

Shropshire Council

Legal Considerations - Local Housing Company

1 Introduction

- 1.1 This note is prepared in connection with the legal issues surrounding the establishment of a local housing company (**LHC**). The Council objectives include supporting new development activity and providing an opportunity to generate a financial return, over an initial 5 year development programme.
- 1.2 There are two key activities that the Council wishes for the LHC to undertake:
- 1.2.1 development of new housing on land acquired or owned by the Council, for sale or rent; and
 - 1.2.2 property investment and rental.
- 1.3 Whilst the Council is primarily considering its options in relation to establishing a LHC and how it can utilise the benefits of using a Council owned vehicle to undertake these activities, it is important that the Council considers its ability to undertake the activities itself and the advantages and disadvantages doing so.
- 1.4 It should be noted from the outset that we have based our advice on the assumption that the Council will, at this stage, be establishing the LHC as a wholly owned vehicle.

2 Power to establish a LHC

- 2.1 Section 1 of the Localism Act 2011 (the **2011 Act**) provides local authorities with the power to do anything that an individual may do, subject to a number of limitations. This is referred to as the "general power of competence". The general power of competence is often characterised as a free-standing power and a local authority may exercise the general power of competence for its own purpose, for a commercial purpose and/or for the benefit of others.
- 2.2 In exercising this power, a local authority is still subject to its general duties (such as the fiduciary duties it owes to its rate and local tax payers – please see **paragraph 5** below) and to the public law requirements to exercise the general power of competence for a proper purpose.
- 2.3 Section 2 of the 2011 Act limits the exercise of the new general power where it 'overlaps' with a power which predates it. This includes the Council's power to trade under Section 95 of the Local Government Act 2003 (the **2003 Act**). Even if the Council were to rely on the general power of competence it would be prudent for it to comply with the requirements and limitations to which Section 95 is subject. These are set out in Regulation 2 of the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 (the **2009 Order**) which requires a business case to be prepared and approved by the Council before a company starts trading. The 2009 Order also provides that the Council must recover the costs of accommodation, goods, services, staff or any other thing that it supplies to a company to facilitate its power to trade.

- 2.4 Section 4 of the 2011 Act requires that, where a local authority exercises the general power of competence for a commercial purpose, it must do this through a company. The Council's stated purpose is to deliver market rent homes and deliver a commercial return to the Council.
- 2.5 Whilst there is no definition of a "commercial purpose" in the 2011 Act, taking the ordinary meaning of the phrase the Council's intention – to provide for an opportunity to generate a financial return – is likely to be a commercial purpose. Therefore, the Council's establishment of the LHC to take this commercial purpose forward would comply with Section 4 of the 2011 Act. Please do note that, whilst the Council would be required to use a company if it was using the general power of competence for a commercial purpose, it is not precluded from using a company otherwise.
- 2.6 Reviewing both the power in the 2009 Order and the 2011 Act, we would recommend that the Council uses the general power of competence under Section 1 of 2011 Act if it decides to establish an LHC. The Council's proposal for the development of properties through a company will amount to the use of the general power of competence for a commercial purpose and therefore the establishment of the LHC will meet the requirements of Section 4 of the 2011 Act.
- 2.7 As a commercial vehicle, the LHC could possibly also, be regarded as a trading vehicle and therefore it would be prudent in our view for the Council to comply with the provisions of the 2009 Order by preparing for approval by the Council a business case in advance of setting up the LHC.
- 2.8 As stated above, the Council will be required to justify that the LHC is being established for a proper purpose and the proposed commercial nature of the operation of the LHC will assist the Council with its justification for developing the LHC. It would, in our view, be an improper purpose if the Council was establishing the LHC as a means to provide 'social rented' housing of the type being developed and provided within the Council's HRA, and is doing so to avoid the RTB applying to any tenancies granted by the LHC (please see **paragraph 9** below). Developing affordable housing only where required by planning conditions, to be transferred to the Council's HRA or an RP, would, however, further evidence its commercial purpose.
- 2.9 Ensuring that the Council has a clear rationale is also important in the light of the concerns that were expressed in the Ministerial Statement issued in March 2015 by the then Housing Minister about the establishment of local housing companies in particular circumstances. The Ministerial Statement provided, amongst other things, that the Government would not support the establishment of local housing companies where such companies are established for the purposes of avoiding the RTB or avoiding the HRA borrowing restrictions imposed by Government.
- 2.10 The Ministerial Statement reinforces the need for the Council to be clear as to its rationale for establishing the LHC at all times, ensuring that there is clear evidence of this throughout the decision making process.
- 2.11 The Housing White Paper, published on 7 February 2017, to some extent echoes the statements of the then Housing Minister stating:

"we want to see tenants that local authorities place in new affordable properties offered equivalent terms to those in council housing, including a right to buy."

- 2.12 This is arguably not a policy shift from the March 2015 Ministerial statement but the wording contained within the White Paper specifically references "a" right to buy as opposed to "the" Right to Buy and is stated to be a Government expectation only. The Government has confirmed that it will not be consulting on this point, nor is there any suggestion that it will be seeking to impose any legislative changes in this regard. Therefore, without a statutory requirement, and provided the establishment of the LHC cannot be struck down as an ultra vires act of the Council (of which we know no relevant precedent), the properties developed by the LHC would not be subject to the statutory RTB.
- 2.13 We would also note that the White Paper "welcomes" innovative models to provide more housing by local authorities and specifically references local housing companies and joint venture models. This is positive as it is a clear statement of support by the Government.
- 2.14 The Council will need to be mindful of the above considerations when justifying its use of powers as we have described above.
- 2.15 Please do note that if in the future the Council were to consider delivering affordable housing then it would need to review and manage any vires/powers risks.

3 **Section 12 of the 2003 Act - Investment Power**

- 3.1 To the extent that other powers are needed to establish the LHC (which we do not believe they are), the Council also has a power to invest under Section 12 of the 2003 Act. We refer to this power for completeness, as it may be available to the Council if it is able to satisfy itself that the development or acquisition of properties and/or the provision of debt and/or equity into the LHC for those purposes amounts to an investment rather than a commercial purpose.
- 3.2 Under Section 12 of the 2003 Act a local authority may invest:
- "(a) for any purpose relevant to its functions under any enactment; or
- (b) for the purposes of the prudent management of its financial affairs."
- 3.3 Section 15 of the 2003 Act goes on to provide that, before exercising the power to invest, the Council must have regard to Guidance issued by the Secretary of State. This is set out in the Department for Communities and Local Government's "Guidance on Local Government Investments" published on 11 March 2010 (the **CLG Guidance**). The Council should also consider related Guidance published by CIPFA under "Treasury Management in the Public Services: Code of Practice and Cross Sectorial Guidance Notes" (the **CIPFA Guidance**) and "The Prudential Code for Capital Finance in Local Authorities" (the **Prudential Code**). The CLG Guidance requires the Council to consider security, liquidity and yield (in that order).
- 3.4 If the Council were to rely on Section 12 of the 2003 Act as a source of statutory power, the Council's Chief Finance Officer will need to be satisfied that the investment is in accordance with the Council's current investment strategy. Given the breadth of the general power of competence we do not believe it is necessary for the Council to rely on the investment power for the establishment of the LHC.

4 Structure of the LHC

4.1 As stated within the introduction, for the purposes of this report we have assumed that the LHC will be wholly owned by the Council, and therefore it could take the form of a company limited by shares (**CLS**) or a company limited by guarantee (**CLG**). For the purposes of Section 4 of the 2011 Act, a Community Benefit Society (**CBS**) is also a corporate vehicle which is included within definition of "company". However, given that a CBS must be established for a community benefit and is restricted in respect of profit distribution we have discounted its applicability for the Council's proposals.

4.2 If the Council uses the general power of competence for a commercial purpose, requiring the use of a company in accordance with Section 4 of the 2011 Act the use of a limited liability partnership (**LLP**) is not permissible. An LLP also requires at least two members and could not be used as a wholly owned vehicle.

4.3 In the light of this and as the Council wishes to establish a company in the most efficient way we have discounted the use of an LLP for these purposes. We focus on the key elements of a CLG and CLS below:

CLG

4.4 A CLG is a company where the general members do not hold shares, but instead each member undertakes to pay a nominal figure (typically £1) in the event of the company becoming insolvent. If the LHC is to be a wholly-owned subsidiary (as envisaged) the Council would initially be the sole member; but a CLG can have many members, and different categories of members with different voting rights. Changing from a single member company to one with many members is also simple.

4.5 However, unless it is charitable (which would not be appropriate for the Council's purposes as it would limit the Company's activities so that it could not, develop housing for market rent and/or sale), a CLG does not offer Stamp Duty Land Tax (**SDLT**) advantages which may be available for a CLS (see **paragraph 4.7** below). It is also impossible to capitalise a CLG with equity.

CLS

4.6 A CLS is the type of company with which most people are familiar. The corporate structure is tried and tested and is underpinned by an established body of law and practice. A CLS is appropriate for companies being used for commercial purposes such as trade and investment and is a typical form of commercial vehicle established with a view to making a profit (unlike a CLG model which will generally be a non-profit distributing model). This means to the extent that an LHC generated a surplus that surplus could be repatriated to the Council by way of a dividend payment.

4.7 The CLS model has the advantage that it can potentially claim group relief for SDLT purposes if the land is transferred from the Council to the LHC. Group relief is available if 75% of the paid up share capital in the company is held by the Council - as would will be the case if the Council is the sole shareholder owning all of the paid up shares.

4.8 In terms of overall control and also financial and tax planning, the structure of a CLS provides considerable flexibility through the creation of different types of share and loan capital. It is also simple to admit equity shareholders if the Council wishes to make the

LHC a joint venture vehicle in the future, possibly to introduce a developer partner or perhaps with the aim of taking the LHC off the Council's balance sheet at a later date.

4.9 The CLS model also lends itself more easily to meeting the test that it is a body with an industrial and commercial character and thus not being 'caught' by European procurement rules (please see **paragraph 11** below).

4.10 In the light of the above and subject to the financial and tax advice from Savills, from a legal perspective we advise that a CLS is the most appropriate form of vehicle for the LHC.

5 **Fiduciary Duties**

5.1 When considering the establishment of a company, the Council must be mindful of its fiduciary duties. The Council's fiduciary duties can be briefly summarised as acting as a trustee of Council tax and public sector income on behalf of its rate and tax payers. The Council in effect holds money but does not own it; it spends money on behalf of its business rate and council tax payers. The Council's fiduciary duty also includes it acting in a "business-like manner".

5.2 In practice the Council, in making its decisions concerning the formation of the LHC and the provisions of services, investments and loans it provides to it (and any similar activities) needs on each occasion to act efficiently and only undertake funding (and related decisions) after proper consideration of the risks and rewards of it doing so. The Court of Appeal in one of the leading cases in this area of law stipulated that local authorities' fiduciary duties extended not only to a consideration of risk and cost but also whether a local authority's involvement in a transaction is proportionate and properly balanced against the anticipated benefit as well as the wider interests of its local tax payers.

5.3 Taking its fiduciary duties into consideration, the Council will want to ensure that it is maximising the chance of success of the LHC and achieving an appropriate return for any risk it takes, whilst minimising the risk and potential cost to it if the LHC became insolvent and/or defaulted on any loan(s).

5.4 In the light of the above, Members will need to evidence that they have taken reasonable steps to discharge this fiduciary duty when considering:

5.4.1 whether the business case for the LHC is viable,

5.4.2 the risks and rewards of investing/lending; and

5.4.3 the wider (possibly alternative) interests of local tax payers (e.g. what else could the money have been spent on / the risk it will have to increase council tax?).

and we would recommend that any reports to Cabinet approving the establishment of the LHC (and or for any loans made to it) reference the Members' consideration of the above.

5.5 The Council's fiduciary duties should be considered throughout the "life" of the LHC and post-incorporation decision making will need to be clearly evidenced.

6 Disposals of Land

Housing Revenue Account (HRA) Land

- 6.1 The Council has the power to transfer land held in the HRA, on either a freehold or leasehold basis, in accordance with section 32 of the Housing Act 1985 (the **1985 Act**). The use of the section 32 power is conditional upon obtaining the prior consent of the Secretary of State. There are some general consents which are currently contained in the "General Housing Consents 2013" (the **General Consent**). General Consent A3.2 provides that a "local authority may dispose of vacant land". "Vacant" is defined in the General Consent as being land on which:

6.1.1 No dwelling-houses have been built; or

6.1.2 Where dwelling-houses have been built, such dwelling-houses have been demolished or are no longer capable of human habitation and are due to be demolished.

- 6.2 The Council is therefore able to transfer vacant HRA land to the LHC for any price. However, if the price is less than market value then that would amount to the provision of financial assistance and/or gratuitous benefit for the purposes of Section 25 of the Local Government Act 1988 (please see **paragraph 7** below).

- 6.3 In relation to the disposal of land with dwellings on it, General Consent A3.1.1 provides that a local authority may, subject to paragraph A3.1.2, dispose of land for consideration equal to its market value. Paragraph A3.1.2 provides that the General Consent to dispose of land for a consideration equal to its market value does not apply to:

6.3.1 A disposal of land which is subject to a secure, introductory or demoted tenancy to occupy from the local authority to a landlord who is not another local authority;

6.3.2 A disposal of land that falls within Consent D (The General Consent for the Disposal of Reversionary Interests of Houses and Flats 2013); or

6.3.3 A disposal of land to a body in which the local authority owns an interest except:

(a) Where the local authority has no HRA; or

(b) In the case of a local authority with a HRA (like the Council), the first five disposals in a financial year.

- 6.4 "Disposal" is defined to include "a conveyance of a freehold interest" or "the grant of a lease of any duration". Therefore, where the land is not vacant (as defined) the Council is limited to five disposals per financial year at market value to the LHC.

General Fund Land

- 6.5 The Council may also consider transferring land from its General Fund to the LHC. Section 123 of the Local Government Act 1972 provides the Council with the power to dispose of land held by it in the General Fund in any manner that it wishes; the restriction on this being that, except with consent from the Secretary of State, the Council shall not dispose

of land (otherwise than by way of a short tenancy), for consideration less than the best that can reasonably be obtained.

- 6.6 If a Council disposes of a property at an "under-value" it requires the consent of the Secretary of State (except for limited circumstances such as short term leases). In any event, there would be State Aid concerns if the Council were to sell land to the LHC at an "under-value" (see **paragraph 10** for full consideration of State Aid). In particular, these State Aid concerns would arise in connection with the LHC operating the business of providing homes at market rent or for market sale as is proposed.
- 6.7 The Council may rely on circular 06/03 Local Government Act 1972 the General Disposal Consent (England) 2003 – disposal of land for less than best consideration that can be reasonably achieved (the **General Disposal Consent**) which sets out the circumstances in which the Secretary of State pre-approves/pre-consents to the disposal of General Fund land at an under-value. To utilise this General Disposal Consent, the "under-value" (in relation to a disposal) must not exceed £2 million and the Council's purpose in making such a disposal must be to contribute to the economic social and environmental well-being of the authority's area and/or its residents. The Council would need to verify the market value of the land in question through a qualified independent surveyor. Please do note that State Aid requirements also require that the Council would need to obtain such a valuation prior to entering into any negotiation with the LHC on a sale price.
- 6.8 Please do note that the LHC would not be subject to any statutory restrictions on the disposal of property or land.

7 Council's power to provide funding to the LHC for privately let housing

- 7.1 The Council also has the power (in accordance with Section 24 of the Local Government Act 1988 (**the 1988 Act**)) to provide any person with financial assistance for the purposes of, or in connection with, the acquisition, construction, conversion, rehabilitation, improvement, maintenance or management (whether by that person or by another) of any property which is or is intended to be privately let housing accommodation (as defined in the 1988 Act which would include property to be let by the Company). To 'make a grant or loan' or 'acquire share capital' are both included within the definition of financial assistance within Section 24 of the 1988 Act. Also, any under value land transfers (please see **paragraph 6** above) and the provision of funding more generally (such as initial set up costs and/or overdraft facilities) are likely to fall within this provision. To the extent therefore that the Council's financial support to the LHC is connected with privately let housing then the power under Section 24 of the 1988 Act is available.
- 7.2 Section 25 of the 1988 Act provides that the power in Section 24 of the 1988 Act may only be exercised in accordance with consent of the Secretary of State. The Secretary of State has issued general consent under Section 25 of the 1988 Act – The General Consents under section 25 of the Local Government Act 1988 (Local Authority assistance for privately let housing) 2010 (the **General Consents**). General Consent C of the General Consents provides that a local authority may provide any person with any financial assistance (other than the disposal of an interest in land or property) for the purposes of or in connection with the matters in Section 24 of the 1988 Act. Accordingly this provides the Council with the power to invest monies in the LHC whether by way of loan or share equity if such investment is in connection with privately let housing. However, the Council could not rely on General Consent C for the transfer of land at an under-value.

7.3 The Council could rely on General Consent AA of the General Consents which allows HRA land to be transferred at an undervalue for development as housing accommodation - but the disposal must be on terms that require the land to be used as privately let housing. In anticipation of the possible future use of HRA land we rehearse the relevant conditions attached to the General Consent below:

7.3.1 any housing accommodation on the land when the disposal is completed is vacant or due for demolition;

7.3.2 the disposal is by way of a transfer of freehold or a lease of no less than 99 years;

7.3.3 the terms of the disposal require the development of any housing accommodation to be completed within three years of the disposal;

7.3.4 the local authority is not under any agreement or other arrangement made on or before the disposal entitled to manage or maintain any other housing accommodation to be developed on the land.

7.4 There are other General Consents issued under Section 25 of 1988 Act which support the provision of disposal of land to RPs, but given that the LHC is not proposed to be established as a RP we have not considered those consents further.

7.5 Please do note that the provisions of sections 24 and 25 of the 1988 Act only apply in relation to the provision of financial support for rented accommodation. In relation to funding made available for other purposes, such as market sale, the Council is not restricted by the constraints in Section 24 of the 1988 Act. Of course this also means that it cannot rely on the express power in that section. The Council could instead exercise its general power of competence on the basis that it is lawful for an individual to lend and/or invest subject to the reasonable exercise of the general power of competence, we are not aware of any pre-existing limitations which would prevent it from doing so in connection with sale activities.

7.6 In order to avoid the requirement to obtain specific consent under Section 25 of the 1988 Act (and to ensure that State Aid requirements are met), the Council would likely need to obtain valuation advice to enable it to satisfy itself that the disposals of any land to the LHC would be at a consideration that is the best that can reasonably be obtained. If a Section 25 General Consent is used it will override the need for the Council to obtain consent under Section 32 of the 1985 Act or Section 123 of the 1972 Act.

8 **Borrowing and on-lending**

8.1 The Council will need to consider how it will be funding the LHC. The Council should ensure that any proposed funding for the LHC is within its strategic budgets and there will need to be co-ordination between the Company's business plan and budget process.

8.2 Section 1 of the 2003 Act gives the Council power to borrow for any of its functions and for the prudent management of its financial affairs. A "function" can include the general power of competence. As it is unlawful for the Council to borrow to on-lend to the LHC to fund revenue expenditure, the Council must be mindful of this when establishing the LHC. Therefore the Council has power to borrow money for the purpose of making such funding available to the LHC, so long as this is only to fund capital expenditure.

- 8.3 Regulation 25 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 2003/3146) stipulates the circumstances in which a loan made by a local authority to a third party (such as the Company) is treated as capital expenditure.
- 8.4 In effect, Regulation 25 imposes a comparative test. If, instead of making a loan to the LHC, the Council:
- 8.4.1 would use that money for the same purpose as the LHC would (under the loan); and
 - 8.4.2 a council would treat this as capital expenditure in accordance with proper accountancy practice;
- then the loan qualifies as capital expenditure.
- 8.5 When providing market loans a local authority is required to act as a notional market lender (often referred to as MEIP or the Market Economy Investor/Lender Principle) (please see **paragraph 10**) and not as a public authority. Her Majesty's Revenue & Customs (**HMRC**) also require that commercial loans between two connected parties – such as the Council and the LHC - are given on the same financial arms-length terms as might apply to a loan made between two unconnected parties (e.g. a bank and the Company).
- 8.6 In order to rely on the MEIP the Council should seek independent commercial/financial advice confirming that the proposed loan agreement is being made on commercial terms and a notional market economy operator would consider acting in the same way. This is important as it will provide evidence that the Council's arrangements do qualify as MEIP
- 8.7 Most local authorities proceeding down the route of establishing property/housing companies opt to borrow from the Public Works Loan Board (**PWLB**) (now, in effect, the Debt Management Office (**DMO**)) and then on-lend to their subsidiary companies. It is likely that the requirements of Section 1 of the 2003 Act will be met but the Section 151 Officer/Finance Director will need to be satisfied about compliance with the Prudential Code and State Aid.

9 **Governance**

- 9.1 Determining and implementing governance arrangements for the LHC at both shareholder and director level is a crucial matter for the Council. Practice varies between other local authorities who have implemented similar initiatives and governance arrangements can be varied, incorporating a mix of officers, Councillors and external advisors/directors (e.g. independent non-executives who may have particular business skills and expertise).
- 9.2 A company's main decision making body is its Board of Directors (the **Board**). As sole shareholder the Council should ensure it has the right to appoint and dismiss directors and restrict the right of the Board to appoint additional directors. This can be achieved through the Company's Articles of Association and a Shareholder's Agreement (please see **paragraphs 9.11 - 9.14** below).

Who should be Directors?

- 9.3 When appointing any director the Council should consider the general statutory duties of directors as set out in chapter 2 of part 10 of the Companies Act 2006 (the **2006 Act**). These duties must be complied with in respect of all matters, but they are not exhaustive nor can they be contracted out of. The duties are as follows:
- 9.3.1 The duty to act within powers;
 - 9.3.2 The duty to promote the success of the company;
 - 9.3.3 The duty to exercise independent judgment;
 - 9.3.4 The duty to exercise reasonable care, skill and diligence;
 - 9.3.5 The duty to avoid conflicts of interest;
 - 9.3.6 The duty not to accept benefits from third parties; and
 - 9.3.7 The duty to declare an interest in proposed transaction or arrangement.
- 9.4 The Council should be particularly mindful of the duty to avoid conflicts of interest. This duty applies to all conflicts, actual and potential, between the interests of the directors and the Council as sole shareholder. There will inevitably be scenarios where conflicts of interest arise because of particular roles of a director of the LHC. These scenarios may not always be clear cut, but examples may include the Council making a decision:
- 9.4.1 to lend money to and / or transfer land to the LHC;
 - 9.4.2 in favour of a third party and to the detriment of the LHC; or
 - 9.4.3 on planning policy and land development.
- 9.5 An officer of the Council, in their capacity as a director of the LHC, may find it difficult to undertake a decision making role in these circumstances. Directors should ensure that they are alive to the fact that conflicts are likely to arise, declare them as required, and ensure that, when they are acting as a director, they act in the best interests of the LHC.
- 9.6 It should be noted that in most circumstances the interests of the Council and the LHC will be aligned as the Council will be the Company's sole shareholder, and both organisations will want to achieve similar objectives. The risk of a conflict of interest on a day to day basis will therefore be limited.
- 9.7 The Council should note that, whilst directors of a company are generally not personally liable for the debts of the LHC, a director may be personally liable if the LHC got into financial difficulty and the director was involved in wrongful or fraudulent trading. To avoid both fraudulent trading and wrongful trading directors must remain sufficiently informed as to the financial situation of the LHC at all times so that they are able to form a view as to whether there is or is not a reasonable prospect of avoiding insolvent winding up. In addition to this, whilst it is extremely unlikely to be a cause of concern for the LHC due the nature of its business, directors can be personally liable under the common law offence of manslaughter by gross negligence if they are the "directing mind" of the company and can also be criminally liable under health and safety legislation. A company can be liable under

the Corporate Manslaughter and Corporate Homicide Act 2007 but individuals cannot be guilty of the main offence, nor aiding, abetting, counselling or procuring the commission of corporate manslaughter.

- 9.8 The LHC may not exempt a director from any liability for negligence, default, breach of duty or breach of trust in relation to the LHC. However, the Council may indemnify the director against defence costs, or costs incurred in an application that the director makes to the court for relief, provided that the director repays the costs if he is unsuccessful and, in practice a shareholder might be the most likely party to bring an action i.e. the Council.

Unconnected Directors

- 9.9 A number of Councils have chosen to appoint persons who are unconnected to it (not being members or officers), to fulfil non-executive roles. Part of their rationale has been to harness the skills and experience of persons who have operated similar businesses. Non-Executive directors generally are appointed for a number of set days which reduces the costs of remunerating them.
- 9.10 If the Council opted for this route it would retain the right (under the Company's Articles of Association and any Shareholder Agreement) to dismiss and appoint the company's directors as it sees fit.

Shareholder role

- 9.11 We would also recommend that the Council and the LHC enter into Shareholder Agreement. The primary purpose of a Shareholder Agreement is to regulate the relationship between the Council and the LHC. Ordinarily other than where legislation and/or articles of association reserve decisions for shareholders the Board of a company is its main decision making body, and is free to act as it thinks is in the best interests of the LHC. Ordinarily this would, for instance, include issuing shares to third parties (which no doubt the Council would want to control) or borrowing (which would impact on the Council's own prudential borrowing limit).
- 9.12 In the private sector a company would, in practice, have "informal arrangements" to ensure that its directors complied with the requirements and strategy of that business' owners. As a public body the Council is hampered in adopting an informal approach. Instead it should seek a codified governance model for the LHC which will both support a business minded approach and protect its own interests.
- 9.13 A Shareholder Agreement should seek to support this approach by stipulating that the Company's Board is responsible for running the LHC. However such an agreement would likely provide the Council, as the sole shareholder, with a number of reserved rights:
- 9.13.1 Issuing new share capital the Council could lose control of the LHC if shares were issued to other parties;
 - 9.13.2 Borrowing – the Company's borrowing forms part of the Council's group debts and it is therefore likely to want to know and approve its debt levels;
 - 9.13.3 Information provision – shareholders are not legally entitled to detailed financial and operational information (though Council owned companies are required to

disclose more information than those with private owners) and as sole shareholder the Council is likely to want access to this;

9.13.4 Business Plan approval – if the Council is to borrow to fund the development/expansion of the LHC then it needs to know the likely future demand to ensure this is included within the budget approved by full Council;

9.13.5 Good governance – the Council is likely to want the directors to comply with private sector good governance standards (including procurement/value for money) and it will want to approve any commercial arrangements between the LHC and its directors;

9.13.6 Controlled Company requirements – as a local authority controlled company the businesses will be restricted in respect of political and certain other activity. The Council is likely to want to enshrine this.

9.14 Below is an indicative decision making matrix, which provides an example of the decisions that can be made at board level or at shareholder level within a housing company. The precise details of the shareholders agreement will be developed in due course.

Issue	Officers of the LHC	Board of the LHC	Council (acting as shareholder of the LHC)
Customer issues			
make any amendments to any Lettings Policy and Sales Policy;			✓
implement the Rent Policy;	✓		
implement the Debt Recovery Policy;	✓		
Business issues			
Approve any business other than as contemplated by the Business Plan;			✓
Engage in business contemplated by the Business Plan (including acquisition of property that fits with an agreed Financial Model);	✓	✓	
Approve any contract with a value in excess of £[tba];			✓
Approve any arrangement, contract or transaction outside the normal course of its business or otherwise than on arm's length terms.			✓

Issue	Officers of the LHC	Board of the LHC	Council (acting as shareholder of the LHC)
Close down any business operation, or dispose of any material asset unless in each case such closure or disposal is expressly contemplated by the Business Plan;			✓
Acquire any land with a value in excess of £[tba];			✓
Approve acquisition of any land or property outside of the Council's administrative area			✓
Make any amendments to the Financial Model;			✓
Adopt or amend housing company's Remuneration Policy;			✓
Adopt or amend housing company's annual Business Plan.			✓

- 9.15 The Council may also consider appointing a Shareholder Committee to exercise its role as sole shareholder. This type of arrangement is entirely within the Council's gift and provides a great degree of flexibility in relation to the role of elected members - members could sit on the shareholder committee, as opposed to the board, providing them with oversight of the Company's actions whilst being removed from the "day to day" decision making and limiting the risk of a conflict of interest.

10 State Aid

- 10.1 If the Council provides financial assistance to the LHC by way of providing below market rate funding or transferring land at an under-value, then this may constitute State Aid.
- 10.2 The legal requirements of State Aid and what will constitute as State Aid is set out in the Treaty of the Functioning of the European Union (TFEU). Article 107 (1) TFEU confirms that the following aspects must be present for State Aid to exist:
- 10.2.1 amount to a grant of public money or a transfer of public resources;
 - 10.2.2 favour certain undertakings (selective element);
 - 10.2.3 which distort or threaten to distort competition in the European Union; and
 - 10.2.4 affect trade between the Member States of the European Union.

- 10.3 Both financial payments to the LHC and the transfer of property to the LHC can be caught by the State Aid provisions and therefore funding arrangements between the Council and the LHC must be correctly structured so that State Aid, as defined above, does not arise. The structure of any financial arrangement between the Council and the LHC will be required to be in a manner which is permitted under the TFEU and European Directives, European Commission communications and decisions from the European Court of Justice.
- 10.4 There are provisions for which the funding could fall outside of the State Aid definition where the Council is acting in a way that a private lender and/or investor would in similar circumstances in a market economy – this is known as the Market Economy Investor Principle (**MEIP**).
- 10.5 The terms of a MEIP compliant loan must be commercial in nature and contain provisions which a private lender would require (clauses on regular payment, default, security over assets and similar terms); have a commercial interest rate which properly reflects the risk and security, and other factors which a private/commercial lender would take into account in calculating an appropriate interest rate.
- 10.6 We would recommend that once the exact type of funding is decided by the Council, an independent report which analyses the relevant risk in relation to the loan is obtained and it is confirmed that the interest rate applied is consistent with that which a private lender would require in the same circumstances and that the non-financial element of the loan complies with the terms and conditions which a private lender is likely to require.
- 10.7 The Council also has the option to invest money into the LHC as equity (i.e. subscription to share capital) either instead of providing it with a loan and/or as mixed equity/debt funding and the evidence which the Council would require in connection with any equity investment mirrors that which is required for a loan.
- 10.8 There is an exemption to State Aid for service of a general economic interest and therefore if the properties are developed or acquired for letting as social/affordable or intermediate housing. We understand however that at present this is not the Council's intention for the proposed LHC. The Council must therefore ensure that any funding or assets transferred are MEIP compliant, being that it is commercial in nature and containing provisions that a private lender would require.
- 11 **Procurement**
- 11.1 The LHC will not be subject to the Public Contracts Regulations 2015 (the **2015 Regulations**) if it does not fall within the definition of a 'body governed by public law.'
- 11.2 A body governed by public law means bodies that have all of the following characteristics:
- 11.2.1 They are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character;
- 11.2.2 They have a legal personality; and
- 11.2.3 They have any of the following characteristics:
- (a) they are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law;

- (b) they are subject to management supervision by those authorities or bodies; or
- (c) they have an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law;

11.3 As such the point here is to determine whether the LHC is a "body governed by public law" for the purposes of the 2015 Regulations and for this analysis the LHC must have a "commercial character" if it is to not be governed by the 2015 Regulations.

11.4 The LHC cannot be said to have a "commercial character" unless it is free to operate as a commercial company would do so and without significant intrusive Council controls.

11.5 If the Council concludes that it requires "real" control over the LHC, it is likely to be classified a "body governed by public law" and if this is the case then the LHC would be subject to the EU procurement requirements.

11.6 If the LHC were not subject to the EU procurement requirements then it can procure services as it sees fit.

12 **Contracts with the Council**

12.1 A service level agreement (**SLA**) or other contract may be needed to govern the arrangements between the Council as parent and the LHC as its subsidiary. In particular, this will provide for those services which may need to be provided by the Council to the LHC. In the absence of employees (which the Council is not envisaging having at present) the LHC will be dependent on the Council not only for officers or employees but also for back office and specialist support, usually including financial and IT arrangements.

12.2 These contractual provisions need to be sufficiently detailed to allow the LHC to operate commercially and, within limits, independently of the Council; but they must also enable the Council to recover its costs. Of course, any SLA would need to be compliant with State Aid requirements (see above).

13 **Tenancies**

13.1 The LHC would not grant secure tenancies since it would not "satisfy" the so-called landlord condition for the purpose of section 80 of the Housing Act 1985 (the **1985 Act**). Any tenants would not therefore have the statutory RTB. Tenants of the LHC would hold assured tenancies under the Housing Act 1988 and we anticipate that it will let units on assured short-hold tenancies (**ASTs**).

13.2 A key feature of an AST is that the landlord has the right to regain possession of the property at the end of the fixed term as long as the landlord gives two months' notice. The tenancy must be for a minimum of six months but the LHC may set the term such length as it (and the Council as shareholder) considers appropriate. Please note that any deposit taken in connection with an AST must be protected in a Government-approved tenancy deposit scheme.

13.3 It is common for ASTs to be let on a fixed term of up to two years. This will allow the landlord to remain competitive in the market and provide tenants with flexibility. An

additional positive feature is that the LHC will, as landlord, have the right to regain possession of the property at the end of the fixed term provided that they provide the tenant with two months' notice.

- 13.4 Any deposit that the LHC takes from a tenant for an AST must be protected in a tenancy protection scheme that is Government approved.

14 **Interaction with propriety controls on local authority companies**

- 14.1 Part V of the Local Government Act 1989 together with the Local Authorities (Companies) Order 1990 (the **Companies Order**) imposes a number of statutory requirements on companies which are controlled or influenced by local authorities. On the basis that the LHC will be wholly owned by the Council and its directors will also be appointed by the authority then the LHC will under this legislation be classified as a non-arm's length controlled company.

- 14.2 The Companies Order includes the provisions that the Council should be mindful of:

- 14.2.1 The LHC will need to ensure that its business documentation states that it is controlled by the Council and states the full name of the LHC, including the word "limited". This includes all business letters, notices, advertisements and other official publications including email and websites, bills, invoices and receipts

- 14.2.2 If Councillors are appointed as directors they cannot be paid remuneration in excess of the greatest amount which would be payable by the Council in respect of a comparable duty performed on behalf of the Council.

- 14.2.3 The LHC will be required to provide any member of the Council any information about its affairs as that member requests which is reasonably required for them to properly discharge their duties (other than where this would be in breach of legislation or another legal obligation).

- 14.2.4 Minutes of general meetings (not board meetings) of the LHC must also be made available for inspection by the public.

- 14.2.5 The same restrictions on publishing political materials as apply to the Council will apply to the LHC.

- 14.3 The Freedom of Information Act 2000 (**FOIA**) will also apply to the LHC which means that it will be obliged to adopt a "publication scheme" which commits the LHC to making available information which falls into categories identified by the Information Commissioner, such as key organisational, financial and policy information. In addition, members of the public may request access to recorded information held by the LHC (provided it is not exempt) under FOIA in the same way as they may from the Council.

15 **Could the Council undertake the activities itself?**

- 15.1 As these are two distinct types of activities we have separated out the Council's powers into 2 parts - the Council as developer and the Council as portfolio holder. Whilst it is our view that the Council would most likely seek to undertake the activities via the LHC, for

completeness the Council should consider its ability to undertake these itself and what the implications of doing so would be.

The Council as a developer

- 15.2 The first consideration for the Council would be whether it has the capacity to undertake development itself and what the implications of doing so would be. For example the Council is a "body governed by public law" and therefore would be required to comply with the 2015 Regulations when appointing third party developers (and others). Hand in hand with this, the Council would be taking on all of the risk of development, as opposed to having a degree of ring-fencing by using an LHC.
- 15.3 If the Council were minded to undertake development itself it is able to do so using a number of different powers.
- 15.4 The first power that the Council could consider is Section 2 of the Local Authorities (Land) Act 1963 (the **1963 Act**). This power gives the council the power to erect any building and construct or carry out works on land and may only be used where the development of buildings/works is for the benefit or improvement of [that local authority's] area. From a practical point of view, if the council can evidence that the construction of housing will benefit its area by increasing housing supply (and/or other reasons) then it is arguable that the council could rely upon the 1963 Act.
- 15.5 In considering the use of this power the council should reflect upon the judgement of the LAML case¹ which addressed the use of *well-being power*². To an extent the well-being powers criteria of promoting or improving the well-being of their areas is analogous to the requirement under the 1963 Act for a council to undertake development to *benefit or improve its area*. In LAML LJ Pill stated, "*I do not consider that Parliament was giving a carte blanche to make arrangements...or the identification of some advantage, or potential advantage, to the local authority's financial position*"³.
- 15.6 As officers may be aware the well-being power enabled local authorities (subject to a number of restrictions) to undertake activities if this promoted or improved the economic, social or environmental well-being of their areas. Brent Council (together with other authorities) formed an SPV with the intention that those authorities would share insurance risks and make financial savings. In the LAML case the Court of Appeal decided that saving money for the local authorities, though indirectly advantageous to residents, did not in itself improve or promote the economic, social or environmental well-being of those local authorities' areas. Brent Council was found to have misapplied the law and consequently acted ultra vires.
- 15.7 Applying the court's judgement in practical terms means that if Council is to rely upon the 1963 Act to develop homes and other buildings within the county, its primary purpose must be to benefit or improve its area rather than generating an income. This does not mean that the Council has to be oblivious to the economics of the proposal as it has general

¹ Brent LBC v Risk Management And London Authorities v Harrow LBC - [2009] EWCA Civ 490

² Section 2 Local Government Act 2000

³ Ibid – paragraph 177 of the Court of Appeal Judgement

fiduciary duties⁴ to its tax payers which includes that it should act in a *business-like manner*⁵. However, there is subtle if legally substantive difference between the Council:

- 15.7.1 undertaking an activity to improve/benefit its area and to comply with its fiduciary duties also ensure that activity is properly recompensed ; and
- 15.7.2 undertaking that that activity for the primary purpose of a financial return even if incidentally it may also benefit its area.
- 15.8 It would also be necessary for the Council to consider each proposed development to confirm that each development did *benefit or improve* the County.
- 15.9 The 1963 Act offers the Council a legitimate power to undertake developments which are envisaged. However, the Council will have to be clear that each development will benefit its area and that is purpose to deliver that benefit. Further, the Council should be minded that there is a risk that a hostile party could judicially challenge the arrangements on the grounds that what the Council is actually undertaking is development for a *its own financial reasons rather than the benefit of its area*. In that eventuality, the Court would carefully examine the Council's activities and the evidence of its reasoning to determine whether the Council's purposes and objectives had been constructed as a sham to disguise/sidestep the commercial purpose restrictions under the general power and/or compliance with the 1963 Act.
- 15.10 An alternative power is Section 9 of the 1985 Act. Section 9(1) Housing Act 1985 creates a very clear power for a local authority to build housing ("*A local housing authority may provide housing accommodation— (a) by erecting houses, or converting buildings into houses, on land acquired by them for the purposes of this Part, or (b) by acquiring houses*"). It must be doing so in order to 'provide housing accommodation'. Case law has indicated that "housing" does not necessarily mean "social housing". As previously advised, Section 32 of Housing Act 1985 provides the power to dispose of HRA land and land here includes the dwellings built on it. The argument can therefore be made that you have the power to build houses on HRA land in Section 9(1) and you have in Section 32 the power to sell them – and the Council could utilise these powers to build for sale.
- 15.11 As set out in paragraph 6.1 above, a disposal under Section 32 requires consent, and there are extensive general consents including one for sales at market value. You should note that in the past DCLG has sometimes withdrawn or changed consents at little or no notice and this is a risk factor.
- 15.12 If the Council wished to use its Section 9 power we would expect a legal analysis to be undertaken when the Council was clear as to its intentions. It is also important to note that building for sale on HRA land is not common (although anecdotally we believe it has taken place) and most local authorities that we know of who want to build for sale have taken the decision to do it through a company using the General Power of Competence. If you therefore decide to use the Section 9(1) power you need to know that you would be unusual in doing so.
- 15.13 An alternative approach would be to appropriate HRA land to the general fund by appropriating for planning purposes. You might decide to appropriate to escape the

⁴See paragraph 3.27 (below)

⁵ *Prescott v Birmingham Corporations* [1955] (Ch 210)

complexities of the HRA powers – or because you want to deal with third party rights such as rights of light and rights of way where appropriation enables development to take place without fear of injunctions although those whose rights are affected by the appropriation do of course receive financial compensation. See further our answer below.

- 15.14 Of course, if development is undertaken in the HRA then any Capital Receipt received must be dealt with in the usual way in accordance with the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003.
- 15.15 Finally, the Council could seek to rely upon Section 1 of the 2011 Act, as set out above. However, this option also contains a degree of risk and the Council could only use this power if its purpose was not commercial – otherwise it would have to use a company to do so in any event (see above).
- 15.16 In relation to all of the powers identified above, for each development, the Council would be required to consider its purpose and to document properly its objectives for that development. The Council should also consider the risk of a hostile party, whether a local resident or a business, at some point challenging the Council. In that eventuality, the Court would carefully examine the Council's activities, evidence of its reasoning to determine whether the Council's purpose and objective had been constructed as a sham to disguise/sidestep the commercial purpose restrictions under the general power.

The Council as portfolio holder

- 15.17 Whether developed by the Council directly or by a LHC, the properties being utilised for investment (e.g. the rental properties) can also be held by the Council for housing purposes. There are, however, a number of implications if the Council were to hold housing stock themselves and we have set out the key considerations below.
- 15.18 Any tenancies that the Council grants will (assuming no grounds exist to exclude security of tenure) automatically become a secure tenancy. This is because the Council would satisfy the landlord condition contained within Section 80 of 1985 Act and the tenants would ostensibly satisfy the tenant condition in Section 81 of the 1985 Act (unless any of the exceptions to security set out in Schedule 1 of the 1985 Act apply). Additionally, irrespective of whether the housing stock is transferred subject to tenancy, any future general needs tenancies would automatically be secure tenancies.
- 15.19 Section 118 of the 1985 Act provides that a secure tenant will also have the statutory Right to Buy (**RTB**). Therefore tenants that become secure tenants, or new tenants following the transfer of the housing stock, will have the statutory RTB unless any of the exceptions to the RTB apply (set out in Schedule 5 to the Housing Act 1985).
- 15.20 Section 74 of the Local Government and Housing Act 1989 provides a duty on local authorities to keep a Housing Revenue Account (**HRA**) of the sums credited or debited in relation to Part 2 of the Housing Act 1985 (the provision of housing accommodation as per section 9 above). This essentially means that if section 9 is relied upon to develop accommodation then it must be accounted for in the Council's HRA (and the HRA debt cap and associated constraints would apply).
- 15.21 Whilst the establishment of an LHC, and any rental portfolio being held within the LHC, is likely to be desirable due to the above, the Council needs to be mindful that this cannot be the primary rationale for doing so – please see paragraphs 2.8 - 2.15 above- the Council's

rationale for establishing a company for the purposes identified needs to be thoroughly thought through and objectively justified as an appropriate use of power.

- 15.22 Of course, if the Council were to be the portfolio holder of properties it would receive all of the rental income directly as opposed to receiving this "via" the LHC. The Council would also retain complete control over the properties, which may be attractive to the Council from a presentational perspective.

16 **Summary of Advantages and Disadvantages**

- 16.1 We have set out below the key advantages and disadvantages to the Council undertaking the development and becoming portfolio holder for any properties, and the same for the Council establishing an LHC to undertake these activities.

16.2 Undertaking the activities within the Council

Advantages

- 16.2.1 The Council retains full control of all developments and its portfolio;

Disadvantages

- 16.2.2 The Council would need to consider whether it has the requisite capacity to undertake the developments and / or manage an additional property portfolio.

- 16.2.3 There is no flexibility to the type of tenancies that can be provided as any tenancy provided by the Council would automatically be a Secure Tenancy;

- 16.2.4 The Council's ability to dispose of any properties is limited and subject to statutory restrictions

- 16.2.5 The Council would be "taking" all of the risk of the developments;

- 16.2.6 The Council would need be restricted by the 2015 Regulations and would need to undertake (depending on value) a procurement exercise to appoint developers.

16.3 Undertaking the activities via an LHC

Advantages

- 16.3.1 Surplus could be repatriated to the Council by way of a dividend payment.

- 16.3.2 If there was a clear strategy on the part of the Council at the outset that the assets would only be held for a particular time and would be disposed of in the foreseeable future then the process for disposal is likely to be less onerous than if these were held by the Council.

- 16.3.3 The LHC will be unrestricted as to the types of tenancies that it offers - whether these are at a market or sub-market rate – providing a wide range of flexibility.

- 16.3.4 The LHC will be, if were not established as a body governed by public law, able to contract with third parties as a commercial body would.

16.3.5 There is a limited element of development risk being ring-fenced.

Disadvantages

16.3.6 The Council may feel that it loses a certain level of control over the developments and the portfolio if land or property is transferred to the ownership of the LHC.

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