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The National Security and Investment Act 2021 – the impact on loans and finance transactions

On 29 April 2021, the UK's National Security and Investment Act 2021 ("**NSIA**") received Royal Assent after more than four months' of debate and scrutiny in Parliament.[1] Owing to the volume of secondary legislation that will need to be passed to give effect to the NSIA, the new regime (to be overseen by a newly established Investment Security Unit, sitting within the Department for Business, Energy & Industrial Strategy ("**BEIS**")) will not enter into force until the end of 2021. This is notwithstanding the fact that the NSIA, once operative, will have retrospective application to matters entered into after 12 November 2020.[2] Nonetheless, it is more important than ever for investors to be aware of the potential implications of this new regime, which will completely overhaul the Government's existing mechanisms for reviewing transactions on national security grounds.

One of the most salient (and less publicised) aspects of the NSIA is its potential to affect different finance transactions, such as loans and debt instruments convertible into equity. Any loan arrangement in which a lender takes security over the shares, voting rights and/or assets of a borrower could be within the scope of the NSIA. Despite calls from The Law Society to create a safe harbour for loans in order to avoid considerable uncertainties and difficulties for the UK finance market,[3] the Government has so far refused to do so (albeit it has noted its expectation that the majority of loans will not present any national security concerns).

In this briefing (which supplements our previous publications on this new regime), we will explore how the NSIA can potentially apply to secured lending transactions and we will outline some practical steps lenders can take to mitigate these risks.

When could the NSIA apply to finance transactions?

Although the Government has so far published little guidance on how the NSIA shall apply to financing arrangements, it has been very clear that financing arrangements such as loans are not exempt from the scope of the NSIA.[4] Whilst this position is consistent with other foreign direct investment ("**FDI**") screening regimes like CFIUS[5] in the USA, it also has significant practical implications for the structure and planning of these deals.

Briefly, the NSIA could apply to financing arrangements in the following ways:

1. **Underlying Transaction:** In the event that lenders are financing an underlying transaction – such as a property purchase, a construction project or a company acquisition – they will need to conduct sufficient due diligence to understand whether the underlying transaction could trigger a review under the NSIA (even though the primary responsibility falls on the parties to the main deal). This could be of concern to lenders were BEIS, following a review under the NSIA, to ultimately block/unwind or impose remedies in respect of the underlying transaction which might, as a result, prevent or delay the lenders in their ability to recover funds from the borrower. Accordingly, lenders may want to consider including an NSIA regime condition precedent or other contractual mitigants in the finance documents.
2. **Loan Agreements:** The granting of a loan is not, in and of itself, intended to fall within the scope of the NSIA, unless: (i) the loan agreement provides the lenders with a degree of control/material influence over the borrower or the security granted by the borrower ; and (ii) the nature of the borrower's

[1] The full text of the NSIA is available at: National Security and Investment Act 2021 (legislation.gov.uk).
[2] Now that the NSIA has passed into law, we expect the Government to begin publishing this further legislation within the coming months. Details of the secondary legislation that will need to be published can be found here: https://www.gov.uk/government/publications/national-security-and-investment-bill-2020/policy-statements-regarding-statutory-instruments-required-for-the-commencement-of-the-nsi-regime.
[3] The City of London Law Society. *National Security and Investment Bill – Joint Response of the Company Law Committees of the City of London Law Society and the Law Society: 2 December 2020*. Available at: CLLS-Company-Law-Committee-National-Security-Bill-Committee-response-submission.pdf (citysolicitors.org.uk).
[4] See, for instance, the Government's current Statement of Policy Intent at: Statement of policy intent - GOV.UK (www.gov.uk).
[5] The Committee on Foreign Investment in the United States is an inter-government agency responsible for overseeing and reviewing FDI in the U.S.

activities give rise to the risk of any potential mandatory notification or "call-in" by the Government. In most standard loan agreements, it is unusual to grant lenders such control/material influence rights. This notwithstanding, it is prudent for lenders to assess upfront whether they might inadvertently trigger the NSIA at the stage of granting the loan.

3. **Enforcement of Security:** The act of creating or taking security will not usually itself trigger the application of the NSIA. Rather, it is at the point a lender *enforces* its security over the shares, voting rights or assets that the provisions of the NSIA may take effect. The only exception to this is where the lender is immediately afforded the ability to control or direct how its rights are exercised upon taking security, rather than having to wait for the occurrence of events which are beyond its control (such as an event of default) before it can exercise its rights.[6]
4. **Sale of Security:** Lenders do not just face potential difficulties at the time they enforce any security but also at such time as they decide to realise the value of the security by effecting a sale in the wider market. Any such sale could also trigger a potential review under the NSIA. As such, lenders also need to be conscious that realising the value of any security could give BEIS a second bite at the apple.
5. **Administration Carve-Out:** Despite the broad potential application of the NSIA, the legislation provides a carve-out and exception for administrators and creditors while an entity is in administration (or similar proceedings under the laws of another country).[7] Namely, any administrator or creditor who exercises control over the borrower in such circumstances will not trigger any review under the NSIA. However, notably, this carve-out only applies to administrators/creditors, so it will not apply to other officeholders appointed in respect of other insolvency processes (such as liquidations) or any enforcement action taken by a secured party, including the appointment of receivers.
6. **Other Financial Arrangements:** Although this briefing focuses on application of the NSIA to secured loans, the NSIA can apply to other types of financial arrangements. For instance, if a borrower has issued a debt instrument to an investor which, upon the occurrence of certain events, is convertible into equity then such an arrangement could fall within the scope of the NSIA. As with an enforcement of security, the NSIA will only be triggered at such time as this conversion takes place. Similarly, the NSIA could apply to any other types of financial arrangements at the point at which there is a transfer of ownership, such as options and futures contracts.

As the most likely scenario to be faced under the NSIA is the issue of enforcement of security in loan transactions, the remainder of this briefing focuses on this aspect.

A. When will a lender need to make a mandatory filing?

In the context of loans, the mandatory notification regime under the NSIA will only apply where a lender enforces security over shares and/or voting rights of a borrower which has a UK connection. There will be a UK connection if the borrower or the security in question involves a UK entity which carries on activities in the UK or supplies goods or services to persons in the UK. Importantly also, if the lender(s) is taking security over assets only, then the mandatory notification regime will **not** apply but rather the voluntary regime.

Lenders must ask themselves two questions to determine whether the mandatory notification regime could apply to any enforcement of security:

1. Is security being taken over shares/voting rights and, if so, would enforcement of that security constitute a "trigger event"?

The enforcement of any security by a lender will constitute a "trigger event" where it relates to:

a) the acquisition of 25% or more of the borrower's shares and/or voting rights;

b) the extension of existing shares or voting rights above 25%, 50% or 75%; and/or

c) the acquisition of such a level of voting rights that would enable a lender to approve or prevent the passage of any class of resolution in the borrower.

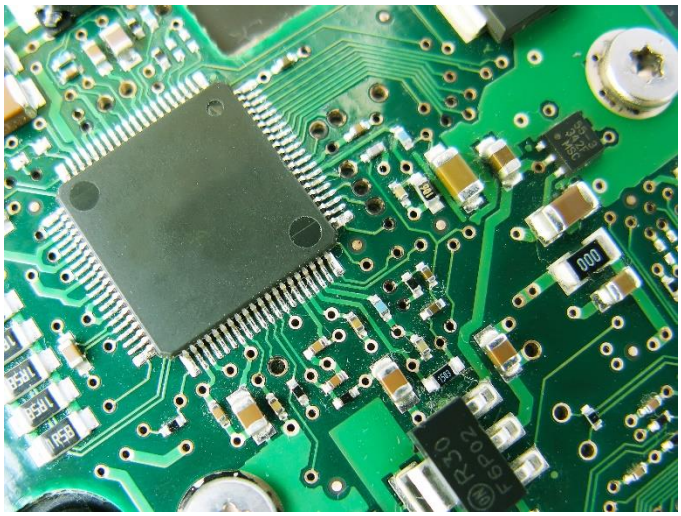
[6] Para 5 of Schedule 1 of the NSIA.
[7] Para 6(2) of Schedule 1 of the NSIA.

2. Is the borrower or the security granted by the borrower involved in one (or more) of the 17 key sectors?

If the borrower (including any of its parent or subsidiary companies) or the security granted by the borrower are involved in one (or more) of these so-called key sectors, this may require a notification if the "trigger event" thresholds are met (see Question 1 above).

These 17 key sectors include: (i) critical national infrastructure (e.g. civil nuclear, communications, data infrastructure, defence, energy and transport); (ii) advanced technologies (e.g. artificial intelligence, autonomous robotics, computing hardware, cryptographic authentication, advanced materials, quantum technologies and engineering biology); (iii) critical suppliers to Government and emergency services; (iv) military or dual-use technologies; and (v) satellite and space technologies.[8]

The Government recently undertook a public consultation on the proposed definitions of the 17 key sectors. These definitions have attracted criticism over their broad and, in some cases, ambiguous drafting which some fear will create uncertainty for parties as to whether or not they apply to certain deals and arrangements. Though the Government has duly provided some welcome clarifications, the definitions still remain broad and capable of applying to a great number of UK companies.[9]



If both elements of the two-limb test above are met, a lender will need to make a mandatory filing to BEIS before enforcing its security. Note that it does not matter whether any potential national security concerns arise – a mandatory notification must be submitted regardless and BEIS will then review and decide whether or not to investigate further.

Any failure to submit a mandatory notification will incur severe penalties, namely a fine of up to 5% of the company's annual global turnover (or £10 million, whichever is the higher) and even criminal penalties for company directors (e.g. up to five years in prison). Additionally, and probably more importantly for a lender, the unnotified transaction would be void and of no legal effect.[10]

Set out below is a hypothetical example of when a lender may be required to make a mandatory filing to BEIS:

Example

A UK company ("**Company B**") takes out a loan with a bank which is domiciled in a foreign jurisdiction ("**Lender A**"). One of Company B's portfolio companies' principal business activities is the manufacture of specialised semiconductors with military applications, where this portfolio company supplies many of its products directly to the UK defence sector. As part of the loan agreement with Company B, Lender A takes security over a new class of preferences shares, equivalent to 50% of the voting rights in Company B, which are exercisable upon any event of default. Again, Lender A would need to obtain mandatory approval from BEIS before enforcing this security as: (i) the preference shares would provide Lender A with more than 25% of the voting rights in Company B; and (ii) the activities of Company B's portfolio company would fall within the key sectors of 'Advanced Materials' and 'Defence'.

[8] Department for Business, Energy & Industrial Strategy. *National Security and Investment: Sectors in Scope of the Mandatory Regime – Government Response to the consultation on mandatory notification in specific sectors under the National Security and Investment Bill*. 2 March 2021. Available at: National Security and Investment: Sectors in Scope of the Mandatory Regime - government response (publishing.service.gov.uk).

[9] For more details, please see our separate briefing here.

[10] It is possible for parties to apply for retrospective validation of an unnotified transaction under the mandatory regime. However, whilst this might ultimately secure clearance for the transaction itself after BEIS has reviewed it, it has no bearing on the potential sanctions BEIS might impose on the parties for the failure to notify in the first instance.

B. When might lenders choose to make a voluntary filing / when might BEIS use its "call-in" powers?

If the mandatory regime does not apply, parties will be under no obligation to make a filing to BEIS. However, BEIS has a discretionary power under the NSIA to "call-in" transactions for review if it has any concerns that a particular transaction – in this case, any enforcement of security – poses a potential national security concern. In such circumstances, a lender may wish to consider making a voluntary notification to pre-empt any "call-in" by BEIS.

Note that BEIS' "call-in" powers are subject to a limitation period of five years from the date the transaction closes (i.e. security enforced) or the NSIA regime comes into effect (whichever is the later) – though this is reduced to six months once BEIS is "made aware" of the transaction.

Parties considering whether to make a voluntary filing, or assessing the likelihood of a "call-in" by the Government, should ask themselves the following questions:

1. Are the relevant "trigger events" met?

As with the mandatory regime, the voluntary/"call-in" regime is also triggered by specific trigger events.

- Regarding enforcement of security over shares, these are notably wider than the trigger events under the mandatory regime as they include all the triggers set out above at Question 1 (Section B) and also a "material influence" threshold – namely, if the lender acquires "material influence" over the borrower or the security of the borrower. Material influence may arise in relation to a lower shareholding/percentage of voting rights than under the mandatory regime, potentially even below 15%. It can also be deemed to arise if the lenders are able to exercise rights over and above those necessary to protect their investment, e.g. veto rights over strategic decisions such as business plans, budgets, appointment/dismissal of senior management, etc.
- In relation to enforcement of security over qualifying assets (namely, land, tangible property, IP, software) situated in the UK or used in connection with activities carried out in the UK or the supply of goods or services to persons in the UK, the trigger event will occur where there is an acquisition of a right or interest in the asset. It must give the lender the ability either to use the asset or to direct or control how the asset is used to a greater extent than prior to the enforcement of the security.

2. Is there a potential national security concern?

It is currently difficult to assess whether a national security concern exists, not least because the Government has deliberately withheld guidance on this point. The Government's Statement of Policy Intent states that BEIS will consider: (i) the target risk (i.e. whether it operates in a sensitive area of the UK economy); (ii) the trigger event risk (i.e. whether the level of control being acquired could conceivably be used against the UK's national security interests); and (iii) the acquirer risk (i.e. the extent to which the acquirer itself poses a national security threat).[11] This, in itself, does not provide much insight as to what specific issues BEIS will consider. The Government is expected to finalise and re-issue its Statement of Policy Intent at the same time that it issues secondary legislation and further guidance under the NSIA, which may mean that further clarify on this particular point will be forthcoming.

However, the previous decisions the Government has taken on national security grounds under the public interest regime[12] (the national security elements of which will be replaced by the NSIA) provide guidance on the sorts of issues that will be considered to be a potential national security concern in the context of enforcing security. For example:

a) Would enforcement of the security allow the lender to obtain access to sensitive information, sites or technologies and could this access corrupt certain processes or systems?

b) Are the land/properties and assets being acquired located near sensitive UK sites, such as military bases or scientific research facilities, which might facilitate espionage opportunities?

[11] See Statement of policy intent - GOV.UK (www.gov.uk)
[12] The UK's public interest regime is set out under the Enterprise Act 2002.

c) Could the enforcement of security impair the functioning of a critical supply chain, national infrastructure or natural resource?

d) Is there a risk that key assets and technologies might be acquired by a lender that would result in such assets, technologies and jobs being moved overseas?

e) Could the identity of the acquirer itself, and any entities/individuals which hold the ultimate beneficial interests in the acquirer, be perceived to be hostile and is there a risk they might look to act against the best interests of the UK?

Set out below is a hypothetical example where a lender may consider that there is a risk of BEIS "calling-in" the matter for review and which, as a result, may incentivise the lender to make a voluntary filing.

Example

A UK company based in Wiltshire which specialises in the development of various agricultural products ("**Company C**") takes out a loan with a foreign-domiciled bank ("**Lender B**") to finance the development of a new product line. As security for the loan, Company C offers mortgages on some farming land it owns which is used for testing its agricultural products but also happens to be situated near a top-secret Government research facility at Porton Down. In this scenario, BEIS may wish to ensure that, in the event the ownership of these properties might pass to Lender B after an event of default, that: (i) Lender B is not owned or controlled by any hostile foreign entities, governments or individuals; and (ii) the acquisition of this land would not help facilitate any espionage activities against the UK.

Practical steps for lenders

There are a number of questions lenders can ask themselves and (depending on the answers to those questions) key practical steps lenders can take at the outset of a secured lending transaction to help mitigate the NSIA risk on lending transactions.

1. Does the underlying transaction fall within the scope of the NSIA? If yes, should any provisions be included in the finance documents to mitigate the NSIA risk?

2. Could the exercise of any rights by the lenders in the loan agreement amount to a trigger event? If so, is any mandatory or voluntary notification necessary at the point of *granting* the loan?

3. Would the enforcement of any security amount to a trigger event (i.e., the acquisition of control or material influence over a qualifying entity or asset)?

4. Is the borrower (or are the assets/operations over which the lender has taken security) involved in one of the 17 key sectors which could trigger a mandatory notification?

5. Could the acquisition of control over the security give rise to a national security risk and, if so, is there a risk of a "call-in" by the Government? If this is the case, consider whether it would be prudent to make a voluntary notification to BEIS at the time at which security is enforced.

6. Consider, in light of the above, whether it might be possible to structure the security package in any particular way to mitigate against any national security risk or other NSIA risk (e.g. the type of security taken, the degree of control over security that would arise in an event of default, the type of remedy that could be offered if necessary to address any concern and even whether to take no security at all).

7. Consider also whether it would be prudent to include any specific NSIA conditions precedent, cooperation provisions or any representations, warranties or undertakings in the finance documents to mitigate against any NSIA risk.

Practical steps for borrowers

Whilst the risk of BEIS reviewing any security enforcement is much more a concern for the lender than the borrower, it would still be prudent for the borrower to be aware of this risk (and the extent of it) nonetheless – especially if it is already facing NSIA concerns with respect to the underlying transaction itself.

It would therefore be advisable for the borrower to conduct its own due diligence on the lender's ownership structure in order to understand whether the lender might be owned or controlled by a potentially hostile foreign entity or individual (which might lead BEIS to "call-in" any enforcement of security for review, assuming that the borrower is outside the scope of the 17 key sectors and no mandatory notification is triggered). Where the lender is an established UK bank the need to do this will be far less than if the lender is incorporated in a jurisdiction posing a perceived potential national security concern.

Potential consequences of underestimating the NSIA risk

Although the Government has stressed that reviews under the NSIA are expected to be swift, BEIS has the discretion to spend a significant period scrutinising

deals for any national security concerns. Not including the time it would take to prepare any filing or informally discuss the matter with BEIS before making any formal filing, BEIS can spend up to 105 working days or more reviewing a particular matter. Such an extensive review period will, of course, be most unwelcome for lenders and would be counterintuitive for a well-functioning, efficient loan market in the UK given that the efficient enforcement of security is an integral part of it.

However, as the legislation and guidance currently stand, lenders are likely to err on the side of caution and make voluntary filings prior to enforcing "in scope" security where there is a possibility there could be a national security risk. In the worst-case scenario, BEIS has the power to block and, if necessary, unwind any matter once it has completed its review under the NSIA. BEIS can also impose an interim order pending a final decision on clearance which may restrict the sale of the shares or the ability of the lenders (or subsequent purchaser of the secure shares) to exercise their voting rights. This is a considerable risk for lenders and makes it all the more important that sufficient due diligence on the NSIA risk is conducted before loans are entered into and security put in place. Moreover, BEIS will, as mentioned above, be able to impose draconian penalties for any failure to make a mandatory notification under the NSIA (where the transaction itself will be rendered null and void).

In the event that BEIS identifies a potential national security concern in a transaction and it decides to stop short of blocking and/or unwinding it, it may have recourse to a number of other remedies. For instance, BEIS might ringfence or otherwise restrict access to certain sensitive information, limit the amount of shares/voting rights that can be acquired and/or seek a wide range of behavioural/structural commitments from the parties.

Retrospective effect of the NSIA

Importantly, the NSIA will have retrospective application to any matter entered into after 12 November 2020. The Government has not yet confirmed what specific application this retrospective power will have to loan arrangements - namely whether it will apply only to *loan agreements executed* after this date or, alternatively, to any *security enforced* after this date. If this retrospective power applies to the latter – which seems likely – lenders in existing secured finance transactions entered into before 12 November 2020 will need to consider the potential application of the NSIA to any future enforcement of security they take (and past enforcements, if they occurred after 12 November 2020).

Whilst there will be no obligation to make a mandatory notification until such time as the NSIA regime becomes fully operational (which, again, is estimated to occur by the end of 2021), BEIS could nonetheless have the retrospective power to "call-in" any enforcement of security taken after 12 November 2020 in regard to loans that were executed even before that date. This would be an exceptionally broad power but, to judge from the rest of the NSIA, this would not be inconsistent.

Looking forward

The exact approach that the Government will take remains to be seen, as does the nature of the guidance it shall issue on this topic. As to this, the Government has indicated that further guidance will be made available to parties later in the year. Let us hope that at least some of these ambiguities are addressed in due course.

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