The Charity Law & Practice Review

CHARITABLE COMPANIES: REGULATED COMPANIES?

Elizabeth Yates[1]

The Local Government and Housing Act 1989 may seem strange territory for the attentions of those interested in charities but the provisions of Part V of the Act, which define local authority "controlled" and "influenced" companies, and the associated regulations, are capable, and deliberately so, of bringing charitable companies within the regime of regulation. The significance is that "regulated" companies are treated as if they are part of the "local authority group" and their finances count in respect of capital receipts and credit approvals for the authority by virtue of s.39(5) LGHA 1989. Local authorities are expected to use their control or influence to ensure that the company complies with the regulations.[2]

Charitable trusts are not included within the Act. The draft regulations produced in 1989/90[3] seemed likely to exempt many local charities, and indeed it was rumoured that Part V would not come into force. The Government's Private Finance Initiative changed that. Part V hampered the establishment of local authority partnerships through companies. The Regulations introduced in March 1995[4] free authorities to hold minority interests in companies but do not provide the same exemption from the regulations for charities.

The regime of Part V applies to companies limited by shares; by guarantee with or without share capital; unlimited companies and registered (or deemed registered)

---

1 Elizabeth Yates LLB, MPhil., Chief Officer, Telford Community Council, Meeting Point House, Southwater Square, Telford TF3 4HS Tel: (01952) 291350. Visiting Lecturer in Law at Wolverhampton University.

2 s.70(2) and (3) LGHA 1989.

3 "Local Authorities' Interests in Companies in England and Wales - A Consultation Paper in the Form of a Draft Circular", D. of E. and Welsh Office, October 1989.

4 The Local Authorities (Companies) Order, SI 1995 No 849.

industrial and provident societies;[5] and it applies to all local authorities including parish councils.[6]

Companies Subject to the Control of One or More Local Authorities (s.68 LGHA 1989)

For a company to be "controlled", a local authority (or authorities) must be able to control the voting in general meetings; have powers to appoint or remove a majority of the board of directors of the company; control the company alone pursuant to an agreement with fellow members or the company may be subject to the control of another "controlled" company.[7] It is very unlikely that charities other than regional or national bodies which have a significant membership drawn from local authorities would be within this category and such organisations will probably be able to convince the Department of the Environment that they should be exempted by a Direction. One such company is already the subject of a Direction.

Companies Subject to the Influence of One or More Authorities (s.69 LGHA 1989)

The concept of "influence" owes much to the notion of dominant influence in company law. In order for a company to be subject to the influence of one or more local authorities there must be a personnel **and** business connection between the authority and the company.[8] If several authorities contribute to both the personnel and business connections the company is subject to their joint influence[9] The **personnel** connection is satisfied if at least 20% of the voting rights of the members, or of the board, are held by persons associated with the local authority, or if 20% of the directors are so associated. Those associated are individuals who are or have been a councillor within the previous four years; are an officer of the authority; or are an employee and director, or officer of a controlled company.[10]

---

5 s.67(1) LGHA 1989.

6 s. 67(3) LGHA 1989.

7 s.68(1) LGHA 1989.

8 s.69(1) LGHA 1989.

9 s.73(2) LGHA 1989.

10 s.69(1)(a)(c) LGHA 1989.

Thus, if one-fifth of the company's members or directors are councillors or officers of the authority (or authorities) with which the company also has a business relationship, the company is "influenced".

The **business relationship** test can be satisfied in several ways: if, within the previous twelve months, one or more authorities have together contributed to more than half the turnover shown on the company's profit and loss account; or if more than half its turnover is derived from assets in which the authority has an interest, the test is satisfied. There is also a business relationship if grants of expenditure for capital purposes and shares or stock owned by the authority exceed half the company's net assets; or if capital grants and loans made by the authority together with shares held by it exceed half the fixed and current assets of the company. The test is also satisfied if the company occupies land from the authority at less than the best consideration or if the company intends to enter into any of these arrangements.[11]

It is clear from this that many local charities including, for example, councils for voluntary service, may be caught within the definition of an "influenced" company. For example, a voluntary body may have several local authority representatives on its board of management, perhaps from several authority departments, or from parish, district and county councils and more than half of its funding may be derived from grants or service level agreements with those authorities. Traditionally, local authorities have provided assistance to voluntary organisations by providing premises at peppercorn or low rents and at the same time been represented on the management committee.

The simplest solution for charities which could be "controlled" or "influenced" is to re-structure and amend their memorandum and articles of association to reduce the local authority's voting power or membership of the company or the board. If the personnel connection with the local authority is reduced below 20% the company is neither controlled nor influenced and thus avoids any regulation, although the authority must still provide opportunities for councillors to question the authority's representatives about the company's activities.[12] This is not the only solution, but in view of the susceptibility of this legislation to alteration by the Secretary of State[13] it is probably the safest for charitable companies.

---

11 s.69(3) (a)(f) LGHA 1989.

12 s.71(5) LGHA 1989.

13 Part V largely provides the definitions and leaves it to the Secretary of State to provide the regulations. There are 3 opportunities for the Secretary of State to give Directions and 8 opportunities for regulation by Statutory Instrument, including the power to include significant additional personnel in the category of those associated with the local authority, and a power to define and regulate non-charitable influenced trusts.

Most local authorities will already have re-structured some of the companies which they have established to avoid control or influence. Many charitable companies do not use "limited" in their titles, so the authorities may not be conscious of their corporate status, or of the degree to which their involvement potentially influences or controls the charity and thus will not have considered them. Nevertheless, the local authorities themselves will not want the unnecessary complication of outside companies being "regulated", so will probably support the re-structuring.

It may be, however, that a local authority is unwilling to reduce its current opportunity to participate in a company. For example, the authority may own a theatre or art gallery which is leased to a charity at a peppercorn or reduced rent, and wish to retain strong links. Or it may be that an authority which has 'externalised' its old folks homes to a charitable company may want to retain influence to maintain the style and 'ethos' of the provision. It is necessary to look at the detail of the Statutory Instrument to consider whether such a body is included as a "regulated" company.

Regulated Companies

The concept of "regulated" company[14] owes much to the definition of a "group" in section 258 of the Companies Act 1985.

A. Automatic Regulation

"Controlled" companies, and "influenced" companies which are either unlimited companies or industrial and provident societies are, without more, "regulated", although industrial and provident societies could consider conversion into suitably structured registered companies as a means of escape from regulation.

B. Regulated by Meeting One or Both Specified Conditions

"Influenced" companies which meet either or both of two conditions are also "regulated".

Both conditions work firstly, by treating the authority as if it were a registered company which was the "parent" and the "influenced" company its subsidiary, and then by referring to the Companies Act 1985 and the Financial Reporting Standards 2 and 5[15] for definitions and explanations.

---

[14] The Local Authorities (Companies) Order, SI 1995 no 849 para 1(4).

[15] FRS 2 - "Accounting for Subsidiaries" and FRS 5 - "Reporting the Substance of Transactions", published by the Accounting Standards Board.

The first condition is that the authority would be regarded as having the right to exercise, or has actually exercised, a dominant influence by virtue of section 258 during the previous year. The second condition is that the authority would be required by virtue of section 229 to prepare group accounts, and for the purposes of this second condition the only exemptions are those in section 229(3)(a) and (c) CA 1985.[16]

(1) Condition 1 - The Right to Exercise or Actual Exercise of Dominant Influence Under s.258

(a) The Right to Exercise a Dominant Influence - s.258(3)(c)

This would apply where the authority is a member of the company and could exercise the influence by virtue of provisions in its memorandum and articles of association, or by virtue of a control contract.

Schedule 10A CA 1985 defines a dominant influence for the purposes of this subsection as the right to give directions with respect to the operating and financial policies of the potential subsidiary with which its directors are obliged to comply whether or not they are for its benefit. The definition of a control contract in Schedule 10A is a contract in writing, conferring a right of a kind authorised by the company's articles and which is permitted by law.

It is suggested that no charity ought, legitimately, to fall within these elements of the condition.

(b) Actual Exercise of a Dominant Influence - s.258(4)(a)

For the actual exercise of a dominant influence to apply, the local authority must have a participating interest, i.e., an interest held on a long term basis to secure a contribution to its activities. There is a presumption that an interest of 20% or more in the subsidiary is a participating interest[17] but it is open to the company to show that the contrary is the case (i.e., the interest is not held to secure a contribution to the authority's activities). The interest is not confined to a shareholding, and would include potential contributories, i.e., members of a company limited by guarantee.

This applies therefore to companies where the personnel test is satisfied by 20% of the membership being associated with the authority (i.e., s.69(1)(a) LGHA 1989) but where that is the case the influence needs to be analysed.

---

16 ibid paras 1(5) and 1(7) respectively, and 1(8).

17 CA 1985 s.260(1) and (2).

A different definition - of actual exercise of a dominant influence - applies from that already described.[18] FRS 2 para 7b defines it as an influence that achieves the result that the operating and financial policies of the undertaking are set in accordance with the wishes of the holder of the influence and for the holder's benefit whether or not those wishes are explicit. In this case the influence is identified in practice rather by the way in which it is exercised. Paragraph 72 of the FRS refers to the existence of a veto or other reserve power that has the necessary practical effect. It suggests that the full circumstances of each case should be considered, including the effect of any formal or informal agreements. Although FRS 2 states that commercial relationships such as that of supplier, customer or lender do not of themselves constitute a dominant influence, those relationships could be very powerful indeed for some charitable companies. For example, in the context of the arrangements for care in the community, a charity might be dependent on an authority for nearly all its business through contracts or service level agreements and, if it were providing residential care, the inspection unit of the authority would have the power to de-register it if its operating policies and practice do not come up to scratch. Are such a company's operating and financial policies being set by the authority? It is conceivable that such a charity could be caught by this condition, notwithstanding that for the purposes of the Community Care Transitional Grant it would be seen as within the independent sector!

(2) Condition 2 - Requirement to Consolidate Accounts Under s.227 or Accounting Standards Unless Exempted by s.229(3)(a) or (c) CA 1985

Section 227 requires a parent company to produce group accounts. This again relates to the group, definition in s.258(4)(b), presumably subsection 4(b) since the other elements have already been covered. It also refers to 'quasi-subsidiaries' identified in FRS 2 and explored in FRS 5.

(a) Participating Interest Held and Both Managed on a Unified Basis s.258(4)(b)

The definition of a group includes the situation where the parent, the local authority, has a participating interest in the company and it and the subsidiary are managed on a unified basis. It is difficult to see how a charity would be caught by this condition. It could conceivably arise where the authority, its members or officers were the trustees of the charity and it was managed 'in-house', but even then the charity should be managed separately. To fall within this category, the whole of the operations must be integrated and the company and authority be managed as a single unit. Paragraph 12 of FRS 2 states that unified management does not arise solely because one undertaking manages another as this may not fulfil the condition that the operations of the undertakings are integrated.

---

[18] CA 1985 Sched 10A para 3.

(b) Quasi-Subsidiary

FRS 2 para 63a explains that a quasi-subsidiary can arise where a company is directly or indirectly controlled by the parent but does not qualify in the other tests. In the normal company context a quasi-subsidiary might be a trust or a partnership and need not be a company. In this context, however, it must be a company limited by shares or guarantee. FRS 5 explains: "Sometimes assets and liabilities are placed in an entity (a 'vehicle') that is, in effect controlled by the reporting entity but does not meet the legal definition of a subsidiary", in which case the FRS requires its accounts to be consolidated with the parent. In the context of this article it appears to be a catch-all category for the companies which do not meet the other elements of the two conditions. Potentially, therefore, it could include companies where the personnel association is at board level (LGHA 1989 s.69(1)(b)(c)) as well as in the membership. The relevant elements of the definition in FRS 5 para 7 are that it is directly or indirectly controlled by the potential parent and gives rise to benefits for that parent. Again, para 8 states that the control is the ability to direct the financial and operating policies of the company with a view to benefiting the parent and in this FRS 5 para 32 suggests that regard should be had to the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them and (para 33) who, in practice, directs the financial and operating policies of the vehicle or who can prevent others from benefiting from the vehicle's assets. If the control is contractual, it may be by one transaction or a series of linked transactions.

It is conceivable that charities operating externalised local authority services could be caught by this condition.

(c) Exceptions to Condition 2

The SI provides exemption from the requirement to consolidate accounts, but it must be noted at this stage, that the SI and its explanatory guide[19] are at odds. There is either a misprint in the SI or a mistake in the guide. According to the SI as currently printed, the permitted exclusions are those within sections 229(3)(a) and 229(3)(c) CA 1985 which may, rather than must, be excluded from the consolidation under the Companies Act.

(i) Where severe long term restrictions substantially hinder the control - s.229(3)(a).

The restrictions are to be identified by their effect in practice rather than by the way they are imposed, but FRS 2 para 78c provides the example of a company

---

19 "A Guide to Local Authorities' Interests in Companies including an Explanation of the Local Authorities (Companies) Order 1995" D of E, March 1995.

subject to an insolvency procedure where control of the undertaking may have passed to a designated official such as an administrator, administrative receiver or liquidator. On that example, this exclusion is no help to a healthy charity! Does the fact that it is a charity provide such a restriction per se? The Department of the Environment seems to think not.

(ii) The authority's interest is held exclusively with a view to subsequent resale - s.229(3)(c)

As charities are not companies to be bought and sold, there is little help here either.

(iii) The activities of the subsidiary are so different from others included in the consolidation that it must be excluded in order to give a true and fair view - s.229(4)

Because clarification is not yet available from the Department of the Environment it is worth considering this exclusion, which is described in the guidance note and labelled s.229(3)(c) in it.

The fact that some of the undertakings are industrial, some commercial and some provide services, or because they carry on industrial or commercial activities involving different products or provide different services, is not sufficient difference on its own. One difficulty for charities attempting to extricate themselves from the problem of "influence" is that local authorities are diverse organisations. It has been held that the funds of a local authority are held for public and therefore charitable purposes[20] and, now that charities are providing services under contract or service level agreement for local authorities, distinctions may be increasingly blurred.

FRS 2 para 78e suggests that cases where the subsidiary's activities are so different as to warrant exclusion from consolidation are exceptional. The contrast between banking and insurance companies and other companies, or between profit and not-for profit, is not sufficient of itself to justify non-consolidation.

It would seem, therefore, that if a charity is excluded by this subsection, it will be exceptional.

---

20 *A-G v Aspinall 2 My and Cr* 613 (40 ER 773 at 777/8).

Secretary of State's Directions that Companies Be Not Regarded as "Controlled or "Influenced" (ss.68(1) and 69(1) LGHA 1989)

Guidance is not yet available from the Audit Commission, but the decisions to be made in respect of the two conditions will be based on the judgment of the authority's auditor.

In order to be sure that they are not "regulated" the charities concerned should consider an application to the Secretary of State for a Direction under s.68(1) or s.69(1) LGHA 1989.

Certain companies have already been made subject of such Direction (21st March 1995). Groundwork trusts, area museums councils and area or regional arts boards are excluded from the regulations providing they are in receipt of financial assistance from the Secretary of State, presumably because central government is then more influential than the local authority. Building preservation trusts registered with the Architectural Heritage Fund; "specified bodies" for the purposes of section 78 Local Government Finance Act 1988 (e.g., the Local Government Training Board and Fire Service College); Citizens' Advice Bureaux; regional tourist boards; the National Housing and Town Planning Council; and registered Housing Associations were also excluded.

In addition, a company which would be "influenced" by virtue of having received no more than £2,000 in total from the authority(ies) in grants, loans or guarantees, in the relevant year is not subject to the regulations.

It has been suggested that there will be few, if any, additional general Directions granted, so companies need to apply individually. The local authority may apply for a Direction under ss.68(1) or 69(1) LGHA 1989 as may the company itself. If the company applies it should seek the views of the authority(ies) which control or influence it. The application to the Secretary of State should indicate which of the following criteria it meets, namely, whether it is a charity; whether fewer than half of its directors are associated with one local authority; if the company is managed independently of the authority; and whether the authority has guaranteed or indemnified the company against a future liability or loss. The company is also asked to state whether it receives core or substantial funding from a government department, public body, or the European Union.

Does it Matter if Charities are "Regulated"?

Charities may find some or all of the regulations irksome. For example, companies which are regulated are required to state that they are "controlled" or "influenced" as the case may be, and by which authorities, on all relevant documents (as listed in s.349 Companies Act 1985). Their finances are brought within the same regime of controls as local authorities, so that the disposal of

company assets counts as a capital receipt for the authority (except for the disposal of assets held for charitable purposes); borrowings count towards the authority's credit approvals (unless the aggregate amount is less than £10,000); they must provide financial and other information for the authority and the minutes of their annual meetings must be open for inspection by the public.

On a philosophical note, ought we to be concerned that parts of the charity world have become so close to the operation of local authorities that legislation such as this touches them? Perhaps it is an appropriate time for the Commission on the Future of the Voluntary Sector established by the National Council for Voluntary Organisations to consider the degree to which contracting for services or managing 'externalised' services is distorting the voluntary sector or is appropriate for charities.