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Client briefing
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Enviroco Supreme Court Decision on Section 736 CA 1985

In *Farstad Supply A/S v Enviroco Ltd* [2011] UKSC 16, the Supreme Court upheld the decision of the Court of Appeal that a subsidiary ceased to be a subsidiary of its holding company when that holding company charged its shares to a bank which registered them in the name of a nominee – even though the holding company still controlled the subsidiary for all practical purposes. Might a company which has been de-grouped in this way become a subsidiary of the mortgagee or custodian? The answer is no, although in certain limited cases the decision may affect the composition of a borrower group under a facility agreement. Whilst then of limited application, this case is worth having in mind when structuring transactions.

Taking legal security over shares by registering them in the name of the secured party at the outset is rare nowadays. Concerns such as potential liabilities accruing from the Pensions Act 2004 have meant that it is safer to take an equitable security interest in the shares and only to register the shares in the name of the mortgagee should the mortgagee need to enforce the security. The Enviroco case, which was heard recently by the Supreme Court, confirms this approach.

The facts of Enviroco are unusual. A fire started while Enviroco was cleaning an oil rig supply vessel, resulting in damage to the vessel and the tragic death of one of Enviroco's employees. The vessel was owned by Farstad, but chartered to Asco. Farstad sued Enviroco in Scotland in respect of the damage to the vessel.

The charter provided that Farstad would indemnify Asco and Asco's "affiliates" against various liabilities. An affiliate was defined as including any other "subsidiary" of a company of which Asco was a subsidiary, "subsidiary" bearing the meaning in section 736 of the Companies Act 1985 – now Section 1159 and Schedule 6 of the Companies Act 2006 (referred to in this briefing as Section 1159), Enviroco claimed to be a subsidiary of Asco's parent. Enviroco therefore sued Farstad in England seeking a declaration that Farstad was obliged to indemnify it under the terms of the charter for the losses claimed by Farstad in Scotland and, as a result, that Enviroco had no liability to Farstad.

Under section 1159(1), one company is a "subsidiary" of another if that other company: (a) holds a majority of the voting rights; or (b) is a member and has the right to appoint or remove a majority of the directors; or (c) is a member and controls, alone or pursuant to an agreement with other shareholders, the majority of the voting rights. Enviroco was forced to rely on section 1159(1)(c) because Asco's parent did not on its own hold a majority of Enviroco's shares but only did so in conjunction with another shareholder.

Key Issues

A company ceased to be a subsidiary of its holding company where the holding company pledged its shares to a bank, whose nominee became the registered holder of those shares.

This case raises questions on the interpretation of ss.736(1)(b) and (c) of the Companies Act 1985.

Comments made in this case will apply to the interpretation of "subsidiary" in ss.1159(1)(b) and (c) of the Companies Act 2006.

This decision will also apply to the interpretation of "subsidiary undertaking" in ss.1162(2)(b) and (d) of the 2006 Act (formerly ss.258(2)(b) and (d) of the 1985 Act).

On the facts of this case, this decision is of limited application.

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Section 1159(1)(c) requires the parent to be a member of its subsidiary. A member is defined in section 22 of the Act as anyone whose name is entered on a company's share register. The problem for Enviroco was that shares formerly registered in the name of Asco's parent had been charged as security to a bank, resulting in a nominee of the bank becoming the registered shareholder. Asco's parent did not appear to be a member of Enviroco, as required by section 1159(1)(c). In previous iterations of this section and indeed in a remaining equivalent Section 1162 there was a deeming provision which would have made the parent company a member notwithstanding that the shares were registered in the name of the bank. Curiously this provision had not also been applied to the provisions of Section 1159 when it was exacted in the Companies Act 2006, which was generally regarded as a mistaken omission.

Like the Court of Appeal before it, The Supreme Court decided that Enviroco was not an affiliate of Arco. Although acknowledging that the legislation lead to a result which is "certainly odd and possibly absurd", the Supreme Court did not accept Enviroco's arguments that (a) a member need not be registered on the Company's share register, nor (b) that the attribution of membership rights under Section 1159(a)(6) actually meant that a company became a member for the purpose of Section 1159.

The Supreme Court also had some interesting observations whilst dismissing Enviroco's other two arguments relating (c) to a Pepper v Hart claim that the legislation should be interpreted to permit Enviroco to be a subsidiary of Asco's parent and (d) to contractual interpretation and the intention of the parties.

Pepper v Hart allows parliamentary materials to aid statutory construction where the legislation is ambiguous, obscure or leads to an absurdity; and where the material relied on one or more statements made by a Minister or other promoter of the Bill together if necessary with such other Parliamentary material as was necessary to understand such statements and their effect and additionally where those statements were clear.

Notwithstanding that the Supreme Court acknowledged that the difference in treatment of nominees in the two Companies Act sections 1162 and 1159 meant that "it seemed likely that there was an error", it did not view its correction as part of the Supreme Court's role. Under Pepper v Hart rules it could see neither a relevant ambiguity in Section 1159 nor any clear statement which cast any light on any question of interpretation sufficient to meet Pepper v Hart's requirements and so "no clear basis on which the court could be abundantly sure "that there is a drafting error of the nature of which the court can correct". It said that for the Supreme Court to come to any other conclusion would be an impermissible form of judicial legislation.

If The Supreme Court could not intervene to "judicially redraft" the legislation, was there scope to interpret the contract to give effect to the parties' intentions outside the express words in the contract?

There has been an increasing tendency by the Supreme Court to take an interventionist approach to contractual interpretation often at the expense of the Court of Appeal's judgments (see link to our client briefing "The Strange Death of Literal England"). However, on this occasion, the Supreme Court declined to interpret the contract apart from its strict wording. In doing so it addressed itself to three factors relevant to contractual interpretation: first, whether the wording flouts business commonsense; secondly, whether "something must have gone wrong with the language" and thirdly whether there was anything in the factual matrix to suggest that the words should have a different construction then they would have had in the statutory context. It concluded that none of these factors justified interpreting the contract outside of its strict terms. This notwithstanding that the court acknowledged that "it is likely that, if the parties had addressed their minds to it, the parties would not have envisaged that a subsidiary would cease to be so merely because the shares in it were charged to a Scottish bank".

Does this strict approach to the contractual language mark a turning point in the Supreme Court's willingness to take account of the parties' intentions when construing the express words of the contract?

For those who mourned the loss of contractual certainty occasioned by the interventionist activities of the House of Lords and its successor, the Supreme Court, this may be good news.

On the other hand it was bad news for Enviroco and Asco, depriving Asco and its affiliates of insurance that had been paid for on the basis of an unforeseen technicality. Was the Supreme Court influenced by the apparent injustice of allowing Enviroco to be indemnified by the party who suffered loss apparently by virtue of Enviroco's actions? Possibly. Or is the Supreme Court about to put a brake on its recent tendency to ignore the parties' words in contracts? We have to wait and see.

And what about the position of secured lenders? The result in Enviroco may appear curious and counter-intuitive, but secured lenders should not fear unduly. There is, for example, no suggestion that a company that is "de-grouped" like Enviroco becomes a subsidiary of the mortgagee of the shares. The mortgagee is unlikely to be able to control the board of the de-grouped company within the meaning of section 1159(1)(b) or control, alone or pursuant to an agreement with shareholders, the majority of the voting rights within the meaning of section 1159(1)(c). Further, de-grouping can be avoided by not taking a legal mortgage of shares unless the mortgagor holds more than 50% of the voting rights. Holding more than 50% of the voting rights would allow the "subsidiary" test to be met under section 1159(1)(a) which does not require actual membership of the subsidiary unlike the other elements of the definition. It was only because Asco's parent did not on its own hold a majority of the voting rights in Enviroco that Enviroco needed to rely on a definition that required its holding company to be a "member" of it.

In addition, it may be sensible to consider including a deeming provision in the definition of "subsidiary" in facility documents, so that for the purposes of the covenant package, a subsidiary is deemed to include companies which would have qualified as subsidiaries under sections 1159(1)(b) and (c), but for any legal mortgages granted over their shares.

In a worst case, though unlikely, scenario a mortgagee finding that the company over whose shares it has taken a mortgage is no longer a subsidiary of the borrower group, could swap its legal mortgage for an equitable one, by transferring legal title in the shares back to the mortgagor by virtue of the covenant for further assurance and security power of attorney contained in the mortgage, while retaining the equitable proprietary interest.

Enviroco is, therefore, superficially concerning but it is unlikely to have much effect in practice, not least because Enviroco's supposed parent did not on its own control Enviroco and because it is now rare to take security in shares by transferring title.