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Subsidiary & Holding Companies:impact of Enviroco v Farstad

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Company Commercial Partner Max Hudson looks at the definition of 'subsidiary' in the wake of Enviroco Limited v Farstad Supply A/S.

INTRODUCTION

The terms "subsidiary" and "holding company" are frequently defined by reference to section 1159 of the Companies Act 2006 or section 736(1) of the Companies Act 1985 (the former drafted to reflect the latter) which set out that a company is the "subsidiary" of its "holding company" if the holding company:

- holds a majority of the voting rights in it; **or**
- is a member of it and has the right to appoint or remove a majority of its board; **or**
- is a member of it and (under an agreement with other members) controls a majority of the voting rights in it.

A "member" is any person that is entered into a company's register of members.

This definition seems to cover most conventional holding company/subsidiary relationships. However, the Court of Appeal's decision in Enviroco Limited v Farstad Supply A/S ([2009] EWCA Civ 1399), which the court itself criticised as an "uncommercial" outcome, uncovered a weakness in its application. In this case a company was deemed not to be a subsidiary of its holding company on the basis that the holding company had pledged its shares in its subsidiary to a bank by a Scottish "deed of pledge" under which the bank became the registered holder of the shares. The equivalent in England would be a legal charge.

IMPLICATIONS

In most cases a holding company will hold the majority of the voting rights in its subsidiary and therefore will rely on the first part of the above definition. However, in cases where the holding company only controls the voting rights or board appointments and the legal title of the shares has been transferred to a nominee, the relationship between holding company and subsidiary for the purposes of the definition has been broken.

To put this into context, such cases will be rare given that it is unusual to transfer legal title to perfect

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security in English corporate transactions where equitable mortgages or charges are more common. However, in those rare cases where these circumstances do arise, the implications, some of which are set out below, are myriad.

Contractual issues

- Change of control provisions could be triggered.
- Rights to intra-group assignments might cease for the detached subsidiary.
- As was the case in Enviroco Limited v Farstad Supply A/S, the detached subsidiary may no longer be able to benefit from group indemnity clauses.

Banking and finance issues

- Potential breach of financial covenants.
- Potential breach of change of control representations and warranties.
- As a result of either of the above or any similar such provision an event of default could be triggered.

Tax issues

- VAT group rules use the Companies Act definition of subsidiary so a detached subsidiary would fall outside the group for VAT purposes.

Employment issues

- Potential repercussions for employee share option plans where their scope has been defined by reference to a group and the Companies Act definitions have been used. (Often this is not the case as the definitions from the relevant tax legislation tend to be favoured).

Commercial real estate issues

- A detached subsidiary may no longer be able to rely upon provisions which allow the tenant to share premises with, or sub-let premises to, a group company.

Other considerations

- Does the subsidiary that has become detached from its natural holding company become by default a subsidiary of another entity, for example a bank?
- Could this judgment be exploited as a loophole? By registering the holding company's shares in the name of a nominee might it then be possible to circumvent provisions such as section 136 Companies Act 2006, which prohibits a subsidiary from being a member of its holding company, or section 197 Companies Act 2006, which requires members' approval before a loan can be made by a company to its holding company.

PRACTICALITIES

The logical conclusion to be drawn from the above is that careful consideration should be given as to how "subsidiary" and "holding company" are defined in any contract. It has been suggested that it may be preferable to define these terms by reference to the definitions of "subsidiary undertaking" and "parent undertaking" in section 1162 of the Companies Act 2006, which includes a provision allowing the parent/subsidiary relationship to exist even if the parent company's shares in the subsidiary are held by another party acting on behalf of the parent company.

However, there may be some uncertainty here too and a possible issue with other (non-corporate) undertakings being unintentionally included. To err on the side of caution it is probably better either to use the section 1159 definition, where possible, but to add an additional clause that specifically covers

situations where the legal title has been transferred to a third party for security purposes or to put in place other precautionary arrangements to ensure the group relationship is not broken.

If you would like further advice on the above issues, please speak to your usual contact at this firm. Alternatively contact Max Hudson on 0207 465 4300 or mhudson@phb.co.uk.

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