

In *In re Karcredit LLC*, US Bankruptcy Court Holds Stock Issuer Liable to Lender for Double-Pledged Stock

WRITTEN BY

Deborah J. Enea | Alexandra L. Rice

In *In re Karcredit LLC* [1], the U.S. Bankruptcy Court for the Western District of Louisiana was faced with two lenders with claims to one original stock certificate as collateral. On June 1, the court held that the corporation that issued the double-pledged shares was liable to the first lender under Article 8 of the Uniform Commercial Code (UCC), as adopted in Louisiana, as a protected purchaser and for breaching the terms of its merger agreement and the express provisions of its stock certificate.

An insider to a debtor pledged the original certificate as security for its guaranteed obligations under a loan to an affiliated entity. After the replacement certificate was issued, the insider pledged the replacement certificate to a different lender to secure a separate loan made to the debtor. The court noted that although the debtor is at fault for originating the double pledge, the issuer of the stock also must be held accountable because it knew that both lenders held a security interest in the same stock.

The Double-Pledge Scheme

In 2006, Ronnie Ward guaranteed a \$683,825.00 loan made by Caldwell Bank & Trust Company to an entity owned by Ward. To secure the loan, Ward pledged stock shares to Caldwell Bank in Homeland Bancshares, Inc., represented by Certificate 253. Under UCC Article 9, a secured party may perfect a security interest in investment property by filing a UCC-1 financing statement, which is generally sufficient to perfect a security interest, or by control, for example by possessing the original stock certificate. Only one secured party at a time can perfect by possession of an original stock certificate. Caldwell Bank took possession of Certificate 253, thereby perfecting its security interest in the shares.

Subsequently, Homeland Bancshares, Inc. merged with Homeland Interim Company. The merger agreement required the cancellation of all existing Homeland Bancshares, Inc. stock and the reissuance of stock in the Homeland combined entity. The merger agreement expressly stated that only the holder of the existing Homeland Bancshares, Inc. stock certificates could surrender the certificates for replacement shares. Ward signed a lost stock affidavit, falsely claiming he lost Certificate 253, and requested a replacement stock certificate. Homeland cancelled the certificate and issued Ward a replacement certificate: Certificate 495. Caldwell Bank, unaware of Certificate 253's cancellation, made additional loans secured by Certificate 253. Since at least July 11, 2016, Homeland had actual knowledge that Ward pledged his stock in Homeland to Caldwell Bank as security for a loan.

While dealing with Caldwell Bank, Ward also guaranteed loans made by Cross Keys Bank to Karcredit LLC and

other companies owned by him. In 2019, the president of Homeland sent the president of Caldwell Bank an email providing the value of the stock so that Caldwell Bank could value the stock pledged by Ward as collateral for loans. The very next day, the president of Homeland emailed Cross Keys Bank for the same reason. In 2019, Ward signed a security agreement granting Cross Keys Bank a security interest in the stock represented by Certificate 495 and delivered possession of Certificate 495 to Cross Keys Bank. Ward now had pledged the same shares of stock to two different lenders. The situation unraveled when Karcredit LLC defaulted, and Cross Keys Bank called the loan.

Cross Keys Bank filed a lawsuit against Karcredit and its guarantors to collect a promissory note and enforce the commercial guaranties. Caldwell Bank intervened in the Cross Keys Bank action, asserting a higher priority over Cross Keys Bank in the collateral. As a result of the double pledge, Caldwell Bank lost its first priority security interest in the stock when the original certificate was canceled and the new certificate was delivered to Cross Keys Bank because only one secured party can have control of the shares through possession of an original certificate at a time. Further, because Caldwell Bank did not file a UCC-1 financing statement, it went from being fully secured to wholly unsecured.

Outcome

The court found that Homeland Bancshares, Inc. breached the merger agreement and the express provisions of Certificate 253. Under the merger agreement, only the “holders” of Homeland Bancshares, Inc. stock could surrender the certificate. Homeland Bancshares, Inc. breached its obligations to Caldwell Bank by issuing Certificate 495 to Ward, a non-holder of Certificate 253. Likewise, Certificate 253 states that it was “transferable only on the books of the Corporation by the holder hereof in person or by attorney upon surrender of the Certificate properly endorsed.” Homeland Bancshares, Inc. breached the express provisions of Certificate 253 by issuing Certificate 495 to Ward without requiring either Ward or Caldwell Bank to surrender Certificate 253.

The court also found Homeland Bancshares, Inc. liable under the UCC. Both Caldwell Bank and Cross Keys Bank were protected purchasers — a purchaser of a certificated or uncertificated security who:

- gives value,
- does not have notice of any adverse claim to the security, and
- obtains control of the certificated or uncertificated security.

UCC Article 8 governs the replacement of lost, destroyed, or wrongfully taken security certificates, and in cases such as this where both security certificates were pledged to protected purchasers, Homeland Bancshares, Inc. is obligated to honor and register both certificates unless an overissue would result. If an overissue would result, the UCC provides that “a person entitled to issue or validation may recover from the issuer the price the person or the last purchaser for value paid with interest from the person’s demand.” Therefore, Homeland Bancshares, Inc. was liable to Caldwell Bank for the amount owed to Caldwell Bank by Ronnie Ward.

Takeaways

For Issuers:

- Be aware of third-party collateral transactions, where issuer shares are used as collateral by others; and
- Comply with all contractual and statutory obligations regarding the issuance and pledging of shares.

For Lenders:

- Notify issuers that the lender is a secured party with regard to the issuer's shares and obtain an acknowledgement from the issuer; and
- Perfect a security interest in investment property by filing in addition to control, so the lender's position will not be wholly unsecured if control over a physical certificate is lost.

[1] Bankr. W.D. La. June 1, 2021

RELATED INDUSTRIES + PRACTICES

- [Bankruptcy + Restructuring](#)
- [Finance + Banking](#)