FOCUS

SHAREHOLDERS' CONTROL UNDER THE INSOLVENCY ACT 1986

A change in position

The Court of Appeal has brought about a major shift in what was previously thought to be the position in relation to when registered shareholders will be considered to have control of a company under the Insolvency Act 1986 (1986 Act). In *Granada UK Rental & Retail Ltd v The Pensions Regulator*, known as *Box Clever*, the court considered the circumstances in which a registered shareholder (such as a custodian or nominee) or a person holding power over voting (such as a lender with security over shares) will, if the relevant shares represent one-third or more of the voting rights at any general meeting of the company, be taken as having control of the company for the purposes of section 435(10)(b) of the 1986 Act (section 435(10)(b)) (*[2019] EWCA Civ 1032*).

The court overturned previous authority that a registered shareholder holding the shares on trust for a third party, with the third party having power to direct the shareholder how to vote, did not control the relevant shares and so was not associated with the company for the purposes of section 435(10)(b) (*Unidare plc v Cohen [2005] EWHC 1410; www.practicallaw.com/0-201-1879*).

The court's decision in *Box Clever* means that registered shareholders will fall within the section 435(10)(b) definition of having control of a company even though they do not exercise the relevant voting rights attaching to the shares. Any person who itself controls the registered shareholder will also be treated as controlling the company; for example, a bank that owns more than one-third of the shares in the custodian or security agent will be considered an associate of the underlying company.

Associated persons

There are important implications in both insolvency and pensions law if a person is considered to be connected or associated with a company within the 1986 Act.

In insolvency law, extended time limits and presumptions of insolvency can apply where there is a potential transaction at an undervalue, preference or floating charge involving an associate of the company (*sections 238-245, 1986 Act*). In addition, the votes of associated creditors in a company voluntary arrangement (CVA) have a special status (*rule 15.34, Insolvency (England and Wales) Rules 2016 (SI 2016/1024)*).

Under pensions legislation, the consequences of being associated can be even more material. The Pensions Regulator's statutory powers to issue financial support directions (FSDs) or contribution notices apply only to those who are connected or associated with an employer at a relevant time (*sections 38-51, Pensions Act 2004*). In addition, limits on employer-related investment by pension schemes apply to investments with the employer or an associate, and any breach of these prohibitions may be a criminal offence (*section 40, Pensions Act 1995*).

The 1986 Act defines connected persons and associated persons in sections 249 and 435 respectively. The Pensions Act 2004 adopts these definitions (*sections 38(10) and 51(3)*). The definition of associate in section 435 is rather complex and can be difficult to construe. Although these are long-standing provisions, there is not much case law on their meaning.

Control

Section 435(10) gives a wide definition of persons who have control of a company: a person will be taken to have control if the directors are accustomed to act on that person's instruction or if the person is entitled to exercise one-third or more of the votes at a general meeting. Both of these concepts can cause difficulties in construction.

If a company, A, controls a company, Z, and A is controlled (for example it is wholly owned) by a company, B, section 435(10) will apply so that B is also treated as controlling Z, and so is associated with Z. Other members of B's corporate group would also be treated as associated with Z (*see box "Section 435 in practice"*).

Custodians and security holders

Interests in shares in a wholly owned subsidiary (for example) may be held by parties other than the parent company; for example:

- Where a custodian or nominee is the registered shareholder of the shares in the subsidiary but holds those shares on trust for the parent.
- Where a lender takes a fixed mortgage or charge over the shares in the subsidiary. The shares are sometimes then registered in the name of the lender or a security agent so the mortgage is a legal, rather than equitable, security.

If the custodian or nominee is the registered shareholder of the shares in the subsidiary, following *Box Clever*, the custodian will be considered to have control of the subsidiary under section 435. This means that the custodian, and members of the same group of companies as the custodian, will also be associated with the subsidiary.

The tax and company law rules in these circumstances are much clearer. Generally, bare trust or security claims are ignored (at least before an enforcement event) leaving the original owner still treated as owning the shares or the voting power, such as for group accounting purposes; for example, in the definitions of fiduciaries and nominees in paragraphs 5 and 6 of Schedule 6 to the Companies Act 2006, and for the purposes of working out who has significant control under paragraphs 19 (nominees) and 23 (security) of Schedule 1A to the Companies Act 2006.

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This is also the case for the issue of control as used for group tax purposes, such as under section 451(3) of the Corporation Tax Act 2010, which provides that if a person has any rights or powers that are exercisable on behalf of another person, those rights or powers are to be attributed to that other person. This definition of control is also used in section 994(1) of the Income Tax Act 2007.

The definition of control in section 435(10) is not so sophisticated. It does not expressly deal with trust or security rights over shares.

Box Clever

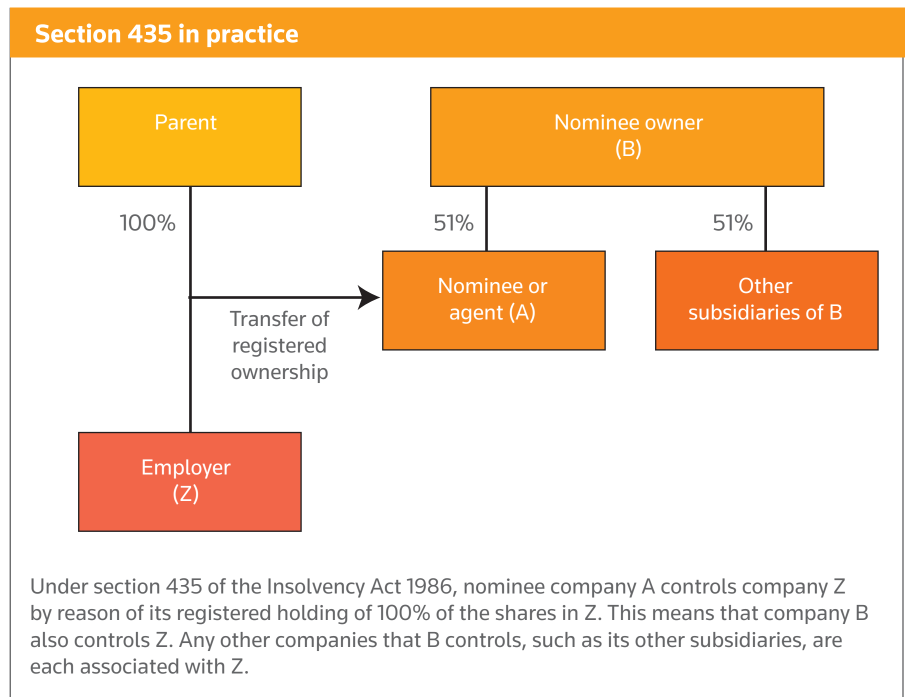
The Pensions Regulator proposed to issue an FSD to five companies (the ITV companies) within what is now the ITV group to provide financial support for the Box Clever Pension Group Scheme (the scheme), which had a deficit of around £115 million (*see News brief "ITV's financial support direction: Pensions Regulator gets tougher", www.practicallaw.com/1-518-2004*). The ITV companies appealed to the Upper Tribunal, which held that it was reasonable to impose the FSD and the ITV companies were associated with the scheme's employer companies in the Box Clever group at the relevant time (*[2018] UKUT 164*). The companies appealed to the Court of Appeal.

One of the issues for the court was whether, for the purposes of section 435(10), the ITV companies remained in control of the scheme's employers where a debenture had been granted over the shares in those employers, including a fixed mortgage, and the employer companies had also entered administrative receivership.

The court held that the ITV companies did retain control of the employers. This was partly because the debenture dealt expressly with voting issues and so the court held that this applied to leave control with the ITV companies even in those cases where the shares were registered in the name of the security agent. The court also extended what had previously been thought to be control in section 435(10), overruling *Unidare*, which was the previous main authority on this point.

Under section 435(10)(b), a person is taken as being able to exercise voting power in shares if that person is entitled to exercise, or control the exercise of, one-third or more of the voting power at any general meeting. The court said that this means that there are two limbs to the test: a person will have control if they are either entitled to exercise voting power or entitled to control the exercise of voting power. The court held that the first limb applies to registered shareholders but the second limb can apply to a person with a voting arrangement with a registered shareholder. It seems inevitable from this that two persons can each be treated as holding the voting power in one set of shares at the same time.

Section 435 in practice



Under section 435 of the Insolvency Act 1986, nominee company A controls company Z by reason of its registered holding of 100% of the shares in Z. This means that company B also controls Z. Any other companies that B controls, such as its other subsidiaries, are each associated with Z.

Therefore, in *Box Clever*, the ITV companies were held to have retained control (on the relevant date) of the employers under the second limb by virtue of the shareholdings in the employers, even where the shares had been registered in the name of the security agent. Under the debenture, the relevant chargor retained the ability to direct the security agent on how to vote the shares.

The court did not expressly deal with the position of the security agent as it was not one of the targets of an FSD by the Pensions Regulator. However, the effect of the decision is clearly that the security agent will also be treated as having control under section 435(10)(b) by reason of being the registered owner of the shares. This will apply despite the terms of the debenture giving the parent company chargor the ability to direct how the shares are voted, at least until a notice is given.

The court noted that "control" in section 435 does not necessarily need actual control in the sense of a need for a majority of votes. It noted that a person can be deemed to have control if they hold just 35% of the shares in a company which in turn holds 35% in a company holding 35% in another company with a 35% holding in a yet further company. The court emphasised that Parliament had obviously not intended section 435(10) to apply only to people or entities that control a company in practical terms. Instead, Parliament had intended section 435(7), and the term "associate" more generally, to have a wide meaning for the purposes of, for example, the provisions on preferences and transactions at an undervalue in sections 239(6), 240(1)(a) and 249(b) of the 1986 Act.

Implications for custodians

In practice, custodians or trustees that become registered shareholders in a company and hold shares carrying over one-third of the votes will satisfy the control test in section

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435(10). This means that they, and any entity that in turn controls them or is under common control, will be associated with the underlying company and so potentially at risk of the relevant insolvency and pensions issues (*see "Associated persons" above*).

In theory, this could even be the case for a listed company if the relevant custodian ends up holding shares with more than one-third of the votes.

It may be unlikely that a pure nominee or trustee would satisfy the other tests for an FSD order; for example, the requirement that the Pensions Regulator considers it reasonable to issue an order. However, a controlling entity of the custodian or security agent, such as a bank, could, depending on the circumstances, have had significant involvement with the underlying company by virtue of the relevant lending arrangements and security, and so potentially be within the Pensions Regulator's sights as a target if "associate" status can be shown. Lenders will not otherwise usually be classed as associates unless they step over the line into being considered a form of shadow director.

In addition, the further conditions for FSDs do not apply in all cases where "control" is relevant under the legislation; for example, the limits on employer-related investment do not seem to depend on knowledge by the trustee or fund manager of the association.

Implications for share mortgages

If a parent or large shareholder grants a mortgage over shares, one issue for the lender will be whether to:

- Agree to leave the shares registered in the name of the chargor; that is, an equitable security.

- Arrange for the registered owner to become the lender or a nominee or agent for the lender; that is, a legal mortgage.

The two approaches can result in different priorities. In either case, the relevant security document will usually deal with whether the chargor can continue to exercise the voting rights attaching to the shares, whether these are retained in the name of the chargor or registered in the name of the lender.

The decision in *Box Clever* means that a significant effect of taking a legal mortgage is that the lender or nominee will become an associate of the company, even if the chargor retains the power to direct how the shares are voted, at least up to an event of default or notice from the lender. This issue will not apply if the chargor retains the registered shareholding and is less likely to apply if the chargor expressly keeps the relevant power to vote the shares, at least until a voting notice is served.

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