

'Enviroco Limited v Farstad Supply A/S'

Introduction

A recent case in the English Court of Appeal has considered the definition of "subsidiary" set out in sections 736 and 736A of the UK Companies Act 1985 (the "UK Act"), in circumstances where a secured party has taken security by way of assignment of title to the shares of an underlying company.

In the case of *Enviroco Limited v Farstad Supply A/S* ([2009] EWCA Civ 1399), it was held that, where a parent company provided security over shares of an underlying company by way of assignment of title, that parent company was no longer a member of the underlying company and, in this case, this meant that the underlying company was no longer its "subsidiary" (as defined), notwithstanding that the parent had retained voting rights and rights to appoint or remove a majority of the board of directors. This is relevant to Jersey because:

- 1 Sections 736 and 736A of the UK Act are in materially similar terms to Articles 2 and 2A of the Companies (Jersey) Law 1991 (the "CJL");
- 2 security over shares by way of assignment of title is one of the two methods by which security can be created over shares pursuant to the Security (Interests) (Jersey) Law 1983 (the "SIJL"), the other being by possession of the certificates of title.

Section 736A(7) of the UK Act (equivalent to Article 2A(7) of the CJL) had arguably sought to ensure that a person providing security over shares of an underlying company continued to be treated as the holder of the shares, by treating rights attaching to the shares as being held by the security provider. However, the Court of Appeal distinguished between (a) membership as a status derived from entry of the shareholder's name in the register of members and (b) rights attaching to such shares as referred to in section 736A(7).

Facts of the Farstad case

The issue in question was whether certain indemnities given by Farstad in favour of Asco UK and its affiliates (as defined by reference to the definition of "subsidiary" in section 736 of the UK Act) could be relied upon in respect of claims of Enviroco as a "subsidiary" of Asco plc, the parent of Asco UK. Asco plc had created security over the shares of Enviroco in favour of the Bank of Scotland pursuant to a Scottish security agreement; this involved shares of Enviroco being registered in the name of the Bank or its nominee, although Asco plc retained "full voting and other rights" in respect of the shares pending an event of default.

Statutory definition of "subsidiary"

Section 736(1) of the UK Act (and Article 2(1) of the CJL) provides that a body corporate ("**Company A**") is a subsidiary of another body corporate ("**Company B**") if Company B:

- (a) holds a majority of voting rights in Company A;
- (b) is a member of Company A and has the right to appoint or remove a majority of the directors of Company A; or
- (c) is a member of Company A and controls alone, pursuant to an agreement with other members, a majority of the voting rights of Company A.

Section 736(2) of the UK Act (and Article 2(2) of the CJL) provides that Company A is a wholly-owned subsidiary of Company B if Company A has no members other than Company B (or its wholly-owned subsidiaries).

Section 736A (and Article 2A) sets out further provisions relating to the interpretation of these definitions. These focus upon how "rights" are held and exercised. In particular, section 736A(7) (and Article 2A(7)) provides that rights held by way of security are treated as held by the security provider, not the secured party, where, apart from the right to exercise them for preserving the value of or realising security, such rights are exercisable only in accordance with the security provider's instructions.

Decision of the Court of Appeal

The Court held that, in section 736A of the UK Act, references to "rights" were to voting rights and rights to appoint and remove a majority of the directors; they did not relate to or affect "membership" of a company.

Therefore, while section 736A(7) provides that, subject to satisfaction of certain conditions, "rights" attached to shares held by way of security are treated as held by the parent providing the security (and not the secured party), this does not have the effect of deeming the parent as security provider to be the member in respect of the shares being secured. Section 22 of the UK Act (equivalent to Article 25 of the CJL) requires that, to be a member, a person must have its name entered on the register of members; there is no carve-out applicable where secured parties take title. This means that where the Bank's name is entered in the register of members pursuant to security, the parent is no longer a "member" and the underlying company could not be its "subsidiary", where the statutory definition required membership as a condition. Patten LJ stated that "membership of a

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company is not one of the rights described in s736 nor is it a right as such at all. It is a status derived from the entry of the shareholder's name in the register of members".

Analysis

The fact that Articles 2 and 2A of the CJL are clearly derived from sections 736 and 736A of the UK Companies Act means that the Jersey Courts will find this judgment persuasive but not binding. The judgment suggests that it is possible that the draftsman of s736 assumed that there was no need to provide for deemed membership in these circumstances because the method of charging shares by way of assignment of title is very unusual in England. However, by contrast, the SIJL provides for the creation of security over shares by either:-

- (i) possession of the certificates of title; or
- (ii) assignment of title to the shares (with the giving of notice).

For practical reasons, secured parties generally take share security by possession only, but there are circumstances where they may choose to take title security (such as to secure its position as against the Viscount, who would otherwise take title on a désastre of the security provider). The consequences are that, applying the Farstad judgment, the underlying company may then cease to be a "subsidiary" (as defined) of the security provider; this may in turn trigger covenant breaches and/or events of default in other documents.

The judgment did not go onto consider whether, as a consequence, the secured party became the holding company of the underlying company. The definition of "subsidiary" in Article 2(1)(b) and (c) of the CJL is dependent upon who holds certain rights attaching to shares; the intended effect of Article 2A(7) is that these rights are generally treated as held by the parent as security provider, not the secured party. However, Article 2(2) provides that "a body corporate is a wholly-owned subsidiary of another body corporate if the first body has no members except the second body." The Farstad judgment makes it clear that membership is defined by the names on the register of members, without being affected by the provisions of Article 2A(7). Therefore, if a secured party takes title to all, but not some only, of the shares of an underlying company by way of security and there are no other members, the likely conclusion is that the underlying company becomes a wholly-owned subsidiary of the secured party.

(Article 2(1)(a) of the CJL does not rely upon membership as a condition of the definition of "subsidiary", so it is possible that, where a majority of voting rights are retained by the parent as security provider, it may remain as the holding company regardless of the Bank being the registered member. Indeed, this may give rise to a scenario where the security provider and the secured party are both holding companies for the purposes of the CJL.)

Conclusion

Secured parties should be aware that, following the Farstad judgment, there could be unforeseen consequences to taking security over the entire issued share capital of a company by way of assignment of title, flowing from the fact that the underlying company may become its wholly-owned subsidiary. However, this should be remedied later this year by the introduction of the revised Security Interests (Jersey) Law.

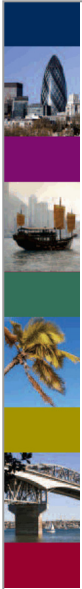
Pending the introduction of that Law, secured parties should take advice before they exercise a right to take security over shares of a company by way of assignment of title, to ensure that they do not inadvertently acquire a subsidiary.

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