Bond Law Review

Volume 2 | Issue 1 Article 6

5-1-1990

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Abstract
All companies incorporated under the Companies Act (and corresponding State Companies Codes), by section 67, have the legal capacity of a natural person. Consequently, all companies can enter into swap agreements without fear of the agreements being challenged by outsiders on the ground that they are outside the relevant company's power. The situation is different for statutory corporations, public authorities, local councils, and other public bodies which invariably do not have the legal capacity of a natural person.

The powers of such public bodies are usually enumerated in their incorporating legislation. Often they will be given a power to raise money by borrowing, subject to conditions, together with either an express or implied incidental power. There is some doubt, in the absence of a specific power, whether a statutory body can enter into a swap agreement. A swap transaction is usually an agreement by two parties to pay each other on certain days amounts calculated by reference to interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. Swaps are often employed as a device of minimising exposure to adverse interest rate fluctuations payable on loans. Since a swap transaction is not a borrowing, a question arises, in the absence of specific power, as to whether swap transactions are incidental to borrowing.

Recently in the English case of Hazellv. Hammersmith & Fulham London Borough Council & Ors1 the Queen's Bench Court of Appeal, reviewing a decision of the Divisional Court, examined the scope of the powers of a local council in relation to the entering into of swap agreements.

Keywords
swap agreements, powers of public bodies, local councils

(1990) 2 Bond L R

Legal Capacities of Statutory Bodies in Relation to Financial Dealings—The *Hammersmith* Decision.

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Introduction

All companies incorporated under the Companies Act (and corresponding State Companies Codes), by section 67, have the legal capacity of a natural person. Consequently, all companies can enter into swap agreements without fear of the agreements being challenged by outsiders on the ground that they are outside the relevant company's power. The situation is different for statutory corporations, public authorities, local councils, and other public bodies which invariably do not have the legal capacity of a natural person.

The powers of such public bodies are usually enumerated in their incorporating legislation. Often they will be given a power to raise money by borrowing, subject to conditions, together with either an express or implied incidental power. There is some doubt, in the absence of a specific power, whether a statutory body can enter into a swap agreement. A swap transaction is usually an agreement by two parties to pay each other on certain days amounts calculated by reference to interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. Swaps are often employed as a device of minimising exposure to adverse interest rate fluctuations payable on loans. Since a swap transaction is not a borrowing, a question arises, in the absence of specific power, as to whether swap transactions are incidental to borrowing.

Recently in the English case of *Hazell v. Hammersmith & Fulham London Borough Council & Ors*[1] the Queen's Bench Court of Appeal, reviewing a decision of the Divisional Court, examined the scope of the powers of a local council in relation to the entering into of swap agreements.

Facts

In that case, the Council during the financial years 1987-1989 had entered into substantial financial transactions including interest rate swaps, options, caps, floors, interest rate collars, forward rate agreements, and gilt and cash options (the 'transactions').

1 Unreported 22 February 1990.

The Council's activities comprised four general phases. The first phase, between December 1983 and March 1987, consisted of the Council entering into a small number of swap agreements. Between April 1987 and July 1988 the number of transactions markedly increased and the notional principal of the relevant transactions increased from £135 million to £3,727.5 million. The Council entered into the transactions with 'view to a profit', and the transactions were not linked to any loan base. During this second phase a capital market fund account was established. Between August 1988 and 23 February 1989, the third phase, the Council continued to enter into transactions, but only those designed to reduce the Council's exposure to loss which would result from a rise in interest rates. After 23 February 1989 Council was only involved in seven transactions, being swaps consequent upon other parties exercising earlier swap options and one gilt option.

Most of the transactions that the Council entered into were predicated on the basis that the interest rates would fall. However, during the relevant period the interest rates had actually increased and the Council stood to lose well in excess of £100 million.

The auditor for the Council made an application to the Divisional Court in May 1989 seeking a declaration, pursuant to the *Local Government Finance Act 1982*, that certain items of account appearing in the capital market fund were contrary to law and also sought an order for rectification of the accounts. The relevant issues were as follows:

(a) (i) whether the relevant transactions were capable of being within the powers conferred on the Council;

(ii) if so, whether the transactions were in fact entered into by the Council in a proper exercise of those powers;

(b) whether the transactions were not such that a reasonable authority could have engaged in organised as the Council was;

(c) whether the transactions were authorised properly or at all by the Council; and

(d) whether the capital market fund was validly established or maintained by the Council.

Divisional Court

Royal Charter

The Divisional Court considered an initial point peculiar to the law in England. The *London Government Act 1963* allowed certain London Boroughs to be granted, upon representations, a charter of incorporation by Her Majesty. It was argued that this royal charter was unfettered and the municipal corporation had such general capacity as the common law attached to a corporation created by charter (ie unrestricted by the doctrine of ultra vires). This argument was rejected by Woolf LJ and French J who decided that the powers that Her Majesty is entitled to grant by the charter to the municipal corporation are to be read subject to the powers granted by the Local Government Acts.

Ultra vires in the narrow sense.

The *Local Government Act 1972* (the '*LGA*') contained specific provisions in relation to the power of the Council to borrow. The *LGA* did not include express power for the Council to enter into swap transactions. However, section 111 of the *LGA* relevantly provided that:

> Without prejudice to any powers exercisable apart from this section but subject to the provisions of this Act and any other enactment passed before or after this Act, a local authority shall have power to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.

The section was a statutory manifestation of the common law principle that local authorities have implied power to do anything which is ancillary to the discharge of any of their functions.

The Court stated that the words 'calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions' were the critical part of the section. Their Honours determined that a 'function' refers to the 'multiplicity of specific statutory activities the Council is expressly or impliedly under a duty to perform or has power to perform under the other provisions of the Act of 1972 or other relevant legislation.' It was noted that the section was merely a subsidiary power and relied upon particular enabling provisions.

The Court identified the power of the Council to borrow and lend money with respect to their funds as being the relevant function. The transactions were capable of assisting the Council to alleviate the consequence of borrowing by assisting the Council to pay interest. However, there had to be a sufficient nexus between the activity and the function of borrowing or investment if the activity is to be authorised by section 111. The necessary nexus could be broken if:

(a) the activity was not subsidiary to the discharge of the function of the Council;

(b) it involved setting up a separate business or undertaking; or

(c) the activity is not sufficiently closely related to the function to which it is said to be subsidiary.

Their Honours declared that the transactions which the Council entered into could at best be capable of being 'incidental to the incidental'. Importantly they decided that it is an incident of borrowing that interest is paid and of investing that interest is received. It is also an incident of the transaction that interest or a sum of money that represents interest is paid or received. The Court stated, however, that the transactions did not involve borrowing or investing.

The Court also indicated that there was a fundamental difficulty in regarding the transactions as being within section 111 of the *LGA*. The activities involving the transaction were inconsistent with the structure of the *LGA* and in particular the highly specific provisions in relation to borrowing and investing money.

The Court concluded that:

> As we have sought to indicate, the financial activities are statutorily constrained in a way which makes it impossible in our view to imply functions of debt management or interest risk management which would provide authority for entering into the transactions which are not expressly referred to in the legislation.

Their Honours also said that:

> In coming to this conclusion we are not indicating that the transactions were not capable of being advantageously used by the Council in connection with its interest obligations. On the contrary we can see that properly controlled activities of this nature could provide a useful tool which if it were available to the Council would enable it to minimise its expenditure on interest and increase its income from investments.

The decision effectively meant that swap transactions were always beyond the power of the Council.

Ultra vires in the broad sense

The Court then considered, assuming their decision to be incorrect and the transactions were capable of being within the power of the Council, whether the Council had engaged in interest risk management. Their Honours said the scale and range of transactions entered into during the second phase made it clear that the Council was not engaged in interest rate risk management but engaged in a trade designed to exploit the market with the transactions with a view to a profit. Interestingly, the Court held that transactions entered into during the third period were part of interest risk management, notwithstanding that these transactions involved the Council seeking to reduce its exposure as a result of its earlier activities which were beyond its powers.

The Court held that the following transactions were incapable of being used for interest rate risk management:

(a) transactions entered into as an 'intermediatory' with a view to obtaining a profit including transactions entered into to assist another local authority with a lesser credit rating; and

(b) transactions in which the Council sold options or otherwise received premiums for entering into them.

However, the Court stated that swaps, forward rate agreements, the purchase of caps and floors, and the purchase of swap options could be capable of being used for interest rate risk management. Whether they were to be so regarded would however depend on the particular facts.

Further Issues

Notwithstanding their earlier conclusions, the Court also commented upon the remaining issues which involved questioning:

(a) whether there was valid delegation;

(b) whether there was valid establishment of a capital market activities fund; and

(c) the '*Wednesbury*' unreasonableness principle.[2]

The Court held that there was no proper delegation to the particular officials who conducted the transaction and that the capital market fund was never validly established. It then considered the *Wednesbury* principle. The principle involves questioning the reasonableness of the decision by Council to exercise its power in a particular way. The test is framed in a negative fashion, and the Court applied it to the facts by asking whether 'no reasonable authority, organised as the Council was, could have engaged in the Council's scale of capital market activity'. The Court in considering this issue, had regard the following circumstances:

(a) no legal advice was obtained by the Council before it undertook capital market activity;

(b) the officers engaged in the activity were not equipped by training or experience to operate within a highly technical, sophisticated and competitive market;

(c) the Council was lacking the appropriate expertise and resources; and

(d) lack of information in the reports to the Finance and Administrative Committee and to the Council.

The Court concluded that the officers' conduct was unreasonable within the *Wednesbury* principle during the second phase where they were operating with a view to a profit. However, in relation to the third phase, being the interim strategy, and the first phase the Court said that the exercise of the power was reasonable.

Enforceability

Since the transactions were not capable of being within the power of the Council the Court held that the contracts were void from a public and private law point of view, and thus void for all purposes and properly described as ultra vires. The Banks had no enforceable rights under the contracts.

Court of Appeal

The Court of Appeal delivered its decision on 22 February 1990.

Royal Charter

The Court conducted an exhaustive summary of the history of the legislative provisions relating to constitution of local governments in England. Under the subject legislation, the Court held that the municipal corporation could be incorporated pursuant to Royal Prerogative and that in such case it would have the capacity to enter into contracts of a natural person. There was a distinction between the Council and the municipal corporation and the Court declared that the exercise of such wide power by the municipal corporation was constrained by the permitted

2 *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223.

use of Council funds imposed by the Local Government Legislation. Hence the capacity to enter the relevant transactions was to be determined as if it were the Council contracting.

Ultra Vires in the narrow sense

Unlike the Divisional Court, the Court of Appeal held that all of the types of transactions were capable of being within the power of the Council. Such transactions were not inconsistent with the legislative provisions where they were entered into as part of 'interest rate risk management'. In principle and in law, their Honours declared, interest rate risk management was incidental to or consequential upon a local authority's powers of borrowing and investment and 'the attendant duty resting upon it to take reasonable care to manage its borrowings and investments prudently in the best interests of the ratepayers and for those for whom the authority provides services'.

It is interesting to examine the legal analysis of the legislation which led the Court to this conclusion. The Court stated that strict legislative powers and conditions applicable to borrowings did not necessarily lead to the conclusion that swap instruments would be incompatible with those powers and duties. The Court noted that the rate of interest was left to the discretion of the Council under the legislation and that it is with that field that interest rate risk management is concerned.

The Court also considered the transaction not to be inconsistent with the legislative provisions controlling debt re-structuring since the transactions did not involve replacement borrowing, but merely effected a similar result. An 'acceptably liberal interpretation' was also taken in relation to the legislative provisions regarding debiting a borrowing account annually by an amount which included a calculation made by reference to 'interest at the due rate'.

An argument was advanced during the appeal that an interest rate swap is a transaction unconnected in law with any existing debt of the local authority since the lender is still entitled to be paid the agreed rate of interest by the Council. The Court responded by drawing an analogy with insurance policies:

> The absence of a legal connection is equally a feature of insurance policies. The justification for a local authority taking out a policy of insurance has to be found elsewhere than in the terms of the policy. So it is with interest rate risk management. In a case of swap transactions entered into as part of interest rate risk management, their justification lies in the existence of the particular debt or debts with reference to which they were entered into.

The Court seemed to take account of the convenience of swap transactions and their economic effect in determining whether such transactions were incidental to the borrowing power. This approach differs from the strict legal analysis of the Divisional Court.

Ultra Vires in the broad sense.

Since the transactions were capable of being within the power of the Council, a question remained as to whether such transactions were used for the proper purpose of 'interest rate risk management'. The feature to which the Court attached importance in determining whether a transaction was proper was the clear linkage between a swap transaction and a particular debt or debts (or investment or investments). The purposes and commercial effect of the swap transactions in the case of such 'parallel contracts', the Court stated, was 'to substitute for a cash flow in respect of a debt or investment a different cash flow'. The Court expressly left open the question whether interest rate risk management includes altering the 'profile' of a Council's 'loan portfolio' (i.e. not linked to a particular debt).

Contrary to the Divisional Court's analysis, all of the types of transactions which the Council entered into, were capable of being used by way of interest rate risk management. The Court focused upon the purpose of the transaction rather than the particular type of transaction. 'Intermediation' was a purpose, their Honours stated, but in the context of the case the purpose was trading. Similar reasoning was applied to swap options, gilt options, cash options and caps, floors and collars.

The Court considered that the transactions entered into by the Council during the first two periods were tainted with the improper purpose of trading since the Council officers made no attempt to match the Council's actual debts and investments, either singly or in aggregate, with any of these transactions. The Court made a declaration for transactions entered into during these two periods as being unlawful.

Conversely, in relation to the third and fourth phases, the Court considered these transactions to be entered into for a proper purpose, notwithstanding that some of the transactions were entered into in order to minimise the losses arising from transactions which had been entered into unlawfully. Their Honours stated that the correct principle was:

> If a local authority has unwittingly and in good faith exceeded its powers, but is with good reason uncertain whether or not it has done so, it has implied power for such period as it reasonably takes to resolve that uncertainty to take such steps as it reasonably and prudently can to limit and reduce the loss which its earlier conduct may cause its ratepayers or community charge payers.

The legal issues presented to the Court were structured on the assumption that a principle analogous to that applied in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation*[3] applies to persons dealing with the Council. If, as the Divisional Court had previously found, the transactions were not capable of being within the power of the Council, the contracts would be void and unenforceable by the other party. However, it was argued that if the transactions were capable of being within the power of the Council, but they were entered into for an improper purpose, then rights would be vested in the contracting party. Both the Divisional Court and the Court of Appeal expressed no opinion on the enforceability of the contracts in these circumstances, thereby

3 (1986) Ch 246.

leaving open the question of the applicability of the *Rolled Steel* case to statutory bodies.

Wednesbury Unreasonableness

There was no necessity for the Court to determine unreasonableness in relation to transactions entered into during the first and second phases, but they did say that it was a very weighty complaint that the Council plunged into the market on the extravagant scale in which they did. Their Honours noted that the Council's lack of equipment and expertise reasonably necessary for engaging in this activity on the scale involved would not of itself lead to the conclusion that the resulting items of account were contrary to law but the Court might readily reach an unreasonableness conclusion where outside advice was not sought and the necessary skills and expertise were lacking within the authority itself. The transactions entered into during the third and fourth phases were not disputed in terms of the *Wednesbury* principle.

Authorisation

The Court considered that there was no due authorisation to enter into the transactions, but in the exercise of its discretion refused to grant a declaration of unlawfulness in respect of those transactions entered into during the third phase.

Summary

Interest rate swap transactions are capable of being within the powers conferred on local authorities. Such transactions, however, must be entered into for purposes of interest rate risk management and not for trading purposes. The transactions entered into by Council during the first and second phases were entered into for the purpose of trading and were unlawful. The transactions entered into by the Council during the third and fourth phases were entered into for the purpose of mitigating or averting potential loss to the ratepayers and were therefore lawful. Whilst the transactions were not authorised by Council, the Court, in the exercise of its discretion, refused to grant a declaration of unlawfulness in relation to the third and fourth periods. The Court left open the question as to whether any outstanding contract is enforceable.

Australian Position

Local Government

It is conceivable that issues similar to those raised in the *Hammersmith* decision could arise in Australia in relation to local councils. For example the *Local Government Act 1919* (NSW) (the 'Act') regulates the activities of councils in New South Wales.

Not surprisingly, the Act contains no express provision allowing councils to enter into swap transactions. As in England, councils possess the power to borrow but only in accordance with the strict requirements

specified in Part VII of the Act, including terms and conditions determined by the Minister. Further, councils have an implied ancillary power and additionally section 516 of the Act provides:

> Council may enter into any contract for the purposes of this Act.

The purpose of 'repaying or renewing any other loan and for paying the expenses incidental thereto' is recognised in section 176 of the Act. Such purpose is analogous to the purpose of interest rate risk management in some respects and was part of the reasoning in the *Hammersmith* decision. It is arguable that section 176 of the Act, when combined with section 516 of the Act, and the incidental power allows a local council to enter into a swap transaction in certain circumstances.

Also, local governments in New South Wales are given power, pursuant to section 529 to do:

> any acts not otherwise unlawful which may be necessary to the proper exercise and performance of its powers and duties.

Whilst it may be theoretically possible that the *Hammersmith* issue could arise, in the absence of Ministerial consent for swap transactions it would be unlikely that a local council would consider entering into such transactions.

Public Authorities

Swap transactions and other interest management devices may fall within the power of public authorities as a result of recent legislation.

Section 10 of the *Public Authorities (Financial Arrangements) Act 1987* (NSW) (the '*PAFA*') allows an authority for the purposes of exercising its functions to effect a 'financial adjustment' *with the written approval of the Treasurer.* The reference to the effecting of a financial adjustment by an authority is a reference to the entering into or the participation by the authority in any of the following arrangements or transactions or a combination of them:

(a) a currency swap;
(b) an interest rate swap;
(c) a forward exchange rate agreement;
(d) a forward interest rate agreement;
(e) a futures contract or a futures option (within the meaning of the *Futures Industry (New South Wales) Code*;
(f) such other transactions or arrangements as may be prescribed (nothing is currently prescribed).

It is interesting that this list does not include collars, caps, swaptions, and other derivative transactions. Whether these more exotic type transactions could be approved by the Treasurer is an open question.

At first glance at section 10 of the *PAFA*, it might be thought that an exhaustive search of the functions and motives of the relevant authority is necessary to ascertain whether the particular financial adjustment is being effected for a proper purpose. However, once written consent of

the Treasurer is obtained the problem is alleviated by the operation of section 13 of the *PAFA* which provides that:

> The written approval of the Treasurer to the obtaining of financial accommodation or to the effecting of a financial adjustment by an authority is conclusive evidence that anything done by the authority in accordance with the approval is authorised by this Act.

The Treasurer may delegate to a person in writing the exercise of the power of the Treasurer to give approval to an authority to effect a financial adjustment in any particular case or class of case.

An 'authority' is any of the bodies specified in Schedule 1 of the *PAFA* and includes County Councils and Public Trusts as well as the New South Wales Treasury Corporation and the Electricity Commission of New South Wales.

Wool Corporation/Wheat Marketing Board

The *Wool Marketing Act 1987* (Cth.) and the *Wheat Marketing Act 1989* (Cth.) both contain provisions allowing each particular authority to enter into swap transactions. Relevantly, the Wool Corporation may only enter into currency contracts, interest rate contracts, or wool futures contracts for hedging purposes at a financial market. A 'hedging purpose' is described in the *Wool Marketing Act* as:

> the purpose of minimising the risks of adverse variations in:
>
> (a) the costs of a borrowing or raising, or a proposed borrowing or raising, of money by the Corporation;
>
> (b) payments made by the Corporation outside Australia for wool use promotion or other services; or
>
> (c) payments to or by the Corporation in relation to transactions in foreign currencies.

The Wheat Marketing Board is constrained by a similar set of provisions.

Conclusion

As has always been the case, a lender contracting with a statutory body or any other non-Companies Code entity (for example, building societies, friendly societies or credit unions) should carefully examine the scope of the body's power. Swap transactions are merely one particular example of the difficulties facing financial institutions in this regard. Where legislation specifically provides the statutory body with an interest rate risk management power, lenders should still carefully check the scope of the power in the light of the particular transaction. It may be that the statutory body is required to enter into the transaction for a 'hedging purpose'. Further, the body may not have obtained any relevant consents or certifications. If no statutory power exists, but the 'incidental' power is relied upon, extreme care would be required to link the transaction as incidental to a specifically enumerated power (eg. borrowing), and in the light of the *Hammersmith* decision a prudent lender might avoid the transaction altogether.