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Implications of the National Security and Investment Act 2021 for distressed deals

The National Security and Investment Act 2021 (the **Act**) came into force on 4 January 2022 and is expected to have significant consequences in the distressed environment, particularly in relation to the enforcement of security and the appointment of insolvency officeholders. The Act requires prior notification of certain events to the Government and once notification has been made, parties will need to await clearance before taking further steps. This will have implications for the speed at which creditors can take enforcement action and must be provided for in any contingency planning. The Act will also have an impact on origination of financing and the taking of security (and therefore also on refinancings).

For background information on the Act, please click **here**. This note will focus on the Act in so far as it is likely to have an impact in distressed situations and aims to offer practical and pragmatic advice.

It is unclear exactly what the intended scope of the Act is. Clarification and guidance has been sought from the Government on a number of points seeking to reduce the potentially very broad ambit of the Act. Unless and until such clarification or guidance is issued, however, we consider that a cautious approach is warranted, particularly given the potential criminal and civil liabilities that could be imposed under the Act. This note therefore represents our current recommended best practice and will be updated should further guidance be forthcoming from the Government.

Key concepts under the Act

– **Trigger events**

These are acquisition events that are specified under the Act and are a trigger for the making of either a mandatory or voluntary notification (which may then lead to a "call-in"). The occurrence of any trigger event also enables the Government to independently "call-in" an acquisition for review.

– **Mandatory notification trigger events** occur in relation to Sensitive Qualifying Entities (see definition below) when:

(i) the percentage of shares a person holds in a Sensitive Qualifying Entity (including indirectly) increases:

(a) from 25% or less to more than 25%;

(b) from 50% or less to more than 50%; or

(c) from less than 75% to 75% or more; or

(ii) the percentage of voting rights a person holds in a Sensitive Qualifying Entity (including indirectly) increases to the thresholds mentioned in (i) above; or

(iii) the person acquires a percentage of voting rights in a Sensitive Qualifying Entity (including indirectly) which enables them to secure or prevent the passage of any class of resolution governing the affairs of the entity.

Although these three mandatory trigger events seem to be firmly based on whether a person legally holds shares or voting rights in a Sensitive Qualifying Entity, the Act makes it clear that other acquisitions of indirect rights and interests (which are not specifically defined in the Act) will also be caught. A right is held indirectly by a person if that person has a majority stake in another entity and that other entity holds the interest or right in the Sensitive Qualifying Entity either directly or through a corporate claim of majority ownership. The "majority stake" text is not only linked to holding shares or voting rights of at least 50%, but it is also met where a person has the right to exercise, or actually exercises dominant/influence or control over another entity which itself has a majority stake in a Sensitive Qualifying Entity.

To illustrate this further, a holding of shares or voting rights does not need to be direct – certain indirect holdings through a corporate chain would also come within the Act. Many corporate structures will involve a holding company at the top of the corporate chain, which is itself unlikely to be a Sensitive Qualifying Entity, with intermediate wholly owned subsidiaries between it and any Sensitive Qualifying Entity. In this situation, any transactions occurring at the holding company level may be brought within the mandatory notification regime through a line of indirect control over the Sensitive Qualifying Entity. More difficult would be a situation where the top company is not itself a Sensitive Qualifying Entity and does not hold a majority (ie >50%) stake in an interim holding company which directly/indirectly owns a Sensitive Qualifying Entity – this will require detailed analysis to see whether the control tests under the Act are met such that dealings at the level of the holding company would be trigger events under the Act. This note assumes that where transactions occur at a holding company level, any interest in a Sensitive Qualifying Entity subsidiary is held through a corporate chain of wholly-owned subsidiaries.

– **Voluntary notification trigger events** occur when any of the mandatory trigger events occur in relation to a Qualifying Entity other than a Sensitive Qualifying Entity. Further voluntary notification events may occur when: (i) there is an acquisition which enables a person to materially influence the policy of the Qualifying Entity; and/or (ii) a person acquires a right or interest in relation to a qualifying asset (which is broadly defined) which enables them touse the asset or to direct or control how the asset is used or, in each case, to do so to a greater extent.

– **Qualifying Entities and Sensitive Qualifying Entities** The Act applies to any entity (a **Qualifying Entity**), whether or not a legal person, that is not an individual. It includes a company, a limited liability partnership, any other body corporate, a partnership, an unincorporated association and a trust. All UK entities are in scope of the regime. Foreign entities are only in scope if they carry on activities in the United Kingdom or supply goods or services to persons in the United Kingdom.

– A **Sensitive Qualifying Entity** is a Qualifying Entity that carries out a particular activity[1] in one of the 17 sensitive specified sectors.

– **Sensitive "specified sectors"**

The 17 sensitive specified sectors are:

– Advanced materials
– Advanced robotics
– Artificial intelligence
– Civil nuclear
– Communications
– Computing hardware
– Critical suppliers to government
– Cryptographic authentication
– Data infrastructure
– Defence
– Energy
– Military and dual-use technologies
– Quantum technologies
– Satellite and space technologies
– Critical suppliers to emergency services
– Synthetic biology
– Transport

[1] As set out in separate detailed Regulations

– **Powers under the Act**

Once a mandatory or voluntary notification is made, the Secretary of State will consider the transaction and will either grant clearance or "call-in" the transaction to consider the risks further before deciding whether to grant clearance; impose conditions or prevent the transaction in its entirety. If an acquisition is subject to the mandatory notification regime it will be void if it is completed without the approval of the Secretary of State, although it can be retrospectively validated.

The Secretary of State also has an independent "call-in" power in relation to transactions that have not been either mandatorily or voluntarily notified. Under the "call-in" regimes, the Secretary of State will review the transaction and may make both interim and final orders if it considers there is a national security risk in order to limit such risks.

Voluntarily notifying a transaction avoids the risk that the Secretary of State "calls-in" the transaction after completion – which could, in a worst case scenario, lead to the imposition of restrictions and even an unwinding of the transaction.

In addition to consequences for the transaction in question, a failure to make a mandatory notification when required, or to comply with any interim or final order made pursuant to the Act, could lead to the imposition of criminal and civil sanctions. There are also offences under the Act in relation to the provision and sharing of information.

The table that follows details the trigger events under the Act that are likely to occur in a standard distressed scenario or restructuring transaction and indicates whether a mandatory notification is likely to be required. By clicking on an "event" in the first column, you will be taken to additional analysis about this trigger event and the likely need for a notification, including additional information about whether a voluntary notification might be warranted. This additional analysis remains relatively high-level and if you have any questions, we encourage you to contact one of the experts listed in this bulletin or your usual Allen & Overy contact.

Possible trigger events in distressed scenarios – do I need to make a mandatory notification?

The table below considers activities in relation to a Qualifying Sensitive Entity or an entity with a "majority stake" in a Sensitive Qualifying Entity and whether a mandatory notification is required. It is always open to parties to make a voluntary notification if a trigger event has occurred and this may be particularly advisable where activities are carried out in a sector closely related to a sensitive sector or assets are used to this effect, but this would need to be considered on a case by case basis.

Key

- ✓ Make notification
- ✗ No need to make a notification
- ? Consider whether a notification is required

Event	Mandatory notification required?
Upon engagement (lawyers/financial advisers etc)	✗
Appointment of administrator	✗
Appointment of liquidator/receiver/administrative receiver	?
Transfer of voting rights re shares (or acquisition of right to require transfer) (eg to lenders/security agent on event of default	✓
Exercise by security trustee / lenders of share voting rights (unless EoD already notified)	✓
Enforcement of share security by sale of shares / consenual share sale	✓
Enforcement of asset (non-share) security	✗
Debt-for-equity swap (more than 25% of equity)	✓
Exercise of put / call option over shares	?
Taking a legal mortgage over shares (title to the shares transfers to the security taker)	✓
Taking new share security other than a legal mortgage	✗
Taking new asset security	✗
Appointment of board members or observers	?
Entry into lock-up agreement	?
Debt trading	?

Upon engagement (lawyers, financial advisers etc.)

– Appointment itself is not a trigger event unless the advisers (i) are deemed to have majority stake in a Sensitive Qualifying Entity by exercising dominant influence or control over a company that has a majority stake in a Sensitive Qualifying Entity; (ii) exercise material influence or control over a Sensitive Qualifying Entity (directly or indirectly). This is very unlikely but advice should be sought where this does occur as to whether a mandatory or voluntary notification is required or advisable

– Consider likely future trigger events in the transaction

– Consider past trigger events and whether any notifications should be made retrospectively

– Begin preparing any anticipated notifications for future use

– Talk to the experts – it is not always clear cut whether a notification is required

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Appointment of insolvency officeholders

– Officeholders wield significant powers in relation to an entity and its subsidiaries. Careful consideration should be given to whether a notification is either required or prudent, prior to the appointment

– Concerns around whether the appointment of a liquidator, receiver or administrative receiver could trigger the "dominant influence or control" (potential mandatory notification) or "material influence" (potential voluntary notification) tests

– Appointment of a UK administrator is not a trigger event – protection in Schedule 1 paragraph 6 of the Act

– Only the appointment is covered by the protection from being a trigger event – many actions subsequently carried out by any officeholder (including an administrator) are likely to constitute a trigger event

– A mandatory notification in respect of the appointment of an officeholder will only be required if appointed over shares in a Sensitive Qualifying Entity or its holding company and not, for example, if appointed directly to another asset such as real estate (eg a power station).

– In relation to the appointment of insolvency officeholders outside of the United Kingdom, an assessment will need to be undertaken of the rights exercisable by the officeholder to determine whether any mandatory or voluntary trigger events are likely to be met

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Events of default

– Occurrence of an event of default is likely to lead to a trigger event where there is related share security and the voting rights automatically vest with the security agent / lenders upon the occurrence of an event of default or an enforcement event (this is likely to be the case for most pre 2022 security agreements)

– Difficult to anticipate events of default or even know when they have occurred – such that prior notification is extremely difficult

– Requires a careful analysis of the finance documents

– On deals involving a Sensitive Qualifying Entity and a pre 2022 security agreement, consider making a mandatory notification very early where the group is in distress – ahead of any actual event of default which would result in the lenders acquiring voting rights

– Failure to make a prior notification constitutes a criminal offence unless there is a "reasonable excuse"

– Clarification is being sought from the government in the hope of reducing the scope of the Act in this area

– For post 2022 security agreements, where amendments may have been made to switch off the automatic vesting of the voting rights, it may be possible to delay notification until prior to the exercise of the voting rights (see below)

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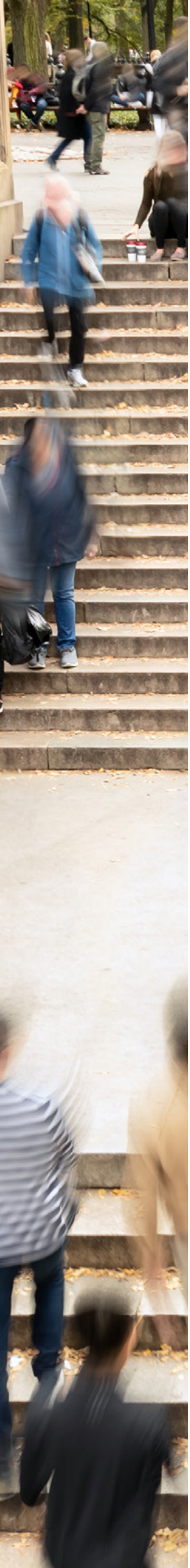

Exercise of voting rights by the security agent or lenders in respect of secured shares

– A notification may already have been made at the point the security agent / lenders acquired the right to exercise the voting rights (eg upon the occurrence of an event of default), in which case it may not be necessary to make a further notification

– If no notification has already been made, in relation to a Sensitive Qualifying Entity or an entity with a majority stake in a Sensitive Qualifying Entity, a notification will be required prior to the exercise of the voting rights by the lenders or the security agent and otherwise, a voluntary notification could be considered

– The most likely exercise of share voting rights in a distressed context is to remove or appoint directors

– It would not be prudent to rely on paragraph 7 of Schedule 1 of the Act, which could be read as allowing secured parties to exercise rights for the preservation of the value of security without a trigger event occurring, as providing protection to security takers, particularly where they are exercising voting rights to change the board of directors

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Enforcement of share security/consensual sale of shares

– A trigger event will occur because of the transfer of shares and voting rights where it affects more than 25% of the shares

– Trigger events will also occur if a party already holds shares or voting rights and they acquire a greater proportion – going beyond the thresholds of 25% or 50% or reaching or exceeding the threshold of 75%, as applicable

– In relation to a Sensitive Qualifying Entity, a mandatory notification will be required if the transfer is of a direct holding and may be required if the transfer occurs further up the corporate chain depending on the level of control acquired

– In circumstances where a mandatory notification is not required, a voluntary notification should be considered

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Enforcement of asset security other than shares

– Not a trigger event under the mandatory notification regime

– Could be subject to the call-in regime and therefore it may be prudent to consider making a voluntary notification in order to avoid the risk of a subsequent call-in which could lead to an unwinding of the enforcement action

– Consider whether there are any likely national security concerns – relevant factors might include: whether the asset is used in a specified sector or to provide services to government bodies; whether the asset is land next to a government facility; or whether the asset forms part of critical infrastructure (power stations, roads etc.)

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Debt-for-equity swap

– Since this involves changing the shareholders of an entity, it could be a mandatory trigger in a structure involving a Sensitive Qualifying Entity and a voluntary trigger where a mandatory notification is not required

– Engaged where any one lender, or group of lenders acting under a "joint arrangement" or having a "common purpose", would hold more than 25% of the shares or voting rights

– Where the holding is directly in a Sensitive Qualifying Entity, a mandatory notification will be required and could also be needed where the aquisition occurs further up the corporate chain

– Could be triggered by the acquisition of a smaller shareholding if such smaller stake could secure or prevent the passage of any resolution

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Exercise of a put/call option over shares

– Since this involves changing the shareholders of an entity, it could be a mandatory trigger in relation to a Sensitive Qualifying Entity and a voluntary trigger otherwise

– Engaged where any one lender, or group of lenders acting under a "joint arrangement" or having a "common purpose", would hold more than 25% of the shares or voting rights

– Where the holding is directly in a Sensitive Qualifying Entity, a mandatory notification will be required and could also be needed where the aquisition occurs further up the corporate chain

– Could be triggered by the acquisition of a smaller shareholding if such smaller stake could secure or prevent the passage of any resolution

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Taking new share security

– The taking of a legal mortgage over shares is a trigger event under the Act provided more than 25% of the shares are subject to the mortgage

– If the mortgage is directly over shares in a Sensitive Qualifying Entity then a mandatory notification will be required, a mandatory notification may also be required where the security is taken at the level of a holding company of a Sensitive Qualifying Entity. Where a mandatory notification is not required, a voluntary notification should be considered

– Although there is an argument that taking a charge or equitable mortgage over shares may be a trigger event because it gives the security agent a proprietary "interest" in the shares and could be said to shift control over the shares to the security agent / creditors, our view is that notification is not required (and the government has now clarified that no mandatory notification is required in this regard)

– The scope of the protection in paragraph 7 to Schedule 1 for security takers is unclear, it could be argued to exempt the security agent/creditors from being deemed to have control of the shares at the point of taking the security

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Taking new asset security

– Taking security over an asset usually gives greater rights and control over the asset

– This is not subject to the mandatory notification regime but may be a trigger under the voluntary regime depending upon the rights conferred

– Particularly in relation to a Sensitive Qualifying Entity, where there are any potential national security concerns, it would be prudent to consider making a voluntary notification prior to taking new asset security

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Appointment of board members or observers

– It is common in a distressed scenario to appoint board observers to ensure the interests of creditors are properly considered

– This will be of concern under the Act where the observer exercises dominant or material influence over the policy of the entity

– The role of a board observer is usually limited to observing and reporting on board meetings to creditors. It would, therefore, be very unusual for a board observer to exercise sufficient control over the entity to constitute a trigger event under the Act

– Different considerations will apply to the appointment of or the right to appoint a board member in connection with a joint venture arrangement or otherwise, where such appointee may exercise greater influence over the policy of the entity

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Entering into a lock-up agreement

– The terms of the lock-up agreement will need to be carefully considered to see whether they enable the creditors to exercise dominant/material influence or control over the entity or a holding company

– If the terms of the lock-up agreement confer dominant influence or control in relation to a holding company of a Qualifying Sensitive Entity then a mandatory notification should be made, otherwise a voluntary notification ought to be considered

– In our experience, it would be unusual for the normal terms of a lock-up agreement to bestow either dominant or material influence or control over policy

– Of greater concern with standard lock-up agreements is that they will require the aggregation of creditor holdings (making creditors more likely to reach the >25%, >50%, ≥75% thresholds under the Act in relation to the voting rights attached to the shares, which may have been transferred to the creditors following an Event of Default) because they constitute creditors as acting under a "joint arrangement" or "common purpose". This could have the effect that notifications may be required in respect of lenders where they have previously only been required in respect of the security agent and / or an individual lender who met the thresholds alone

– Careful consideration should be applied prior to the entry into or the effectiveness of the lock-up agreement

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Debt trading

– Following any notifiable trigger event where the security agent and / or the lenders are the "acquirer" (eg the transfer of voting rights following an event of default) there would be a concern that each time there is a transfer of the underlying debt there could be a further trigger event requiring notification

– The holdings of multiple lenders may be aggregated, such that they are each considered to hold the total holding, where they are deemed to be acting under a "joint arrangement" or "common purpose".

– Even sub-participations (post a notifiable acquisition by the security agent and / or lenders) could require a notification if the sub-participant has voting rights

– Debt trading is very common in distressed scenarios, such that many notifications could be required. This is administratively burdensome

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