

# Pledging Of Shares Of A Limited Liability Company - Facts or Fiction?

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Along with this exists an underlying frustration of lenders at the inability to take security over such companies which, more often than not, represent a substantial value and source of income within any customer group.

There are various issues under UAE law surrounding the pledging of shares in limited liability companies, including the lack of an official register on which to record such security. Although today the debate (or more correctly, the certainty around such debate) has not progressed much further, there are new developments which have prompted this article and a need to revisit the issue.

## II. Companies in the UAE

In order to understand the debate, it is first important to understand the types of companies in the UAE and their corporate structure. Law No. 8 of 1984 ("Commercial Companies Law") defines the structure of various corporate entities and the elements that comprise each. Among these the public joint stock company, private joint stock company and the limited liability company are the key targets for share security.

Joint stock companies issue shares that are easily valued, tradeable, and may be maintained by a bailee in the event they are provided as security, and it is common practice in the market to register pledges over shares of such companies that are centrally deposited. The central depository in such circumstances acts as the bailee on behalf of the pledgor.

A limited liability company on the other hand is much more of a private entity between limited partners. A limited liability company requires a minimum of two partners and a private partners' registry is maintained where the percentage of allocation of ownership is listed, typically referred to as quotas. Such quotas are similar to shares, however they are not actually issued as certificates of ownership, therefore, restricting the ability to perfect a possessory pledge. While it is not uncommon for the memorandum of association of limited liability companies to refer to "shares" and the "shareholding" of owners, from a technical perspective these companies have partners with an interest or quotas in the company.

## III. What are the requirements for a pledge?

When pledging shares of a company, the possessory pledge is the one that is the most relevant in such situations. Therefore, it is important to understand what is a possessory pledge. A possessory pledge is a conditional pledge and assumes that the pledged asset is in the possession of the pledgee or a third party. In accordance with Article 1449 of Law No. 5 of 1985 (the "Civil Transactions Law"), the possessory pledge is comprised of two important elements, requiring that the assets subject to the pledge must be capable of: (i) delivery at the time the pledge is made, and (ii) sale by public auction.

Pledges are a common form of security in the UAE to secure various liabilities and obligations, typically associated with a bank debt. The section below will provide a more general understanding of pledges with respect to the pledging of shares and further explain the difficulties that have been faced with such security in relation to limited liability companies.

The Commercial Companies Law outlines the necessary requirements to obtain a possessory pledge over shares of a joint stock company. Article 164 of the Commercial Companies Law, notes that: shares may be pledged by providing a pledge in accordance with specific requirements as further noted in Article 162 of the Commercial Companies Law. Such requirements include: annotating the share ledger of the company with reference to the pledge, marking the pledge on the share and although, not a formal requirement under the Commercial Companies Law, the execution of a share pledge agreement, which outlines (i) the liabilities, (ii) the conditions to release the security, (iii) voting rights, (iv) dividend rights, and (v) all other matters pertaining to the terms of the agreement is advised. Additionally, it is important to note that in accordance with the Commercial Companies Law all rights related to the pledge of such shares will be deemed pledged unless otherwise agreed between the parties (i.e. dividends and voting rights).

Listed shares of a public joint stock company may be pledged in accordance with Article (26) of the Ministerial Resolution No. 2 for the year 2001 concerning trading, clearing, settlement, transfer of ownership and custody of shares, which allows for shares to be pledged by clearly marking the shares on the shareholders' registry maintained by the clearing department. In this instance, the clearing department is acting as the bailee of the shares pledged and securing the pledge on behalf of the pledgor.

Similarly, when pledging shares of a private joint stock company, in accordance with Article 216 of the Commercial Companies Law, the shares of the private joint stock company are earmarked with the pledge and the shareholders' registry is maintained with licensed ledger custodian ensuring the protection of the pledge.

There are no similar provisions for pledging of shares/quotas in limited liability companies.

#### **IV. Difficulties with the limited liability company**

One of the distinguishing features between the limited liability company and both the joint stock companies is that there is no issuance of shares (or share certificates) of a limited liability company. As previously noted, a limited liability company has quotas.

Under Article 228 of the Commercial Companies Law the company shall retain a special register for partners which shall include the detailed information relating to the quota of each partner including any transactions with respect to each quota. The registry of the partners is maintained in the memorandum of association of the company in addition to a separate register maintained by the company – there is no independent register or third party to maintain it. If a partner purports to grant a pledge over his quota, there is no formal mechanism to mark the quota as required in order to perfect a possessory pledge.

While the Commercial Companies Law lists the requirements for the assignment of a quota, there is no further mention of particular requirements for pledging quotas of a limited liability company.

#### **IV. What changed?**

Recently, the Dubai Economic Department (“DED”) has allowed, on a case by case basis, the filing of pledges over quotas in limited liability companies. While there are no written regulations, of which we are aware, which stipulate the procedure and requirements to file, or the effect of such filing, this development has opened up new possibilities for lenders and has renewed the long standing debate of the ability of perfecting such a security.

At present we understand the DED, when accepting the pledges for filing, is requiring that such pledges are duly notarized. While we are aware of such filings occurring in practice, such practice has not to our knowledge been formally adopted nor is it clear as to the legal effect or the policy of the DED on the maintenance and scope of the ‘security register’. It is further unclear, what restrictions, if any, the DED will impose on filing pledges with respect to ensuring the maintenance of UAE national ownership. Lastly, there is also the possibility that notaries will object to the pledge on the grounds of Article 17 of the Commercial Companies Law (as discussed below).

## **V. Is it enforceable?**

As with any security the focus is on enforceability. Unfortunately, due to the issues outlined in this article and the underlying corporate structure of limited liability companies, the question of enforceability remains uncertain.

However, in terms of enforcement it is worth mentioning Article 17 of the Commercial Companies Law which provides for a restriction on creditors to recover their debt from a partner's quota in a company's capital, rather it is only the dividends/profit of the company which is available. However the article does go on to provide that if shares represent a partner's interest, a creditor may request the sale of those shares.

While the distinction between the capital of the company and a partner's share is not entirely clear for enforcement purposes, including its application to limited liability companies, Article 17 can have implications when applying to court for an attachment against a partner's quota in a limited liability company. The court is likely to reject such an application due to two reasons. The first is Article 17 and the second is that such an application does not meet the attachment requirements under the UAE Civil Procedures Law No. 11 of 1992 under which the attachment application must clearly identify the nature of the assets to be attached. Such an approach was taken by the Dubai Court of Cassation in 2005 although, unfortunately, the judgment did not include substantive legal analysis. However, it could be argued that an attachment application is likely to be accepted by the court if such an application is filed against the dividends/profit of the partner (and not the partner's quota in itself). Although the profit is unknown, Article 290 of the Civil Procedures Law No. 11 of 1992 allows attachment against profits of shares or quotas. The aforementioned Article should be applied in conjunction with Article 157 of the same law which provides for the concept of garnishment under which a creditor may attach the assets of its debtor in the hand of a third party.

One must also consider the many other issues with enforcement – priority between competing security, and the problems which are inherent with any private company including valuations, nominee arrangements, pre-emptive rights, management and the value/marketability of quota in a limited liability company (especially if it is anything less than 100%).

## **VII. So is there any benefit for a lender?**

Notwithstanding the issues highlighted in this article, which will remain the subject of debate until formal procedures are adopted or legal precedent exists, to the extent a lender is able to file a pledge with the DED, such filing may have some value. If nothing else, and assuming the DED follows the role of a normal security register (ie to restrict future dealings), the pledge can act as a registered negative pledge preventing any disposition of the quotas being registered at the DED.

## **VI. Conclusion**

This new filing procedure is untested on many levels, and the underlying issues surrounding the legal ability to pledge quotas and enforcement remains. It clearly does not offer the certainty or value a pledge over listed shares offers to lenders. Notwithstanding this lenders may see value in having at least, in theory, an element of control over the quotas through the filing and to a certain extent it may fall within the category of 'better to have than not to have'.

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