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Hinckley & Bosworth Borough Council

Local housing delivery company - Report on legal issues

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1 Introduction

This report has been prepared following a meeting with Council officers on 6 February 2015. The Council is looking to establish a local housing delivery vehicle (**LHDV**) to provide a mix of housing provision predominantly market rent and market sale units with the potential for delivery of a limited number of affordable housing units. The rationale identified by the Council for the establishment of the LHDV includes the following:

- 1.1 to make a profit;
- 1.2 to access a revenue stream to supplement general fund income;
- 1.3 to "commercialise" service delivery;
- 1.4 to access general fund borrowing headroom;
- 1.5 to complement HRA development which will continue; and
- 1.6 to assist in meeting housing need in the area by offering a different housing product to that offered by the Council traditionally.

2 Powers

- 2.1 On the basis that the properties developed by/for the LHDV are to be held outside the HRA, we believe it will be necessary for the Council to satisfy itself that it can rely upon the general power of competence under Section 1 of the Localism Act 2011 (**the 2011 Act**). This affords power to a local authority to do anything that individuals generally may do. It is subject to what are termed "pre-commencement limitations". There would be a risk of challenge on the grounds of unreasonable exercise of power and/or breach of pre-commencement restrictions limiting the use of the general power of competence under the 2011 Act, most likely from central Government, if it viewed a scheme as simply a mechanism to avoid HRA ring-fencing or the HRA debt cap or to avoid the Right to Buy. Public law considerations in relation to the exercise of powers by local authorities (including those highlighted in the line of cases cited below) would need to be properly followed as they would, in our view, amount to pre-commencement restrictions on the exercise of the general power.
- 2.2 The line of case law including *Hazell v Hammersmith & Fulham LBC [1992] 2AC 1*, *Crédit Suisse v Allerdale Borough Council [1997] QB 306* and *Crédit Suisse and Another v Waltham Forest LBC [1997] QB 362* highlights the importance for Councils to ensure that they act within their powers and discharge their functions in a way permitted by statute. That said local authority powers have changed since these cases were decided. Although at the time it was found that Councils did not have a power to discharge the relevant functions through a company and guarantee the company's obligations and/or indemnify it against losses suffered, Councils now have much broader powers. This was recognised by Neill LJ in his Court of Appeal Judgment in *Crédit Suisse v Waltham Forest LBC* as he stated that later similar schemes may have or will become within the powers of local authorities but he was there constrained to look at the position in October 1988. Indeed, under Section 1 of the 2011 Act Councils are now required to carry out activities which are for a commercial purpose - which would include development of housing for market rent - through a company. It may therefore be reasonably justifiable for the Council to provide housing, particularly where it differs from the Council's HRA general need housing, within

a LHDV, if the Council wishes to differentiate between its general need stock and housing that it develops through the LHDV for market renting/sale to say economically active individuals in order to achieve wider objectives. It would be difficult to justify the provision of general needs housing at social rent levels through a LHDV – which is not proposed here.

2.3 As mentioned above, there is a general requirement that if the exercise of the Section 1 power is for a "commercial purpose" then a Council must use a company to do so; the LHDV would fulfil this requirement subject to the methods raised in the subsequent heading of type of vehicle in paragraph 3.

2.4 The Council may also be able to use its investment power under Section 12 of the Local Government Act 2003 (**the 2003 Act**) if it is able to satisfy itself that the development of the properties is an investment rather than a commercial purpose. Under Section 15 of the 2003 Act, before exercising the power to invest, a Council must have regard to guidance issued by the Secretary of State. This is set out in the Department for Communities and Local Government "Guidance on Local Government Investments" published on 11 March 2010. Councils should also consider related guidance published by CIPFA under "Treasury Management in the Public Services Code of Practice and Cross Sectorial Guidance Notes" and "The Prudential Code for Finance in Local Authorities".

3 **Type of vehicle**

3.1 For a profit making vehicle there are three main models, i.e. being a company limited by shares (**CLS**), a company limited by guarantee (**CLG**) and a limited liability partnership (**LLP**). We have not considered the Community Benefit Society model in any detail because of the Council's obvious focus on profit distributing vehicles. Assuming the LHDV is wholly owned and controlled by the Council (as our instructions make clear) then an LLP might not be the way forward. The obvious difficulty with the LLP route is that the "company" exception (for commercial purposes) for the use of the general power of competence (see above) does not apply to an LLP. We are anticipating therefore that the choice will be between a CLS and a CLG and (assuming that Registered Provider status is not pursued) we are inclined to the view that a wholly owned CLS will be the way forward, if only to avoid stamp duty land tax (**SDLT**) on the value (not price) for the land transferred. A CLS is often favoured also because it is a source of commercial flexibility, i.e. it is a company that can be sold through its shares and without property transfer complications.

3.2 As to whether RP status is worth considering, is for debate. The main constraint on establishing a LHDV as an RP is often the rent standard (requiring dwellings to be let at formula rent levels with some very limited exceptions). Our recent experience is that the Homes & Communities Agency (**HCA**) is seriously concerned about independence and there have been hints - no more - that HCA registration will not be achieved if there is a suggestion that the purpose or simply the effect of establishing the company is to avoid the HRA debt cap.

3.3 Given that a wholly owned CLS (where 75% or more of the paid up shares are owned by the transferor), has the potential to benefit from group relief from SDLT, and thus achieves the same SDLT advantage as an RP, we believe that at this stage registration with the HCA will not be deemed desirable or necessary.

4 **Governance**

4.1 Governance issues need to be considered at two levels. If the company is to be wholly owned by the Council then the Council needs to be the sole shareholder in the CLS. As far as the board is concerned the make-up will be determined by the Council's view on how the company is to operate. There is clearly a choice, at its simplest, between on the one hand a fully commercial board with professional expertise and decision-making "purely" to achieve the practical objective of a substantial number of homes predominantly for market rent and sale, and on the other, the desire for "representativeness". This turns on a political and perhaps conceptual view, i.e. whether the board is designed to reflect interests or whether it is there, at the direction of the Council, to deliver the business plan objectives of a certain number of units in a certain timescale in order to generate a return to the Council as a shareholder. In other words - where would Council Members' interests be best served - on the board or holding the board to account in some form of Council scrutiny function? We would ordinarily recommend a small board - minimum of three (to avoid deadlock) and a maximum of seven. This would naturally limit the number of Council Members who would be able to be company directors, particularly if external expertise is also being introduced. A greater number of Council Members could take an active role in scrutinising the activities of the LHDV. Potential conflicts of interest in connection with Council Members serving as both LHDV directors and elected members would also be avoided. Ultimately it is a matter for the Council to determine what board make-up is "right" for it.

4.2 All board members would need to be mindful of their duties as company directors, including their fiduciary duties which are now codified under the Companies Act 2006. Further, the Council (corporately) and Council officers and members who are not board members of the LHDV would need to be aware of the issue of "shadow directorship". A shadow director means a person in accordance with whose directions or instructions the directors of a company are accustomed to act. If the Council or individual officers are deemed to be shadow directors, they would become subject to some of the same responsibilities and liabilities as the LHDV's actual board members. However, the Council may decide that, on balance, it is preferable to run the risk of being deemed to be a shadow director of the LHDV for the sake of keeping closer "control" over the LHDV and concluding that this is a mechanism of containing project risk. It is unlikely that insurance would be available to mitigate against this risk.

5 **Consent issues**

It is important to consider at an early stage what consents might be required by the Council should it transfer any land to the LHDV and/or provide any financial assistance to the LHDV.

5.1 **HRA land**

5.1.1 If the Council intends to transfer any land to the LHDV which is presently held for housing purposes under Part II of the Housing Act 1985 (**the 1985 Act**), the relevant power to dispose of this land is contained in Section 32 of the 1985 Act. However, such land cannot be disposed of without the consent of the Secretary of State. Section 33 of the 1985 Act allows the Council to impose "such covenants and conditions as they think fit" on the disposal.

5.1.2 The Secretary of State has issued a number of general consents under Section 32 of the 1985 Act – the General Consents for the Disposal of Land held for the Purposes of Part II of the Housing Act 1985-2013 (**the Section 32 General Consent**). Under General Consent A3.2 a local authority may dispose of vacant land. "Vacant" means either bare land or land with dwelling-houses that are to be demolished. This allows the Council to dispose of vacant land for whatever value it wants and to whichever purchaser it chooses. However, if the disposal is for less than market value to someone who is building housing for rent, then that disposal will still need consent under Section 25 of the Local Government Act 1988 (see below for the availability of a general consent under Section 25 which might apply). If, however, the Council disposes of vacant HRA land to the LHDV for market value then no specific consent of the Secretary of State would be required under Section 25 of the Local Government Act 1988.

5.2 General fund land

5.2.1 For completeness we have included advice in connection with general fund land disposals even though we have been told that the intention at present is that only HRA land will be disposed of to the LHDV. General fund land can only be disposed of by the Council in accordance with Section 123 of the Local Government Act 1972 (**the 1972 Act**). If the land is to be disposed of for consideration that is the best that can reasonably be obtained then under Section 123 no specific consent is required for the disposal.

5.2.2 However, if the land is to be disposed of for consideration that is less than the best that can reasonably be obtained, the Secretary of State's consent is required. There is a general consent (the Local Government Act 1972; General Disposal Consent 2003), which is capable of application if the purpose of the disposal is likely to contribute to the promotion or improvement of economic, social or environmental well-being in respect of the whole or part of the Council's area or of any people in the area and the difference between the unrestricted value of the land to be disposed of and the consideration for disposal does not exceed £2 million.

5.2.3 It may be, therefore, that the General Consent under Section 123 will apply for the disposal of a certain amount of non-housing land to the LHDV at an undervalue but Sections 24 and 25 of the Local Government Act 1988 would also need to be considered for any disposal at an undervalue and there would appear to be no relevant general consent under Section 25 that would be available for the disposal at an undervalue of general fund land to the LHDV (which is not an RP).

5.3 Power to provide financial assistance to the LHDV for privately let housing accommodation

5.3.1 Section 24 of the Local Government Act 1988 (**the 1988 Act**) gives the Council the power 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 as housing

accommodation. However, the Council is only able to exercise its power to give financial assistance under Section 24 if it obtains the Secretary of State's consent pursuant to Section 25.

5.3.2 The Secretary of State has issued some general consents in respect of Section 25 - the General Consents under Section 25 of the Local Government Act 1988 (Local Authority Assistance for Privately Let Housing) 2010. General Consent C 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 mentioned in Section 24(1) of the 1988 Act". Therefore this General Consent could apply where the Council grants or loans money to the LHDV or purchases share capital in the LHDV for the purposes of the LHDV purchasing land to be developed, maintained and managed for housing for letting (at whatever rent level).

5.3.3 Insofar as disposal of land at an undervalue is concerned, the General Consent AA (issued in April 2014) permits local authorities to dispose of vacant HRA (but not General Fund) land at less than market value to anybody (whether or not a Registered Provider) provided that the land is to be developed within three years and used as privately let accommodation. There are a number of other conditions attached to the consent including a requirement that the local authority is not, under any agreement or other arrangement made on or before the disposal, entitled to manage or maintain any of the housing to be developed on the land.

5.4 **Conclusion in relation to disposal consents**

The consent regime is complex and would need to be worked through in respect of any particular disposal envisaged by the Council to the LHDV. However on the face of it undervalue disposals of HRA land to the LHDV are permitted under the Section 32 General Consents (for disposal of land) and under General Consent AA of the General Consents issued under Section 25 of the 1988 Act - provided the local authority do not have an agreement on or before the disposal of the land to manage the properties to be developed. Alternatively the Council can dispose of HRA land to the LHDV at full market value under Section 32 of the 1985 Act (relying upon the general consent) and given that there would be no undervalue it would not be providing financial assistance and therefore the condition that the Council could not have an agreement on or before disposal to manage the dwellings developed on the land would not apply. For completeness we mention that consideration would need to be given to the related issue of whether 'gratuitous benefit', as defined under Section 25, existed at the time of disposal to the LHDV. If it did, and we can advise on this in due course, specific consent for disposal under Section 25 of the 1988 Act would be needed.

6 **Funding/finance issues**

6.1 If the Council decides to establish an LHDV then it will need funding in order to meet its start-up and running costs. Of course, the LHDV will receive regular income but in term of cashflows it is likely that, at least initially, it will need financial assistance. Council consent issues with regard to this financial assistance is discussed above, but financial modelling and accounting advice should also be sought to establish the position.

- 6.2 If the Council is to grant or loan money to the LHDV this could come from any available (non-HRA) sources, either as a grant or prudential borrowing on-lent by the Council to the LHDV. Any prudential borrowing by the Council which is on-lent to the LHDV would be General Fund borrowing provided that it relates to properties owned by the LHDV and the Council has used a power other than Part II Housing Act 1985 power to participate and establish the LHDV.
- 6.3 Section 1 of the Local Government Act 2003 (**the 2003 Act**) provides a local authority with the power to borrow money for any purpose relevant to its functions or for the purposes of the management of its financial affairs. The control on the amount that the Council could borrow is governed by the prudential limit which it has determined for itself in accordance with its duty under Section 3 of the 2003 Act. As with any Council borrowing, the Council is also required to have regard to the Prudential Code for Finance in local authorities (**the Prudential Code**) when carrying out its duties with regard to borrowing money. This includes a requirement to have regard to its financial commitments and obligations to any companies or other similar entities in which it has interests (paragraph 76 of the Prudential Code).
- 6.4 Alternatively, the LHDV may be able to obtain private finance secured against the future rental streams for the properties. Financial advice would be needed to assess whether the LHDV could accommodate the required amount of borrowing within its business plan and also the implications of such borrowing on the rent levels that the LHDV would need to charge.
- 6.5 It should be noted that there is a risk that providing grant to the LHDV or on-lending at a preferential rate could be deemed to be State Aid (see below). State Aid implications would also need to be reviewed if the Council were considering guaranteeing any LHDV loan obligations.

7 **Tax and business planning issues for the LHDV**

- 7.1 We would highlight that the Council would need to obtain specific tax advice in relation to the LHDV but we set out below some high level tax implications. In particular, unlike the Council, the LHDV would be subject to corporation tax on its profits. The current applicable corporation tax rate is 20% however it should be noted that tax is payable on the net profits of the LHDV, which is calculated after allowable cost deductions. These include arm's length payments to the Council (appropriate interest costs on loan for example) and other arm's length payments for services provided by the Council. There is also likely to be some additional VAT costs related to management and maintenance of the properties. Further, SDLT might potentially be payable by the LHDV on the market value of any sites transferred to it (and this would be payable at market value in respect of sites transferred from the Council) irrespective of what the LHDV pays for such land, because the Council and the LHDV would be connected parties for tax purposes). As already indicated, SDLT group relief may be available in relation to transfers from the Council to the LHDV if the LHDV were set up as a company limited by shares with at least 75% of the paid up shares owned by the Council but this would need to be confirmed by the Council's tax advisers. In relation to any properties acquired by the LHDV from a third party, it should be noted that this group relief would not be available.
- 7.2 The consequences of these taxes would need to be carefully modelled.

7.3 Because of the likely requirement to transfer land to the LHDV at best consideration and for the terms of any funding and/or services (such as housing management and company administration services) to be provided by the Council to the LHDV also to be provided at market rates, these costs would need to be properly reflected by the Council in its financial appraisal of development by the LHDV.

8 EU procurement

8.1 With regard to any transfer of land by the Council to the LHDV, if it is a pure disposal of land then it would not be subject to advertisement under the EU Procurement Rules – this is known as the "land exemption". However, if the agreement between the Council and the LHDV imposes specific requirements of the Council on the LHDV as to what is to be developed on a site, it is likely to be viewed as a "public works contract" rather than a pure land disposal.

8.2 However, even if the agreement does amount to a public works contract, it is possible that in these circumstances the "Teckal" exemption will apply. The Teckal exemption allows public contracts in relation to works, services or suppliers let by a local authority to a third party (here the LHDV) to be let without following the EU Procurement Regulations where (1) the Council exercises over the LHDV a level of control similar to that which it exercises over its internal department; and (2) the LHDV carries out the "essential parts" of its activities for the Council. The Teckal exemption is now included in the Public Contract Regulations 2015 (at Regulation 12) which are due to come into force on 26 February 2015. The essential services element of the Teckal exemption is now stated as being "more than 80% of the activities of the controlled legal person are carried out in the performance of tasks entrusted to it by the controlling contracting authority ...". Further consideration will need to be given to whether the services element of the "Teckal" (now Regulation 12) exemption is met with the LHDV being the landlord of its own properties, i.e. has the LHDV been entrusted by the local authority to carry out those services for it. For completeness we would add that there can be no direct private capital participation in the controlled body, i.e. the LHDV, in order for the exemption to apply.

8.3 The LHDV is also likely to be a contracting authority itself as a body governed by public law and thus itself subject to the EU Procurement Rules. A "body governed by public law" is defined within the new Public Contract Regulations 2015 as follows:

bodies governed by public law means bodies that have all of the following characteristics:

- (a) They are established for the specific purpose of meeting needs in the general interests, not having an industrial or commercial character;*
- (b) They have a legal personality; and*
- (c) They have any of the following characteristics:*
 - i They are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law;*
 - ii They are subject to management supervision by those authorities or bodies; or*

- iii *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.*

8.3.2 This means that, if the LHDV is a Contracting Authority, the LHDV would need to procure any construction or refurbishment works in housing management which it is to outsource (subject to the Teckal or in-house exemption) in accordance with EU Procurement Rules.

9 State Aid

9.1 The provision of financial assistance to the LHDV (by way of grant or loan) or the transfer of sites or dwellings by the Council to the LHDV at an undervalue or the supply of finance or services at below market rates would, on the face of it, constitute State Aid. We are not aware of any other form of State Aid presently contemplated but this would need to be kept under review particularly if a guarantee from the Council is given to private funders.

9.2 Whilst there is an exemption¹ if the LHDV is to provide a "service of general economic interest", which could include the provision of social or intermediate housing, this would not apply if housing were to be developed or acquired for letting at a market rent as currently envisaged under the Council's proposals.

9.3 State Aid guidance provides that authorities that dispose of land for less than best consideration or provide loans at below market rate need to comply with the State Aid rules set down by the EC Commission.

9.4 EU Treaty provisions

9.4.1 Under the Treaty of the Functioning of the European Union (**TFEU**) any aid granted by a Member State or through "state resources" in any form, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, insofar as it affects trade between Member States, is likely to constitute unlawful State Aid and be incompatible with the common market. What is deemed to constitute State Aid is very broad, and this can include the provision of loans at a rate below market standard, grant funding, lenient taxation regimes, sale of assets at an undervalue or the provision of certain types of guarantee.

9.4.2 If a State Aid is deemed to have been provided, the powers of the EU Commission are extensive; notably it has the power to stop further transactions and order repayment of any aid already paid with interest.

9.4.3 No definition of State Aid is provided as such, but the TFEU sets out four elements, all of which must be satisfied if a measure is to constitute State Aid. These are:

- (a) State Awards – the aid must be awarded by a Member State or through state resources (which would include the Council),

¹ Commission Decision 20 December 2011 – SGEI - Notified under document reference C(2011) 9380 and Case C-280/00 Altmark Trans GmGH and Regierungspräsidium Magdeburg V Nahverkehrsgesellschaft Altmark [2003] ECR I-7747

- (b) Selectivity – the aid must favour certain undertakings or the production of certain goods. In this context an undertaking is an entity engaged in economic activity, (being an activity for which there is a market in comparable goods or services). This can therefore include entities, such as the LHDV, which are engaged in activities which have commercial competitors. The purpose of this requirement is to draw a distinction between aid to certain undertakings or sectors, and general policy measures which are open to all economic entities operating within the Member State.
- (c) Distortion of Competition (or threaten to distort) – the key criteria is that the aid strengthens the position of the recipient in relation to its competitors. The criterion that aid must distort competition is applied very broadly and is nearly always satisfied regardless of the scale of the potential distortion or market share of the aid recipient. It should be noted, however, that *de minimis* aid, which has a negligible effect on trade between Member States, is not considered as falling into the scope of Article 107. The *de minimis* threshold is currently set at €200,000 (assessed over a rolling three year period) and on the basis that the recipient is a provider of services of general economic interest.
- (d) Affects trade between Member States – as most services are traded between Member States, this criteria is easily satisfied unless the aid is to a small, defined local market where cross border trade is not possible.

9.4.4 It would appear on the face of it that a number of elements of the Council's proposals could – if not structured correctly - potentially amount to unlawful State Aid, in particular:

- (a) Disposal of land to the LHDV at an undervalue;
- (b) The provision of any financial assistance (i.e. loan finance or acquisition of share capital) to the LHDV otherwise than on commercial terms;
- (c) The provision of any services from the Council to the LHDV otherwise than on market terms;
- (d) Selectivity will exist as the Council only intends to provide support to the LHDV rather than offer support generally;
- (e) The European Commission has previously decided² that aid to companies providing private rented homes will, if not structured correctly, distort competition and affect trade in the single European market.

9.4.5 We would therefore recommend a valuation should be carried out by an independent asset valuer in order to establish the best consideration of any land disposed to the LHDV. In order to comply with the EU Commission's State Aid decision³ on public sector land disposals this should be undertaken before

² State Aid No. E 2/2005 and No. NG 42/2009 – The Netherlands – Existing and Special Project Aid to housing corporations

the Council and LHDV enter into negotiations on price. A valuation may need to be carried out in any event as part of the satisfaction of the consents regime. This market valuation should be the minimum purchase price that can be agreed without granting State Aid. Therefore, if the consideration received by the Council amounts to the minimum purchase price, then such land disposal will not amount to State Aid.

9.4.6 Equally, the terms on which finance is provided by the Council to the LHDV and the terms on which services are provided to the LHDV should also be full market terms such that these would not amount to State Aid⁴.

10 Overview of likely contractual documentation

10.1 The development of the contractual documentation between the Council and the LHDV will be entirely dependent upon the structure of the LHDV and the relationship between it and the Council. However from experience it is likely that the following corporate and contractual documentation will be required in order to develop the LHDV as an operational vehicle:

10.1.1 Articles of Association of the LHDV;

10.1.2 Company Resolutions and appointment of directors (and secretary if necessary);

10.1.3 Land Transfer Agreement - to transfer HRA (and other?) land from the Council to the LHDV;

10.1.4 Subscription Agreement – if necessary to provide reassurance to the LHDV directors that additional equity will be injected into the company as necessary to facilitate development;

10.1.5 Funding Agreement – to regulate the terms of any loan between the Council and the LHDV;

10.1.6 Debenture and Legal Charge - to be effective as a legal mortgage over the LHDV properties;

10.1.7 Assured Shorthold Tenancy Agreement - standard form tenancy agreement for properties let by the LHDV;

10.1.8 Housing Management Agreement – between the LHDV and the Council assuming the Council will manage the properties on behalf of the LHDV.

11 Conclusion

11.1 It will be clear there are a number of legal choices to be made to establish the company in the right legal form and on the right basis. Central to the evaluation of the legal issues is flexibility and we have emphasised this throughout the report. This is why we think the CLS is the most favourable model for the LHDV.

³ Commission Communication on State Aid elements in sales of land and buildings by public authorities

⁴ Commission Communication on MEIP (OJ C 307, 13.11.1993, p3)

11.2 An initial decision to establish a company can be made straightforwardly, with an agreement in principle as to how the company is likely to be used. Financial modelling will be crucial to understanding the viability of the approach adopted.

This report is prepared for Hinckley & Bosworth Borough Council only and is not to be shared with or relied upon by third parties with our prior written consent.

Trowers & Hamlins LLP

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