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The Legislative Assault on the Scottish Subsidiary

A. INTRODUCTION

On 1 July 2021, part of the National Security and Investment Act 2021 came into force.¹ This Act's clear intention is to enable governmental veto in respect of the acquisition of strategically important businesses.² However, its implementation could capture the grant of a share pledge over shares in a Scottish company³—and it seems that future UK governmental company law reforms will do so too. This disincentivises the incorporation of a Scottish subsidiary. This article will outline existing disincentives to incorporate a Scottish subsidiary, how the 2021 Act makes this worse, and how it signals a statement of intent for future company law reforms.

B. BACKGROUND: DIFFICULTIES FOR THE SCOTTISH SUBSIDIARY

It is rare for a business to only utilise one company in its corporate structure. For operational (including tax⁴) and strategic reasons,⁵ businesses often are structured as a corporate group — many companies, each with their own assets and liabilities, ultimately owned by one parent company, with the ultimate shareholders holding shares in the parent company. Similarly,

¹ National Security and Investment Act 2021 (Commencement No. 1 and Transitional Provisions) Regulations 2021 (SI 2021/788).

² See Department for Business, Energy & Industrial Strategy, *National Security and Investment White Paper* (Cmnd 323: 2020).

³ This is a misnomer—a pledge can only be over corporeal moveables (A Steven, *Pledge and Lien* (2008) para 5-05), whereas shares are incorporeal moveables (see *Morrison v Harrison* (1876) 3 R 406). Nevertheless, a fixed security over corporeal moveables is frequently called a share pledge (see J Hardman, “Scottish share pledges and recent legislative developments: lessons for the Great Repeal Bill” [2018] *Juridical Review* 64; R G Anderson, “Scottish share pledges in the Supreme Court” (2012) 16 *Edinburgh Law Review* 99).

⁴ See J Dine and M Koutsias, “The three shares of tax avoidance of corporate groups: company law, ethics and the multiplicity of jurisdictions involved” (2019) 30 *European Business Law Review* 149.

⁵ R Squire, “Strategic liability in the corporate group” (2011) 78 *University of Chicago Law Review* 605.

structural lenders⁶ usually want to receive as many rights in security as they can in respect of their debt.⁷ They will want to receive real rights in security over the assets of the debtor business.⁸ It is common for such assets to include shares in group companies,⁹ as such security is easily enforceable. Requirements that companies should retain their own accounts mean that the company's profitability is available,¹⁰ and tax rates on the sale of shares are considerably below the applicable tax rates for most asset classes.¹¹

Scots law has long been at a disadvantage to English law in this field—as whilst security can be created over English shares without a title transfer,¹² under Scots law shares must be transferred to the creditor.¹³ This creates a risk that the “pledged” company may leave the security granter's corporate group and/or join the creditor's corporate group. This has disadvantages for both granter and creditor. The granter would lose advantages such as relief on intra-group transfers,¹⁴ and “group” insurance policies would be affected.¹⁵ Corporate groups have to “consolidate” their accounts—that is, show the group's financial picture rather than just the company's.¹⁶ Neither granter nor lender will want the subsidiary's

⁶ See discussion in J H Scott, “Bankruptcy, secured debt, and optimal capital structure” (1977) 32 *Journal of Finance* 1.

⁷ E.g. T H Jackson and A T Kronman, “Secured financing and priorities among creditors” (1979) 88 *Yale Law Journal* 1143.

⁸ See G L Gretton, “The concept of security” in D J Cusine (ed), *A Scots Conveyancing Miscellany: Essays in Honour of Professor J M Halliday* (1987).

⁹ Hardman (n 3).

¹⁰ Companies Act 2006 s 386.

¹¹ For example, the tax rate on a sale of commercial property in Scotland over £250,000 is 5% (Land and Buildings Transaction Tax (Tax Rates and Tax Bands) (Scotland) Order 2015 (SSI 2015/126) Sch 1 para 1), whereas the tax rate on the sale of shares is 0.5% (Finance Act 1999 Sch 13 para 3).

¹² See L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security*, 6th edn (2017) para 6-15.

¹³ For example, *Enviroco Ltd v Farstad Supply A/S* [2011] UKSC 16; Hardman (n 3); Anderson (n 3).

¹⁴ See Hardman (n 3).

¹⁵ As happened in *Enviroco v Farstad*. It should be noted, though, that this case explored whether a joint venture equally owned by two parties was a subsidiary of one of them who had granted a share pledge, so the lessons are not universalisable.

¹⁶ See F Woolridge, “The EEC Council seventh directive on consolidated accounts” (1988) 37 *International and Comparative Law Quarterly* 714.

financial performance to be consolidated in the lender's accounts rather than the borrower's.¹⁷

There are two definitions of “subsidiary” in the Companies Act 2006, which are used in slightly different places. Section 1159 states that a company is another's subsidiary if the other (a) holds the majority of *voting rights*, (b) is a member of it and *has the right to* appoint/remove most directors, or (c) is a member of it and controls (alone or with others) a majority of the *voting rights*.¹⁸ The formulation in section 1162 is identical, but includes another limb—that the other company has *the right* to exercise dominant influence over the company under the articles or by contract.¹⁹ Under all of these limbs, merely holding the shares in the company is not sufficient to meet the test. Instead, holding *rights* in respect of such company triggers the limbs. This is further clarified in the 2006 Act—rights attached to shares held in security are treated as being held by the granter of such security so long as the granter can generally decide how shares are voted (subject to market practice exceptions) and such shares are held in security for a loan.²⁰ The combination of these provisions was clear—a Scottish company whose shares were pledged to a lender under a typical share pledge can only be the granter's subsidiary. The system does not solve the underlying problem—the lender remains the registered holder of shares in a Scottish share pledge—but it mitigates the worst issues manifesting from that problem.

However, 2016 saw the introduction of a regime to look past legal shareholders to identify the ultimate dominant forces within a company—a company's persons of significant control (PSC).²¹ To qualify as a PSC, one must own more than 25% of the company's shares, hold over 25% of voting rights, hold the right to appoint the most of the company's directors, or the right to exercise significant control over the company.²² This, then, copied the section 1162 limbs of the test but added an important first limb: merely holding 25% of the company's shares qualified one as a PSC. This mechanism, too, carves out holding security,

¹⁷ As the borrower will lose assets, and the lender will be associated with a business that is not its business. Similarly, subsidiaries cannot own shares in their holding companies to avoid the orphaning of entire groups. See Companies Act 2006 Part 8 Ch 4.

¹⁸ Companies Act 2006 s 1159, s 1(a) (emphasis added).

¹⁹ Companies Act 2006 s 1162(2) (emphasis added).

²⁰ In respect of s 1159, see Companies Act 2006 Sch 6 para 7, and in respect of s 1162, see Companies Act 2006 Sch 7 para 8.

²¹ Hardman (n 3).

²² Companies Act 2006 Sch 1A Part 1. An additional test, in respect of trust arrangements, also applies which is irrelevant for our purposes.

but in the same formulation as the pre-existing carve outs in the definition of subsidiary: only referring to rights rather than holding shares. Thus the carve out does not apply to the regime's extra limb. A lender with a share pledge over a Scottish subsidiary will not be that company's holding company, but it will be a PSC as it will trigger the first limb and there is no applicable carve out.²³ This further disincentivised the incorporation of Scottish subsidiaries: lenders would not want to take fixed security over them (as there are responsibilities attached to being a PSC²⁴), and therefore would lend less or on worse terms.²⁵

C. NATIONAL SECURITY: A STATEMENT OF INTENT

This takes us to the 2021 Act, which enables the UK Government to restrict the transfer of assets held by, and shares in, businesses important for national security.²⁶ The Secretary of State can give a notice if a trigger event occurs in respect of a qualifying entity or qualifying asset which may risk national security,²⁷ which ultimately unwinds the transaction.²⁸ When the power will be used is left to secondary legislation.²⁹ A qualifying entity is a non-natural entity conducting business within the UK.³⁰ Transactions in respect of certain sectors require to be notified to the Secretary of State.³¹ Draft regulations with seventeen sectors—of differing levels of specificity—have been circulated.³² A voluntary notification regime has

²³ Hardman (n 3).

²⁴ Which includes a series of offences – see Companies Act 2006 Sch 1B paras 5, 13 and 14.

²⁵ J Qian and P E Strahan, “How laws and institutions shape financial contracts: the case of bank loans” (2007) 62 Journal of Finance 2803.

²⁶ See DBEIS (n 2).

²⁷ National Security and Investment Act 2021 s 1(a).

²⁸ National Security and Investment Act 2021 s 25, 26.

²⁹ National Security and Investment Act 2021 s 3. The current draft statement expressly links to national security risk – see Department for Business, Energy & Industrial Strategy, “National Security and Investment Act 2021: Draft statement for the purposes of section 3” (2021) at para 16.

³⁰ National Security and Investment Act 2021 s 7.

³¹ National Security and Investment Act 2021 s 14. Failure to do so automatically makes the transaction void (s 13).

³² National Security and Investment Act 2021 (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021 (Draft SI), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1003506/Draft_National_Security_and_Investment_Act_2021__Notifiable_Acquisition__Specification_of_Entities__Regulations_2021.pdf.

also been created, to allow for transactions outwith the mandatory regime to be “blessed” in advance.³³

How, then, does this affect the incorporation of Scottish subsidiaries? There are four tests for ascertaining whether a trigger event has occurred in respect of a qualifying entity. First, increasing shareholdings between thresholds (from below 25% to above 25%, from between 25% and 50% to above 50%, etc). Second, increasing voting rights between those thresholds. Third, obtaining sufficient voting rights to secure or prevent a resolution passing. Fourth, where an acquisition provides material influence over the entity’s policy.³⁴ Rights in security are carved out. This follows the usual carve out formulation: that rights attached to shares are usually deemed held by the security granter rather than the creditor.³⁵ It therefore cannot apply to the first limb, which applies only to holding shares themselves, rather than any rights. As such, following the PSC approach, a lender being granted a Scottish share pledge will risk falling into this regime. There must be a link to national security, of course, but the breadth of the sectors falling within the mandatory regime could well cause lender caution.

It is bizarre that the taking of the share pledge is seen as the regime’s trigger: if a lender falls within the regime when they are granted the share pledge, then they will not trigger it again were they to appropriate the shares on default. As such, this premature trigger may harm subsequent action should the creditor take actual control over the shares.³⁶ For our purposes, though, it represents another hurdle to taking security over shares in Scottish companies. It therefore represents another reason not to incorporate your subsidiary in Scotland if there is even a risk that it could become, in any way, relevant for national security.

This is not a mere oversight, either, as this precise point was debated by the House of Lords.³⁷ Lord Bruce of Bennachie proposed an amendment to avoid discincentivising

³³ National Security and Investment Act 2021 s 18.

³⁴ National Security and Investment Act 2021 s 8.

³⁵ National Security and Investment Act 2021 Sch 1 para 7.

³⁶ Obviously a third-party sale on enforcement would trigger the regime again.

³⁷ The author was involved in drafting Lord Bruce’s proposed amendment, and took part in the discussions with Lord Bruce, Baroness McIntosh, Lord Callanan and Lord Grimstone referred to in the cited exchange.

establishing Scottish companies for this reason,³⁸ supported by Baroness McIntosh of Pickering.³⁹

Lord Callanan in response stated that the Government wished to avoid a loophole by catering for Scots law share pledges, and noted that English security over shares can be taken by transferring the shares to the creditor.⁴⁰ It should be noted, though, that this option is never usually taken.⁴¹ Worse, Lord Callanan stated that this mechanism merely follows the PSC register, which “has had no discernible effect on the willingness of lenders to provide finance in Scotland”.⁴² There are two implications of this statement. First, the 2021 Act is based on the PSC regime. This implies that the PSC language is the UK Government’s phraseology of choice, despite the fact that it is incongruous for Scottish corporate finance. As such, Lord Callanan’s response is a statement of intent for the longer-term usage of the PSC regime language rather than the traditional subsidiary definition. As the UK Government is currently undertaking considerable work to reform the UK’s corporate registry,⁴³ it seems as if corporate law procedure is on the reform agenda. Whenever such procedure is changed, there is a risk that it continues to use the PSC language and remain blind to Scottish corporate finance. Second, Lord Callanan stated that PSC issues have had no discernible effect on the willingness of lenders to provide finance in Scotland. Research is needed to quantify whether this is actually the case, and also whether company incorporations have been impacted.

D. CONCLUSION

On its own, the 2021 Act may not make that much difference to Scottish corporate finance. However, the PSC regime, and the replication of its tests in the 2021 Act, provide an insight into the trajectory that corporate regulation is taking. This trajectory makes it less attractive to have a Scottish subsidiary. From a lender’s perspective, why risk being a PSC and having to obtain governmental approval for a share pledge when you could avoid this by lending to a

³⁸ HL Deb 15 Apr 2021, cols 1475-1476.

³⁹ HL Deb 15 Apr 2021, cols 1479.

⁴⁰ HL Deb 15 Apr 2021, cols 1480-1481.

⁴¹ Gullifer, *Legal Problems* (n 12) para 5-15.

⁴² HL Deb 15 Apr 2021, col 1481.

⁴³ See J Hardman, “The butterfly effect: theoretical implications of an apparently minor corporate transparency proposal” (2021) *Common Law World Review* (forthcoming).

business with an English subsidiary? From a borrower's perspective, why incorporate a Scottish subsidiary and risk a lender not wanting a share pledge over it (so lending on more restrictive terms) when you could simply incorporate an English subsidiary instead? Each issue on its own is relatively minor, but in aggregate they create disincentives to incorporate a Scottish subsidiary. When coupled with the knowledge that the offending language is likely to appear in future reforms, the issue becomes heightened. The result is minor disincentives to incorporate in Scotland compared to incorporating in England – providing legislation-driven changes to the forces at place within the market for incorporations.⁴⁴

This problem arises because of the nature of the Scottish share pledge. A change to allow for non-floating security to be taken over shares in Scottish companies without the lender becoming the registered holder would avoid the issue worsening. The Scottish Parliament has the tools to make such change,⁴⁵ and a blueprint for how to do so was published in 2017.⁴⁶ The Scottish Government proposed to consult further on the reform in 2019-20.⁴⁷ This was paused during the Covid-19 pandemic, but is in the programme for government for 2021-22.⁴⁸ It is vital that this blueprint be implemented as soon as possible to help mitigate the damage. It is worthwhile noting that a more prompt implementation of this blueprint would have already provided considerable mitigation. Time has been lost, to the detriment of the attractiveness of Scottish vehicles.

Implementing this blueprint will remove a negative in respect of incorporation of Scottish companies. However, it will not replace it with a corresponding positive—it merely removes a disadvantage for Scotland compared to England. Given the combined legislative assault arising from action by the UK Government and inaction by the Scottish Government, removing this negative may be insufficient to fully mitigate the damage caused to the attractiveness of incorporating a Scottish subsidiary.

⁴⁴ See J Hardman, “Further legal determinants of external finance in Scotland: an intra-UK market for incorporation?” (2021) 25 *Edinburgh Law Review* 192.

⁴⁵ As Scots private law, including taking security over shares, is devolved to the Scottish Parliament—Scotland Act 1998 s 29 and s 126(4).

⁴⁶ Report on *Moveable Transactions* (Scot Law Com No 249, 2017).

⁴⁷ Scottish Government, *Protecting Scotland's Future: the Government's programme for Scotland 2019-2020*, available at <https://www.gov.scot/publications/protecting-scotlands-future-governments-programme-scotland-2019-20/pages/8/>.

⁴⁸ Scottish Government, *A fairer, greener Scotland: programme for government, 2021-22*, available at <https://www.gov.scot/publications/fairer-greener-scotland-programme-government-2021-22/pages/12/>.

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