan to such an enterprise.
 - d. Situation #4: The lender is unable to obtain a direct security right in certain assets of the borrower due to legal or economic factors, such as the following:
 - i. The borrower's assets may include leases, licenses, purchase and sale contracts or other assets in which the borrower may be contractually prohibited from granting a security right.

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- ii. Where the assets are owned by a subsidiary or affiliate of the borrower, applicable corporate governance laws may restrict the ability of a company to grant a security right in its assets to secure a loan made to its parent or affiliate.
- iii. Applicable secured transactions laws may not recognize security rights in certain of the assets of the borrower, such as certain types of intellectual property.
- iv. Where the requested loan is intended to finance the acquisition of the shares of the borrower, applicable “financial assistance” laws (prevalent in the EU) may make it unlawful for that borrower to grant a security right in its assets to secure such a loan.
- v. Applicable tax laws may impose a substantial economic burden on a company that grants a security right in its assets to secure a loan its non-domestic parent or affiliate companies.

In each of these circumstances, even though the lender is unable to obtain a security right in the assets of a company, it may be able to secure its loan with such assets indirectly by obtaining a security right in the shares of the company. Although a security right in the shares of a company will be subordinate to the claims of other creditors of the company, such a security right nevertheless may have sufficient value to induce a lender to extend credit.

- 3. The option of preserving the going concern value of the borrower and its subsidiaries can be important to the borrower and third parties as well as to the lender.
 - a. It may induce the lender to extend more credit to the borrower than it otherwise would, or to extend credit on better terms.
 - b. It decreases likelihood of a deficiency, and increases likelihood of excess recovery for other creditors and equity holders
 - c. It provides a potential social benefit in that jobs may be preserved.
- 4. The laws of most States currently provide a mechanism for obtaining a security right in shares of at least certain types of domestic corporate entities. However, as is currently the case with security rights in receivables, inventory, equipment and other movables, these laws vary greatly from State to State.
 - a. Creation (degree of formality required)
 - b. Third-party effectiveness (possession of certificated shares, filing)
 - c. Priority
 - d. Enforcement (judicial vs. nonjudicial)
- 5. Modern laws setting forth clear and predictable rules for the creation and enforcement of such security rights in an efficient and cost-effective manner would facilitate the extension of secured credit for small and medium-size companies in States that adopt such laws, by encouraging lenders to extend credit in situations where they would otherwise be unwilling to do so, or to provide more credit on better terms.
- 6. Therefore, UNCITRAL should consider further work in the area of security rights in directly held securities.