



dated 8 September 2020

Lancaster City Council

Report

in relation to on housing delivery vehicles

Trowers & Hamblins LLP
3 Bunhill Row
London
EC1Y 8YZ
t +44 (0)20 7423 8000
f +44 (0)20 7423 8001
www.trowers.com

trowers & hamblins

1 Background

- 1.1 We produced a report in January 2020 (the **January Report**) relating to the Lancaster City Council's (the **Council's**) aspirations for residential and commercial development, including advice on the Council's powers, the possible company structure, Council duties, land disposals, appropriation, funding, public procurement and high level tax issues.
- 1.2 Following consideration of the January Report the Council has detailed its requirements and narrowed its objectives with regards to the incorporation and running of the Council's corporate entities to improve housing delivery within the city (the **Group**). We have used the term Group to evidence the likelihood that more than one corporate vehicle may be optimal. This report addresses the updated objectives of the Council and proposes more specific structuring options with associated analysis in terms of risk and efficiencies.
- 1.3 The Council's more detailed objectives include:
- 1.3.1 A corporate vehicle/group of vehicles that are wholly owned by the Council for investment as well as social purposes;
 - 1.3.2 the Group will be undertaking housing development (but contracting outside the Group for works and project management);
 - 1.3.3 the Group will undertake mixed tenure, and mixed use (with a significant housing component) new build development;
 - 1.3.4 housing management services will in some cases be provided by the Council to the Group for a management fee;
 - 1.3.5 development will also include the acquisition of existing properties and contracting for refurbishment of such properties to deliver mixed affordable tenures (seeking affordable homes grant from Homes England);
 - 1.3.6 the Council is seeking to strike the right balance of governance and financial flexibility against achieving the appropriate and necessary level of oversight from the Council as Shareholder and funder;
 - 1.3.7 other broad objectives that the Council has for the Group are:
 - (a) raising the bar with regards to the standards in the local housing market;
 - (b) providing employment and training opportunities;
 - (c) regenerating areas;
 - (d) creating income; and
 - (e) lettings policies in line with Council priorities.
- 1.4 As a recap, the broad pros and cons regarding the use of a corporate vehicle to deliver housing for Lancaster are:

Pros	Cons
More tenure flexibility	Set up costs
More rent flexibility	Additional governance arrangements to put in place
Opportunity for additional revenues	Vires issues to be carefully worked through
Act as an exemplar PRS provider – raising the bar	Corporation tax payable on profits and likely irrecoverable VAT
Streamlined governance and decision making	Lack of security of tenure for all tenants
Ability to act outside local government constraints (including public procurement procedures)	

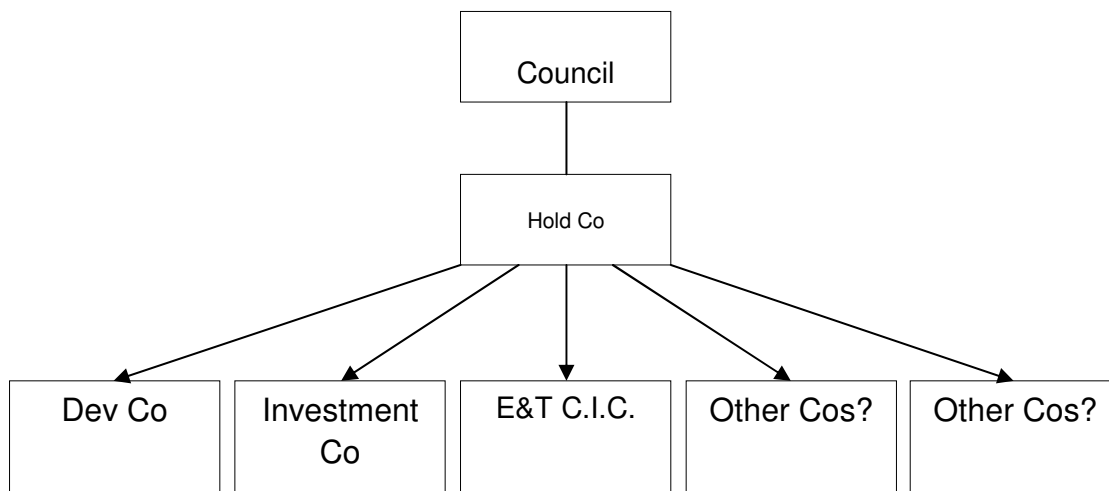
2 Group Structure

2.1 Feedback following the January Report suggests that the Council would prefer a streamlined governance model. Taking into account the other factors that play into the structuring (for example: tax, public procurement, land disposals and flexibility for the future) a Holding Company (**Hold Co**) model, as set out in the January Report and illustrated below, would appear to be most suitable. We set out below a list of pros and cons of the Hold Co model.

Pros	Cons
Single focus for the Council's shareholding role	Multiple companies require more governance and audit
Ring fencing risk in different vehicles	Complexity could bring lack of clarity if the Group isn't properly understood and managed
Specific focus of activities in different vehicles	
Ability to spread losses (for tax purposes) across the Group	

2.2 The various subsidiary companies can be set up each with a distinct activity and/or objective in mind – to keep financial management separated as well as keeping governance and decision making simple and agile. A Hold Co or Group structure model also allows for the ring-fencing of risk in separate vehicles as well as the flexibility to

introduce new (and potentially unrelated) subsidiary undertakings within the structure whilst the Council can maintain overall control through its ownership of the Hold Co. A diagrammatic illustration of the potential Hold Co arrangements is now set out:



2.3 The Council would need to consider the separation of each entity's activities bearing in mind the various considerations listed above and explored further below. Based on the Council's objectives and envisaged activities for the Group, we have given some examples of the sorts of division of activities that may suit the Group (and that we have seen elsewhere):

2.3.1 Dev Co – Development Company - driven by tax (VAT, SDLT and Corporation Tax) and public procurement considerations to carry out the development of any sites– but not intended to hold the resulting assets. This vehicle could also undertake any market sales of developed assets in the event that the Council was unable to do them itself for vires reasons (i.e if the sales were purely commercial in nature to raise profit for the Council, rather than to subsidise overall viability of the development, the Council would need to carry out the sales activity in a corporate vehicle);

2.3.2 Investment Co – Investment Company - to hold the completed residential assets as landlord;

2.3.3 E&T C.I.C – Employment and Training Community Interest Company - Given the likely activity to be undertaken within the Group regarding these objectives they could suitably be captured within a C.I.C. (see C.I.C. information included at paragraph 3.3 below) in order to recognise its non-commercial objectives but also enabling some aspects of more commercially-focussed vehicles – such as paid board members and limited payment of dividends.

3 Corporate forms

3.1 CLS

The January Report explored the different types of corporate entities including a company limited by shares and company limited by guarantee. Broadly the primary consideration is whether the Group is envisaged to distribute dividends (where available) as a revenue stream for the Council. A company limited by guarantee is more restricted in distributing

profit, whereby a company limited by shares can distribute profit. The Council states that one aim of the Group will be to generate income and therefore we would propose companies limited by shares would appear to be the more natural fit for the Group as this would allow profit distribution to the Council as ultimate shareholder of the Group and would also allow for SDLT Group relief on land transfers from the Council to the Group members which is not available if the land is transferred to a guarantee company.

3.2 **LLP**

3.2.1 The January Report excluded considerations of a limited liability partnership (**LLP**) model because of the Council's pursuit of income generation from the Group's activities. However, a LLP model could bring corporation tax savings as the income/profit is taxed in the hands of the partners rather than taxed within the company. The Council would need to carefully consider the suitability of an LLP model as there are some nuances with regards to governance that require the Council's objectives to be aligned with the case law regarding Council owned LLP's. There is also the added complication that an LLP requires at least 2 members and setting up an LLP with, say, the Council as one member and a wholly owned Council company as another member, this raises issues as to the veracity of the structure. Under a CLS model, these issues are not problematic.

3.2.2 If the Council uses its general power of competence under section 1 of the Localism Act 2011 for a commercial purpose, it must do so in a company (which does not include an LLP model). In the recent case of *Peters v Haringey* it was found that it is the Council's "dominant purpose" which is relevant, and if it can be evidenced that income generation is not the "dominant purpose" then an LLP model may well be permissible. Such dominant purpose could be regeneration or other purposes dedicated to the local benefit. Stating such objectives can have ramifications on other regulatory aspects, such as the public procurement status of the entity. In the *Peters v Haringey* case there was a bonafide partnership between two distinct entities, Haringey Council and Lendlease, so the point raised in the previous paragraph about the veracity of the Council and a Council company forming an LLP did not arise.

3.2.3 It is for these reasons that we have ruled out an LLP structure and recommend share companies (save for the Employment and Training C.I.C. vehicle if that is pursued).

3.3 **Community Interest Company (CIC)**

3.3.1 The CIC was introduced as a corporate structure in 2006 as a response to the growing importance of social enterprise. The CIC seeks to address the 'gap' that existed for social entrepreneurs who could not, or did not want to, establish themselves as charities but who wanted some recognition that they were not a purely commercial business and sought to achieve some social good. CICs are regulated by the Office of the Regulator of Community Interest Companies.

3.3.2 The CIC therefore sits somewhere between a traditional commercial company and a charity and shares some features with both. For example, CICs can pay their board of directors a salary and can pay dividends on shares (up to a maximum aggregate cap of 35% of available profits). At the same time, CICs

must be established for a purpose which is beneficial to the community. CICs are also subject to an "asset lock", meaning that their assets must be used for their community benefit purpose and cannot be transferred for another purpose or for private gain (subject to limited exceptions such as the permitted dividend payments).

3.3.3 However, CICs are not charities and do not receive any preferential tax treatment (except for being eligible to claim discretionary rates relief).

3.3.4 Given there is an ambition to have a focus on employment and skills training this may be best captured within a single corporate entity (as outlined in the indicative Group structure chart above). There is no legal requirement for this to be in a separate vehicle and, if the Council did not want to create too many different vehicles to begin with, it could consider establishing such a vehicle some time in the future but as an interim measure could entrust the employment and training activities to one of the other Group members

4 Procurement

4.1 The January Report set out the public procurement considerations relevant for the Council's Group. Primarily:

4.1.1 whether each entity should be structured as a "body governed by public law" (**BGPL**) and subject to the Public Contracts Regulations 2015 (**PCR**). If not a BGPL then that entity could award contracts to the private sector without a full public procurement procedure; and

4.1.2 whether each entity should be structured as a "Teckal" company which the Council could legitimately award contracts to without opening up the opportunity to public procurement procedure.

4.2 From the Council's updated objectives, we are still of the view that the Council's objectives do not materially restrict the structuring options from a public procurement perspective. We set out below, supplementary to the January Report's overarching commentary on public procurement, some observations and potential pitfalls as the Council continues to develop its Group structure.

4.3 BGPL

4.3.1 As the January Report set out the Council can legitimately structure any of the Group entities as non-BGPLs and therefore allow them to award contracts without a procurement procedure. However, whilst this would provide freedom for the Group members to contract with 3rd parties free from the obligations of the PCRs it would severely limit the ability of the Group members to contract directly with the Council. For example, if the Dev Co was structured as a non-BGPL, it would be very difficult to argue that it was also a Teckal company. The Council would therefore not be able to take advantage of the Teckal (or in-house) exemption to the PCR and be freely awarded development contracts by the Council.

- 4.3.2 It is possible that some Group members are structured as BGPLs and others are not. This could mean that the Dev Co was structured as a Teckal company (for the reasons above) and the Investment Company was a non-BGPL.
- 4.3.3 It will be important for the Council to consider what are the likely contracts that each entity will enter in to and consider whether there is any merit in seeking to structure the companies to be outside public procurement rules.

4.4 **Teckal exemption**

- 4.4.1 As the January Report set out the Council can legitimately structure any of the Group entities so that the *Council* can award that entity a contract without a public procurement procedure.
- 4.4.2 Again, it is possible *and probable* that this would apply to some but not necessarily all entities, primarily due to the requirement that they must conduct 80% of their business activity on services entrusted to it by the Council.
- 4.4.3 Another key point to note is that the Teckal exemption is not limited by an immediate connection, ie. the Council would be able to award the Teckal Dev Co a contract despite the fact the Council is not its immediate parent.
- 4.4.4 We note the Council's intention for a stock-owning subsidiary (eg. Investment Co) to award a housing management contract to the Council for a management fee. This would be, similarly, a so called "reverse Teckal" and such a contract would not need to go out to tender provided that the Investment Co was a Teckal subsidiary.
- 4.4.5 In conclusion, if the Council intends for the Dev Co to be responsible for all developments as directed by the Council, in order to allow the Council to direct the nature of those developments, the Dev Co would need to be structured as a Teckal company. If the Council wishes for the Investment Co to award a management contract to the Council (assuming it is above the OJEU value threshold for a services contract) then it too would need to be structured as a Teckal company.

4.5 **Conclusion on Structure and corporate form**

The Council's ambition is to develop mixed tenure scheme which could include outright sale units, market rented units and affordable housing. The outright sales could both provide a return to the Council and cross subsidise the level of affordable and social homes built. The market rent units should be able to provide a long term revenue stream to the Council. The market rent units would need to be held (long term) in a separate vehicle and we recommend a company limited by shares (Investment Co). Social Housing units are likely to be required to be held within the Council's HRA. We would like to discuss further with the Council the rationale for development of the market sales units as it could be possible for the Council to retain the title to these units and sell the properties itself (employing agents as necessary) rather than transferring the land for development into the Dev Co with the Dev Co effecting the sales. This way the Council would (potentially) not be losing any of the outright sale unit receipts though corporation tax which it doesn't pay. The issue will turn on whether the Council is acting for a commercial purpose and needs to effect the sales through a company.

We recommend the establishment of a Dev Co as a Teckal company to carry out the development activities on behalf of the Council (without the Council having to procure those opportunities) and each development scheme would be worked up to identify the optimum deal structure - whether land is transferred (to deal with the market sales issues above but also optimum tax structuring) and if so at what point in the development.

As we are recommending more than one company (with the potential for adding additional companies in future) we are also recommending a Hold Co structure in order to streamline governance.

5 **Key documents**

5.1 We appreciate the Council's objectives regarding striking a balance between flexibility (and agility) with the requisite level of oversight and control from the Council's perspective. From our experience we set out below the key documents that would set out the relationship between the Council and the Group, including how flexibility and agility can be achieved within them.

5.2 As stated in the sections above, given the Council's desire for flexibility we expect that a Hold Co model as illustrated in the diagram above will be better suited to deliver on this objective rather than a separate direct relationship between the Council and each Group member. The Hold Co would be the single source of control over the group entities. The key therefore will be for the governance arrangements between the Council and Hold Co to be clear and provide for the Hold Co to control the subsidiaries without the subsidiaries needing to seek approval from the Council directly. This can be achieved by, for example, an overarching approval process between Hold Co and the Council.

5.3 **Articles of Association**

5.3.1 Articles set out the broad powers of Hold Co but reserve headline decisions for the Council, for example amending the Articles, board appointments, restrictions on third party borrowing etc.

5.3.2 The objects are likely to provide that the company will act as holding company controlling various subsidiary undertakings. In that way, given that the Council would control any changes to the Articles, the Council will be protected from the company doing anything other than acting as a Hold Co without Council approval.

5.4 **Shareholder Agreement –**

5.4.1 We strongly recommend that the Council and the Group companies enter into Shareholder Agreements.

5.4.2 The primary purpose of a Shareholder Agreement is to regulate the relationship between the Council (as shareholder) and the relevant Group company. Ordinarily, other than where legislation and/or the Articles 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 Company. 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). A Shareholder Agreement therefore provides the

Council with the ability to specifically control certain activities or decisions of a company by setting out specific matters which are reserved for "shareholder consent".

5.4.3 The Council will be the sole shareholder of the Hold Co (and ultimately the owner of the entire Group) and will be making a (or a series of) investment(s) in the Hold Co/Group. The Council as shareholder will therefore need to ensure that it has appropriate arrangements in place (usually in the Shareholder Agreement) to ensure that it is monitoring the performance of the Group/Hold Co and holding it to account for the proposed return on its investment. This will require ensuring that the Group is delivering on its approved business plan. The Shareholder Agreement between the Council and Hold Co would set out the limits of the Hold Co's authority (as shareholder of the various subsidiaries) by reserving certain matters to the Council as ultimate shareholder.

5.5 **Business Plan**

The business plans can set out (and approve in advance) the activities which Group may undertake, including a pipeline of anticipated developments and funding that the Group subsidiaries may undertake. This may set out financial parameters and specific projects which can be approved ahead of time in order to avoid each individual business decision within the Group going back to the Council.

5.6 **Funding Agreement**

An agreement between the Council and Hold Co (or directly to the Dev Co) which would, subject to bespoke funding conditions being satisfied, be approved by the Council for drawdown by the Hold Co (or the Dev Co). A streamlined funding model could provide sufficient flexibility and agility for the Group to act quickly with, for example, a purchase of a strategically important site. As the January Report set out, there are some public law restrictions with regards to how the Council funds its Group, which also touches on the issues of State aid and financial assistance (and associated powers and required "consents" from the Secretary of State). The January Report set out various methods and conditions upon which the Council may fund the Hold Co and other Group companies for the purposes of housing. The Council may also fund the Group by on-lending PWLB funds, for which the Council may charge an appropriate interest rate (subsidised interest rate for affordable or commercial interest rate for market rent or sale housing/commercial lettings).

6 **Governance Issues**

6.1 **Council directors**

Who sits on the various boards is a matter for the Council to determine initially, officers or members are permitted to sit as directors of Group companies (subject to rules regarding remuneration, conflicts and propriety). There will be different considerations for the Hold Co (which is the shareholder of the Group) and the subsidiary undertakings carrying out specific activities. The Council would need to take into account the following relevant matters:

6.1.1 it is appointing persons to run and make decisions about businesses;

6.1.2 skill sets which may be advantageous for the Director role (particularly for the subsidiary undertakings) are likely to be:

- (a) financial skills;
- (b) experience of development and property management; and/or
- (c) experience of running a comparable business,

6.1.3 there will be *conflicts of interest* between being a Director of a company and making decisions *in the Council* which relate to the Company, examples:

- (a) decisions to lend to the company (the **Funder Role**);
- (b) decisions to transfer land to the company; and/or
- (c) a decision in favour of third parties which may not be advantageous to the company.

Members or Officers who might be expected to make the above decisions within the Council may find it extremely difficult to undertake the Director role.

6.1.4 The Council, as any commercial shareholder, should monitor and hold the businesses to account (the **Shareholder Role**). This is a vital role, with its own skill set, to ensure that these businesses deliver the financial outcomes required by the Council. If there is confusion and conflict between the same persons being a Director and undertaking the Shareholder Role then there is a danger that the Council as Shareholder will neglect to critically analyse whether the businesses are delivering the required financial outcomes.

6.2 **Unconnected Directors**

A number of Councils have chosen to appoint persons who are unconnected to them (not being members or officers), particularly to fulfil non-executive roles. Part of their rationale has been to harness the skills and experience of persons who have operated similar businesses.

6.3 **Council control and Member involvement**

6.3.1 It is at the Council's discretion as to how it wishes to carry out its Shareholder Role. As with the composition of the board, there have been a range of different approaches to the shareholder function within the various local housing projects that we have worked on. These range from full delegation to a single officer (often the Section 151 officer) through to the establishment of shareholder committee made up of a politically balanced number of Council Members. There are certain functions of the shareholder which will be set out in the Shareholder Agreement between the Council and Hold Co (which will then pass down to the subsidiary undertakings) that will be largely procedural, for example approving contracts above a certain value. Other matters will be fundamental to protecting the Council's investment, such as use of private funding or changes to the business plan. The range of matters for shareholder approval will be contained within the list of shareholder consent matters in the Shareholder

Agreement. We have included an indicative flow diagram showing the high level governance arrangements at Appendix 1 to illustrate the potential model.

6.3.2 The Council is a representative body and its Members are accountable to the electorate for the Council's performance. Our understanding is that part of the Council's rationale is to use the businesses as tools to increase income for the Council. Members, who must also decide on potentially competing priorities for resources, are likely to be in the best position to lead on holding the financial and general performance of the businesses to account. Part of this role, if the businesses do not perform well, may be a decision to limit future Council support, sell them or even wind them up. These types of difficult strategic decisions are in any event likely to rest with Members.

6.3.3 There is also the important role of ongoing oversight of the activities of the Group and approval of (and amendments to) the business plans. The Council should give consideration as to how the Group will be governed and in particular what role members will take, whether as Directors or in a shareholding capacity and if so in what form. For these reasons a number of Local Authorities have decided that members are better placed to hold the companies to account (in a shareholder or scrutiny role) rather than as directors of their commercial companies.

7 **Availability of grant**

We understand the Council would like to understand any restrictions around the availability of grant funding for the Group's envisaged delivery model. Private developers can take advantage of grant available from Homes England by having an "agreed transfer" with a Registered Provider which would include the Council as a public Registered Provider (ie. that after the development is completed the grant funded units will be held by/transferred to an RP). Provided therefore that the grant funded units would be held by the Council (or another Registered Provider) then Homes England grant should be available.

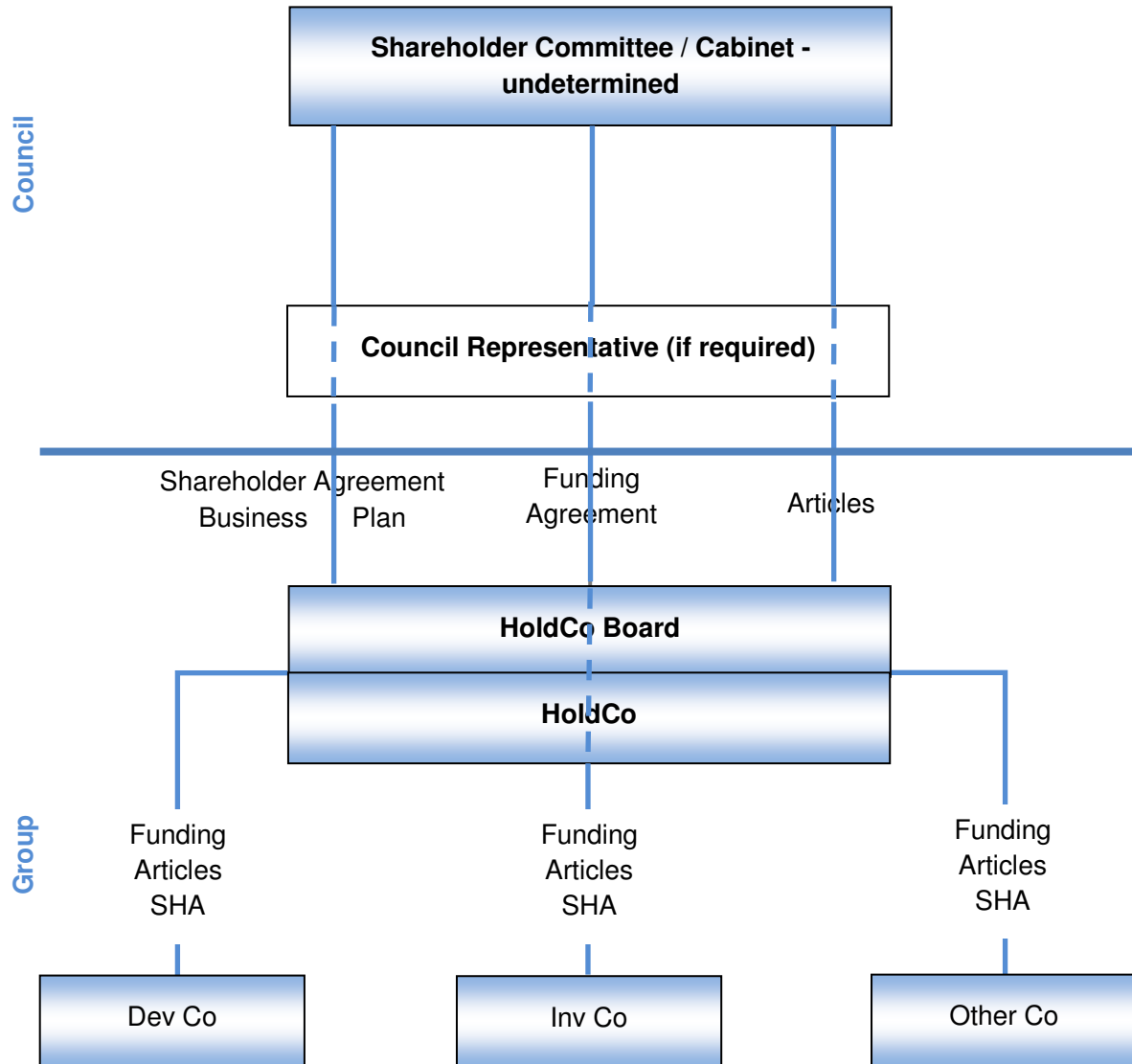
8 **Conclusion**

We have included some indicative next steps at Appendix 2 of the Report to highlight the decisions required to move the incorporation and assurance process along.

Trowers & Hamlins LLP
8 September 2020

Appendix 1

High Level Governance Structure



Appendix 2

Indicative next steps

- 1 **Resolution on company formation – including approval of structure:**
 - 1.1 HoldCo Group or single company;
 - 1.2 Split of business activities per entity (if applicable).
- 2 **Officers consult, take advice on and decide key characteristics of companies regarding:**
 - 2.1 Structured as subject to public procurement?
 - 2.2 How Development will pass through the Group
 - 2.3 Potential developments for the Group
 - 2.4 Board structure and composition
 - 2.5 Funding sources
- 3 Officers to instruct production of governance documents/agreements for the Group / entity to be discussed and finalised prior to resolution on incorporation. These would include:
 - 3.1 Articles (needed prior to incorporation)
 - 3.2 Governance documents, including terms of reference for any shareholder committee, conflicts of interest protocols, board member service agreement
 - 3.3 Business plan(s)
 - 3.4 Shareholder's Agreement
 - 3.5 Funding Agreement;
 - 3.6 Debenture;
 - 3.7 Equity Subscription Agreement;(to ensure appropriate debt/equity split for state aid purpose)
 - 3.8 Form of tenancy agreement