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Bath and North East Somerset Council

Report on the establishment of Aequus Construction Limited

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1 Introduction

- 1.1 Bath and North East Somerset Council (the **Council**) is contemplating establishing a construction company (Aequis Construction Limited) (**ACL**) as a subsidiary of its wholly owned company (Aequis Developments Limited (**ADL**)).
- 1.2 The Council originally established ADL to develop a variety of sites in its local area and then sell a proportion of the developments to third parties, retaining the majority of properties to generate a long term rental income stream. Following advice from its tax advisors, Monahans, it is now proposed that ACL will carry out the construction work on these projects. The development sites will be transferred to ACL from the Council and , following construction, ACL will sell the market sale units (the trading stock)on the open market and transfer the properties for rent (the investment stock) to ADL.
- 1.3 ACL will be a wholly owned subsidiary of ADL and will be a company limited by shares i.e. a normal trading company registered at Companies House.
- 1.4 Although ACL would be a subsidiary of ADL, who in turn is a subsidiary of the Council, it must be separately registered for VAT in order to be effective in achieving the recovery of VAT on professional fees and services. This means that ACL must sit outside the Council's VAT group.
- 1.5 The Council has already received advice from Monahans on the tax implications of creating ACL and this report therefore focusses on the legal aspects, and not the tax implications, of doing so.

2 The Umbrella Development Agreement

- 2.1 This is an overarching development agreement by which the Council agrees to transfer the relevant sites in order for them to be developed by ACL. The Council is free to issue instructions (in the form of an Instruction pro forma as a schedule to the agreement) about the developments to be carried out. The agreement also obliges ACL to transfer the completed investment units (those that will be built for long term rent) to ADL and to sell the market sale units on the open market. Under the Umbrella Development Agreement ACL is obliged to obtain collateral warranties for the Council/ADL. This is a relatively light touch agreement on keeping with your instructions to minimise complexity. The agreement could be bolstered by additional provisions in relation to planning, construction obligations, appointments of the professional team, site meeting etc, but given the control that the Council exercises over ACL as part of the group of companies the council can take a view as to the detail required. In any event the agreement is drafted such that the Council is free to issue specific Instructions in respect of any development site.
- 2.2 It is important that ACL is properly operated if the desired VAT savings are to be achieved. This not only includes entering into the necessary contractual documentation for each development, but also making sure that staff are aware of how ACL operates and act accordingly. For example, the relevant building contract with the contractor should be

entered into by ACL, not the Council nor ADL, and it must be ACL who corresponds and deals generally with the building contractor at all times.

3 Various issues to consider when setting up ACL

3.1 The ACL board

3.1.1 We understand that you wish to have the appropriate minimal governance arrangements and our advice below has been structured in this way. Given that ACL's function is to act as the developer in the place of ADL (which was originally set up for that purpose (amongst others) it is questionable whether different or additional (from ADL) board directors are necessary for ACL. Its directors could be the same directors of ADL. We have also included the option (in the Articles of ACL) of having a minimum of two directors so there doesn't have to be a 100% overlap and the Council is free to decide that some (or all) of the ADL Board become directors of ACL. We would not recommend a completely overlapping board as it would be useful for there to be some degree of separation at director level between ADL and ACL so as to provide a degree of "independent" consideration for any ACL matters reported back to the ADL board and also to provide a solution for conflicts (see below). The Council could give consideration to have a degree of "real" independence on the ACL board by appointing someone (possibly with house sales and marketing experience or construction experience) on the ACL board – but this is not legally required.

3.1.2 If ACL's board mirrors ADL's board, conflicts of interest would be difficult to manage. A conflict would usually involve any parent (ADL) board member standing away from decisions regarding the subsidiary (ACL) when discussed at parent board level. If all (or even a large majority) ADL board members were required to stand aside from a decision, ADL may not be in a position to make a quorate decision.

3.1.3 Please note that every company needs to have at least one director that is a natural person meaning ADL cannot act as sole corporate director.

3.2 Shadow directorship

3.2.1 Whilst it is acknowledged that ADL and the Council will wish to exercise control over ACL by appointing its board members and/or executive officers to the ACL, there is a fine line between control and being deemed a shadow director. If ADL or the Council is deemed a shadow director it may be subject to some of the codified duties of directors set out in the Companies Act 2006. If ADL or the Council directs the operation of ACL then in an insolvency situation ADL or the Council may be treated as a shadow director and in certain circumstances liable for the debts of ACL.

3.2.2 Whilst there is this issue of shadow directorship to consider, it is important to put this into context. This is only an issue in certain circumstances and is most likely to arise where there is an insolvency situation in the subsidiary. Provided that ADL and ACL are properly managed and operated, then the risk of an insolvency situation, the kind of which would give rise to shadow directorship claim against ADL and/or the Council, arising should be low.

3.3 Funding and Investment

The Council will need to give consideration as to how to channel funding through to ACL in order for ACL to acquire land from the Council and to carry out the development on that land. We have been working with the Council on a Loan Facility to be put in place between the Council and ADL. That funding route could continue and be reshaped so that ADL on lends the funds to ACL. The alternative route is for the Council to directly fund ACL through a separate Loan Facility. Provided the Council is able to exercise the degree of control it requires in the "indirect" funding route (ADL on-lending to ACL), there is no significant difference between either route.

4 EU Procurement Regulations

4.1 There is no express exemption under the Public Contract Regulations 2015 (the **2015 Regulations**) for services or works provided to organisations within the same group. On the face of it therefore, a contract in writing for consideration between the Council and ACL for the carrying out of works or services (the Instructions issued under the Umbrella Development Agreement in relation to the Development of the sites are likely to be may be regarded as works) may be construed as a public works/services contract for the purposes of the Regulations.

4.2 However, as ACL will be a wholly owned subsidiary of ADL (who is a subsidiary of the Council) it will in our view be able to take advantage of the exemptions under the 'Teckal' principle (now incorporated within Regulation 12 of the 2015 Regulations). This provides that if the Council exercises control of ACL in a similar way which it does of its own departments, 80% of the activities of ACL are carried out in the performance of tasks entrusted by the Council and there is no direct private capital participation in ACL, then the contracts between the Council and ACL would not be subject to the EU procurement regime. Although the Council is not the direct owner of the shares in ACL, it is able to control ACL on the same basis as if it was the sole shareholder by virtue of its sole ownership of all the shares in ADL.

4.3 It is then necessary to consider the status of ACL itself from an EU perspective. The Regulations will only apply to ACL if ACL can be said to be a "body governed by public law". A body governed by public law means bodies that have all of the following characteristics:

- 4.3.1 They are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character;
- 4.3.2 They have a legal personality; and
- 4.3.3 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;

4.4 Given the underlying purpose of ACL and its position as a subsidiary of ADL, the prudent approach would be to treat ACL itself as a body governed by public law. Any contracts for works/services that ACL lets would therefore be let in accordance with the Regulations.

5 **The risk of insolvency**

5.1 Since ACL will be a company with limited liability, the debts of ACL will not pass to ADL in an insolvency situation. However, there are a number of ways in which ADL or the Council may nevertheless lose out in such a situation:

- (a) If Council have invested in ACL by means of a loan (either directly or indirectly), ACL may not be able to repay the loan and ADL/the Council may also lose out on the payment of any future interest that would have accrued. The Council will likely have the benefit of a charge over ACL's assets and this will give the Council priority over the proceeds of sale of those assets. However this would depend on the value of those assets and whether this would be sufficient to repay the loan.
- (b) Any unpaid share equity which ADL holds may be called up by ACL's administrators and any share equity already paid would rank behind any other creditors of ACL. At the point of incorporation ADL will hold only a limited number of shares and its liability as a shareholder will not extend beyond that for as long as this is the only share it holds.
- (c) ACL may be unable to pay any outstanding fees for services provided by ADL.
- (d) Liability for ACL's debt could arise if ADL or the Council were to be deemed a shadow director of ACL and the company was involved in any fraudulent or wrongful trading.

5.2 **Staff**

5.2.1 In the first instance, it is unlikely that ACL will require its own full time staff. The more likely scenario is that the Council's / ADL's current employees will spend part of their time carrying out work for ACL.

5.2.2 ACL should be charged a proper cost for any services provided. The supply of services in this case can be documented by way of a service level agreement (which we could prepare for you). ACL is not likely to be within the Council's VAT Group (see above) which means that there will be a charge to VAT on this supply.

6 **Next steps**

6.1 The establishment of ACL as a subsidiary of ADL is a relatively simple and quick process. The articles of association for ACL mirror ADL (save that the minimum number of directors

is two rather than three to allow for a more streamlined board of directors for ACL), substituting of course the parent provisions to relate to ADL as opposed to the Council.

- 6.2 A side letter to the shareholder agreement between the Council and ADL has been prepared to ensure the ADL doesn't do anything to allow ACL to carry on business other than for the reason it was set up, but this is more of a formality as, ultimately, the Council retain control over the "group" as the sole shareholder of ADL.
- 6.3 The Umbrella Development Agreement will be entered into between the Council and ACL which includes pro forma instructions and pro-forma contractor and consultant collateral warranties in order to allow the Council the requisite degree of control over each development and to obtain the benefit of all collateral warranties relating to the development. These are likely to be matters required to be put in place as part of any funding arrangements in any event but are usefully documented in the Umbrella Development Agreement as it separates the Council's funding and land ownership functions.

7 **Conclusion**

We hope that this report is of assistance to the Council. This report has been prepared for and it is to be relied on by Bath and North East Somerset Council and by no other party without our written consent

Trowers & Hamlins LLP

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