

REVIEWING A SHARE CHARGE FOR A CHARGOR: CHECKLIST

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A checklist of key points for a chargor's lawyer to consider when reviewing a share charge prepared by the lender's lawyers.

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CONTENTS

- Scope of this checklist
- Preliminary considerations
- Type of security
- Covenant to pay (or not)
- Representations and warranties
- Undertakings
- Treatment of distribution and voting rights during the security period
- Enforcement and other provisions
- Post-execution formalities

SCOPE OF THIS CHECKLIST

Lenders often take share charges as security for the monies owing to them by a borrower under a loan agreement. A share charge will typically enable the lender to take control of the company in which shares are held upon enforcement.

This checklist focuses on the key points for a chargor's lawyer to be aware of when reviewing and negotiating a share charge. However, it does not aim to provide a comprehensive analysis of all potential issues associated with taking security over shares. For more information on taking security over shares, see [Practice note, Taking security over shares and debt securities](#) and [Toolkit, Security over shares](#).

This checklist assumes the following:

- The security is being granted by the chargor which is a company incorporated in England and Wales.
- The security is being granted in favour of a single lender that is a bank.
- The shares subject to the security are certificated registered shares owned by the chargor in the share capital of a private limited company (the issuing company) incorporated in England and Wales.
- The liabilities being secured are those owed to the lender under a bilateral loan agreement.

PRELIMINARY CONSIDERATIONS

- Consider what kind of shares have been issued by the issuing company.

Certificated registered shares are typically evidenced by a share certificate (the original of which is usually delivered to the lender (or its nominee) upon execution of the share charge, along with a stock transfer form), but title in respect of which is transferred only upon the registration of the transferee in the register of members.

RESOURCE INFORMATION

RESOURCE ID

w-022-4895

RESOURCE TYPE

Practice note

CREATED ON DATE

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JURISDICTION

England, Wales

Exceptionally, the shares issued by a company may be negotiable or bearer shares or dematerialised (uncertificated) shares held in a clearing system such as CREST. However, this checklist does not consider the implications of granting security over bearer shares or uncertificated shares.

- Consider whether taking security over the issuing company might lead to the lender incurring liabilities.

Share charges in respect of certificated registered shares are amongst the most popular forms of security interest, as they are quite simple to create and enforce in practice. However, there may be certain kinds of English company over which share security is not attractive from the lender's perspective, in particular if on enforcement a lender could inherit certain liabilities.

Examples of companies over which lenders might be wary of taking share charges (because to do so might mean the lender incurs certain liabilities) include the following:

- those with unlimited liability (for information on these types of company, see *Practice note, Unlimited companies*);
- those with a defined benefit pension scheme which is underfunded (for information on this issue for lenders, see *Toolkit, Security over shares*); and
- those that could possibly have environmental liabilities (for more information, see *Practice note, Environmental issues in finance transactions*).

- Consider the identity of the shareholder(s).

Matters are usually straightforward where the shares are held by a single parent company incorporated in England and Wales. Complications can arise where there are multiple shareholders, both logistically but also legally where, for example, there are shareholders' agreements in place that may place restrictions on what shareholders can or cannot do with their shares.

If a lender is taking security over some (but not all) of the shares issued by a company with multiple shareholders, be careful to clearly identify which of those shares are subject to the security by reference to the share certificate numbers held by the relevant chargor(s). Simply referring to the charged shares as, for example, "60% of the issuing company's shares" in such circumstances is inadequate. For further information see *Practice note, Taking security over shares and debt securities: Which shares or debt securities is security being taken over?*

- Check the articles of association of the issuing company to see if they contain provisions providing for any of the following:
 - a lien on any unpaid share capital;
 - pre-emption rights in favour of any specified persons on any transfer of shares; or
 - any discretion for the directors of the company whose shares are charged to decline to register any transfer of shares to a new shareholder

A secured lender will want any provisions dealing with the above to be removed or dis-applied for the duration of the security period so that they do not interfere with any enforcement of its security over shares in the issuing company. As such, it is a good idea to remove such provisions or suspend them for the duration of the security period from as early as possible during negotiations on a transaction to avoid any delays later. For more information on disapplying restrictions of the kind referred to above, see *Toolkit, Security over shares: Restrictions in issuing company's articles of association*.

- Consider whether the shares to be subject to the security are admitted to trading on a regulated market (a listed company) or a prescribed market (such as the Alternative Investment Market (AIM)).

If the shares are admitted to either of these markets, there may be disclosure obligations under the Financial Conduct Authority's Disclosure Guidance and Transparency Rules and the Market Abuse Regulation, as well as the AIM Rules for Companies in the case of AIM companies, that the chargor will have to comply with. For more information, see *Practice note, Taking security over shares and debt securities: Disclosure obligations*.

- Check to ensure that the issuing company has not issued a restrictions notice in respect of any shares that are intended to be subject to security.

A company may issue a restrictions notice in respect of its shares if a registrable person with significant control (PSC) or a relevant legal entity (RLE) fails to comply with certain notices served on it by the company in connection with creating or maintaining its PSC register (under *sections 790D* and *790E* of the Companies Act 2006).

A restrictions notice prevents any rights in respect of those shares being exercised (and voids any transfer of those shares unless pursuant to a court order), and therefore prevents any enforcement of security over those shares. This means that a lender would be unable to sell those shares or exercise any right of appropriation over them in the absence of a court order authorising the same.

As such, it is not unusual to find the following provisions included in share charges to minimise the risk that the lender's enforcement rights are limited by the issue of a restrictions notice:

- a representation from the chargor that no restrictions notice has been issued that could limit the lender's right to enforce its security;
- a covenant that requires the chargor to comply with any notices it may receive under sections 790D and 790E Companies Act 2006; and
- a provision entitling the lender to enforce its security if a warning notice is issued in respect of shares over which it has security.

All of these provisions are acceptable from a chargor's perspective.

For more information on this, see [Toolkit, Security over shares: PSC register](#).

- Finally, before reviewing any share charge, consider whether there are any agreed common security principles governing the terms of all security interests to be granted in connection with the transaction.

Common security principles are often agreed at the outset of any large finance transaction, and where they exist a security provider's lawyers should be familiar with them as they will inform much of the content of each security document.

TYPE OF SECURITY

- Consider what type of security the lender is taking over the shares.

The type of security being taken will affect the chargor in terms of practical steps it will need to take, and documents it will need to produce, to ensure the security is properly created. The chargor will also need to consider the impact the type of security taken will have on any voting and dividend rights it may have in respect of the relevant shares.

- Consider whether the lender is taking a legal mortgage over the shares.

A legal mortgage over registered shares requires the transfer of legal title to the shares to the lender (or its nominee). This involves the following:

- transfer of ownership of the shares (using a stock transfer form) to the lender (or its nominee);
- registration of the lender (or its nominee) as owner of the relevant shares in the share register of the issuing company; and
- the issue of a share certificate evidencing the lender (or its nominee) as holder of those shares.

So if the lender is taking a legal mortgage, from the chargor's perspective it is critical that the security document includes an obligation on the lender to re-transfer or assign the shares back to the chargor once the secured obligations have been discharged.

However, most shareholders will want to avoid transferring ownership of their shares to a lender before the lender enforces its security. There are also good reasons why a lender may not wish to be registered as the legal owner of the shares and will favour the use of an equitable mortgage or charge instead (for a discussion of this issue, see [Practice note, Taking security over shares and debt securities: Advantages and disadvantages for a lender of taking a legal mortgage](#)). These reasons mean that, in practice, most share security documents in respect of certificated registered shares issued by a private limited company take the form of a share charge or an equitable mortgage over shares. These share security documents will typically purport to create a fixed charge or equitable mortgage over the relevant shares, and any dividends, interest and other rights arising in respect of those shares.

If, however, a lender is taking a legal mortgage then, as registered owner of the shares, the lender will typically acquire dividend and voting rights in respect of them. However, a chargor will usually want to retain dividend and voting rights at least until the lender enforces or can enforce its security. The chargor's lawyers will therefore need to discuss this with the lender's lawyers and consider how to deal with this in the documentation. For more information on how dividends and voting rights may be dealt with in a share security document, see [Toolkit, Security over shares: Voting rights and dividends](#).

- Consider whether the lender is taking a charge or equitable mortgage over the shares.

Share charges or equitable mortgages usually require (in addition to the execution of the security document itself) the chargor to deposit the following with the lender (or its nominee):

- the original share certificate(s); and
- a signed but undated stock transfer form with the name of the transferee left blank.

This means that on enforcement the lender holds the necessary documentation to transfer the shares either to itself or another entity. The directors of the issuing company will still need to register any transfer in the issuing company's register of members for legal ownership of the shares to change. So, the lender's lawyers will require any directors' discretion to decline to register any such transfer to be suspended, at least for the duration of the security period. This requirement is uncontroversial from a chargor's perspective.

Since the lender will not be the registered owner of the shares in the share register of the issuing company, it will not ordinarily acquire any dividend or voting rights in respect of the shares (unlike the situation when a legal mortgage is taken over shares). Dividend and voting rights will typically continue to reside with the chargor before the lender enforces its security and this is often specifically stated to be the case in a share security document. This is obviously a more favourable position from a chargor's perspective. For more information on how dividends and voting rights may be dealt with in a share security document, see [Toolkit, Security over shares: Voting rights and dividends](#).

COVENANT TO PAY (OR NOT)

- Think carefully about what recourse the lender should have to the chargor in the event of enforcement.

Share charges are often taken by way of third party security, where the chargor is not acting as a guarantor of the borrower's obligations. In other words, the chargor is merely providing some security to the lender for the borrower's obligations. Where that is the case, the lender's recourse should be limited to the charged shares only, without any recourse to the chargor or any of its other assets if realisations from enforcing the share charge are insufficient to discharge the borrower's liabilities. Limited recourse wording can be included in the share charge to this effect and some chargors may ask to delete any covenant to pay since the intention is that the chargor should not owe any direct debt obligations to the security beneficiary.

- Where a covenant to pay is included, check the scope of the secured obligations to ensure that any appropriate limitations are included.

In particular, consider whether the secured obligations should be all monies in nature or extend only to those arising under specified loan arrangements.

Where share security is taken together with other security interests, ensure the secured obligations mirror and do not go beyond the scope of the secured obligations in other security documents.

- Check whether the covenant to pay includes language entitling the lender to charge default interest on any sum outstanding under the share charge.

If so, the default interest rate should correspond to that agreed under the relevant loan agreement. A default interest provision is not strictly necessary if the share charge secures the obligations owing under another agreement (such as a loan agreement) if that other agreement already includes an appropriate default interest clause that covers defaults in payment under the share charge.

REPRESENTATIONS AND WARRANTIES

- Review the representations and warranties set out in the share charge.

From the chargor's perspective, representations and warranties should preferably be limited to the nature of the security being granted. It is common in a share charge to see representations and warranties that confirm the following:

- That the shares are fully paid and are not subject to any option to purchase or similar rights.
- That the chargor is the sole legal and beneficial owner of the shares.
- That the shares as described or identified in the share charge represent the entire issued share capital of the issuing company.

- That the constitutional documents of the issuing company do not contain any restrictions that might inhibit the enforcement of the share charge (see *Preliminary considerations*).
- That the chargor has complied with any notices received by it pursuant to *sections 790D* and *790E* of the Companies Act 2006 (see *Preliminary considerations*).
- That the shares are not subject to any other security and the obligations of the chargor are legal, valid, binding and enforceable. This last representation does not need to be included if the representations and warranties in any related loan agreement already extend to other finance documents including the share charge.

For examples of the representations and warranties typically included in a share charge, see *Standard document, Charge over shares: clause 5*.

- Check that any representations and warranties which are similar to those in the loan agreement adopt the same wording as those in the loan agreement.

Check that the same qualifications are included, and also that the representations and warranties are given or repeat at the same time(s) (but no more frequently) at which the representations and warranties are given or repeat under the loan agreement.

Alternatively, if any representations and warranties are the same as those contained in the loan agreement, delete them entirely if the representations and warranties in the loan agreement extend to all finance documents.

- Check whether any representations and warranties need to be qualified if the chargor is unable to give the security with “full title guarantee”.

The use of the words “with full title guarantee” in a charging clause operates to incorporate the covenants set out under *sections 2* and *3* of the Law of Property (Miscellaneous Provisions) Act 1994. These include the covenants that the person making the disposition (that is, the chargor) does so free from all charges and other encumbrances and all other rights exercisable by third parties.

There may be situations where it is not possible for a chargor to give such covenants without some qualification, for example, where there is a second ranking charge being granted over all or some of the same shares. In such cases, it is common to leave the full title guarantee statement unamended but to qualify any related representations and warranties to reflect those other interests.

UNDERTAKINGS

- Check the undertakings in the share charge.

From the chargor’s perspective, the undertakings included in any share charge should be quite limited in length, and certainly less extensive than one might expect to see in a debenture given the more limited nature of the assets subject to security.

A share charge will typically include the following undertakings:

- A negative pledge, prohibiting the creation of any other security over the shares in question. For information on negative pledges, see *Practice note, Negative pledges in loan transactions*.
- A restriction on disposals of the shares.
- An obligation to pay all calls and other payments which might be made or become due in respect of the shares. For information on why this undertaking is included, see *Standard document, Charge over shares: Drafting note: Calls and other obligations*.
- An obligation to procure that the issuing company does not allot or issue any additional shares except in favour of the chargor and then only to the extent that any new shares are covered by the share charge (including in relation to any perfection requirements), amend its constitutional documents (except for minor or administrative amendments or amendments that do not materially affect the interests of the lender or any other finance parties), or implement any variation of any rights attaching to any of the shares subject to the security.
- An undertaking to perfect the security by delivering original documentation of title to the lender, and to take any further steps necessary or desirable to create the security in question.
- An obligation to ensure the chargor complies with requests for information that it may receive from the issuing company under *sections 790D*, *790E* and *793* of the Companies Act 2006 (see *Preliminary considerations*).

For examples of the undertakings typically included in a share charge, see *Standard document, Charge over shares: clause 6*.

- Beyond the above, be careful to ensure that there are no unusual or inappropriate undertakings in the share charge unless they have been specifically agreed.

Examples of undertakings we have seen included in share charges but which in our view go too far are the following:

- information undertakings that go beyond the information undertakings set out in the loan agreement; and
 - an obligation to ensure that a lender representative is appointed as a board observer or member of the board of directors of the issuing company before enforcement.
- Check that any undertakings which are similar to those in the loan agreement adopt the same wording as those in the loan agreement.

Alternatively, if any undertakings are the same as those in the loan agreement, delete them entirely if the undertakings in the loan agreement extend to all finance documents.

TREATMENT OF DISTRIBUTION AND VOTING RIGHTS DURING THE SECURITY PERIOD

- Check how distributions and voting rights are treated during the security period.

It is now quite common for lenders to allow the chargor to continue to receive distributions with respect to the shares subject to security pending the occurrence of a default or enforcement of the security.

A similar regime often applies with respect to the exercise of voting rights by the chargor during the security period, although an additional caveat is often added that the charger should not exercise voting rights in any way that may be detrimental to the interests of the secured parties. This caveat is not controversial for a chargor.

- Consider how distributions are treated under the terms of the loan agreement.

Often there will be a “permitted distribution” concept in a loan agreement which should then be reflected in the share charge. This concept often allows the declaration of distributions at a level below the borrower or parent entity because the recipient will typically be within the security net.

There may, however, be more restrictions on the making of distributions at borrower or parent level to prevent cash leakage outside of the obligor group. These restrictions are likely to apply for so long as the borrowing group’s leverage levels are above a certain threshold. If the share charge relates to shares in a borrower or parent entity, ensure that it respects such principles.

ENFORCEMENT AND OTHER PROVISIONS

- Consider whether the chargor can comply with perfection formalities within any prescribed deadlines under the share charge.

For example, if the share charge is being taken at the same time as the relevant shares are acquired from a third party, it will not be possible for the chargor to deliver a share certificate evidencing its ownership of those shares until after a duly completed stock transfer form is presented for stamping to the Stamp Office. In such cases, it is usual for the lender to require that the chargor provide the lender (or its representatives) with a signed but undated blank stock transfer form in respect of the charged shares at or shortly following execution of the share charge. The lender will also require the chargor to deliver the signed share certificate evidencing its ownership of the charged shares following receipt of the stamped stock transfer form (concerning the transfer of the charged shares from the third party to the chargor) from the Stamp Office.

- Check when the security becomes enforceable.

A chargor will usually prefer that the lender is able to enforce its security only after (and not before) a declared default. This means following the occurrence of an event of default, in respect of which the lender has elected to accelerate the underlying loan facilities.

- Make sure that the provisions dealing with the application of any proceeds of enforcement are aligned to any relevant provision in any loan or intercreditor agreement.

Typically, recoveries will be required to be applied in the following order:

- first towards the costs of enforcement (including in discharging any receiver or similar person's fees, costs and expenses);
- then towards the discharge of the secured obligations; and
- finally any surplus recoveries are ordinarily distributed to any other person entitled to them.

- Check when the power of attorney in the share charge can be exercised by the lender.

Powers of attorney are often included in share charges as with any other security document. A chargor will often request that the power is not exercised by the lender unless an event of default occurs and is continuing. If that is not acceptable to the lender, an alternative is to ask that it is only exercised where the chargor has failed to comply with an obligation under the share charge after being given notice of such failure by the lender.

- Ask for an undertaking by the lender to release the security constituted by the share charge at the end of the security period.
- Delete costs provisions to the extent they are already covered by any loan agreement or, alternatively, align those provisions to the equivalent provisions in the loan agreement.

It is usual for a chargor to reimburse the lender for its reasonable costs and expenses incurred in connection with the negotiation, execution and implementation of a share charge within an agreed period of time following demand. Enforcement costs are often not subject to any reasonableness qualification.

POST-EXECUTION FORMALITIES

- Check whether the share charge needs to be registered at Companies House.

A share charge in respect of shares in a company incorporated in England and Wales should be registered at Companies House if the chargor is itself a company (or limited liability partnership) incorporated in England and Wales.

Even though the registration regime is voluntary, where the chargor is a company or limited liability partnership incorporated in England and Wales, it is common practice to register a charge within 21 days of its creation at Companies House by filing Form MR01. This is because of the consequences of non-registration of a charge at Companies House which are as follows:

- the charge will be void against a liquidator, administrator or any creditor of the company. This will be a concern for the lender; and
- the monies secured by the charge will become immediately payable at the end of the 21 day period. This will be a concern for the chargor.

However, if the *Financial Collateral Arrangements (No.2) Regulations 2003 (SI 2003/3226)* (FCA Regulations 2003) apply to the arrangement, then registration may not be necessary (for more information, see below).

For more information on this registration regime, see *Practice note: overview, Registration of charges created by companies and limited liability partnerships on or after 6 April 2013*.

A share charge does not need to be registered under the Bills of Sale Act 1878 if the chargor is an individual, as that statute expressly excludes security over interests in the capital or property of incorporated or joint stock companies or any choses in action (see *Practice note, Security bills of sale*).

- Check whether the FCA Regulations 2003 apply to the arrangement.

Where the FCA Regulations 2003 apply:

- the security does not need to be registered at Companies House; and
- the security taker will be entitled to enforce the security without the consent of any administrator, court or liquidator, even if a moratorium is in place.

At first blush, share security arrangements would appear to fall within the scope of the FCA Regulations 2003 which define "financial collateral" as including "financial instruments" (which, as defined in the FCA Regulations, include shares in companies and other securities equivalent to shares in companies).

However, in order for the FCA Regulations 2003 to apply, both the security taker and security provider must be non-natural persons. Moreover, the financial collateral must be in the possession or control of the security taker, which in the case of a share charge might be achieved by the chargee holding the original share certificate and blank stock transfer form in respect of the charged shares.

Given the uncertainty around the applicability of the FCA Regulations 2003 (in particular, where a share charge covers both financial collateral and other assets), practitioners often err on the side of caution and choose to register share charges at Companies House as described above. For more information on why practitioners often choose to comply with these registration formalities, see [Practice note, Financial collateral arrangements: Reasons why formalities are still complied with](#).