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Good practice

Related companies: recommended practice guidelines

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HIGHER EDUCATION hefce FUNDING COUNCIL FOR ENGLAND

DEFINITIONS

HEFCE	Higher Education Funding Council for England
SHEFC	Scottish Higher Education Funding Council
HEFCW	Higher Education Funding Council for Wales
DHFETE	Department of Higher and Further Education, Training and Employment
Institution	University or higher education college in England, Wales, Scotland or Northern Ireland
Governor	Member of council, board, governing body or other body ultimately responsible for the affairs of the institution
Related company or company	Any company over which the institution has control or exercises a substantial degree of influence in relation to that company's activities*
Guidelines	Recommended practice guidelines issued to institutions from time to time by the HEFCE
Shadow director	A person (or a body corporate) in accordance with whose directions or instructions the directors are accustomed to act
SCOP	Standing Conference of Principals
CVCP	Committee of Vice-Chancellors and Principals
UNICO	The Universities Companies Association
AHUA	The Association of Heads of University Administration

* Under this definition the institution would in most cases have a controlling or majority interest in the company. However, there may be situations where a related company is not a subsidiary undertaking, as defined by accounting standards, but where the relationship between the institution and that company is such that the Guidelines may still be applicable.

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PART I: INTRODUCTION

The Higher Education Funding Council for England

The Higher Education Funding Council for England was established in 1992 to administer public funds made available for the provision of teaching and research and related activities in higher education institutions.

One of its key objectives is to promote the efficient use of institutional assets and effective accountability for public funds, while recognising the autonomy of institutions.

Accordingly in 1995 the HEFCE commissioned RSM Robson Rhodes to conduct a study of related companies operating within the higher education sector, and to produce guidance for the sector in the form of recommended practice guidelines. In 1999 the HEFCE commissioned RSM Robson Rhodes to review how the Guidelines have been used and whether they could be improved. These Guidelines have been reviewed and updated, where necessary, in the light of this review.

Both SHEFC and HEFCW officers and institutions participated in the initial study, and SHEFC officers and institutions have also been involved in the follow-up study. The Guidelines are therefore intended to be of use to all institutions funded by the three funding councils and DHFETE. Reference to HEFCE within these Guidelines should be taken to refer to any of the UK higher education funding bodies.

Institutions

Institutions of higher education are legally independent corporate bodies which have a common charitable purpose of providing education and undertaking research. They are accountable through their governing bodies, which carry ultimate responsibility for all the affairs of the institution.

The constitutions and powers of institutions within the higher education sector are extremely diverse and may (depending upon the type of institution) be laid down in, for example, the charter and statutes of the institution or in the Education Reform Act 1988 (as amended by the Further and Higher Education Act 1992), together with the instruments and articles of government.

Members of governing bodies (governors) act in a fiduciary capacity and must act in the best interests of the institutions they govern. In certain circumstances, for example if they act negligently, they may face personal liability for loss resulting from a failed project.

Not all institutions may have the power to set up related companies; in addition, some of the proposed activities of such companies may not be directly in accordance with the institution's constitution. Governors should seek proper advice on all aspects of proposed projects.

More detail on the responsibilities of institutions may be found in the 'Guide for Members of Governing Bodies of Universities and Colleges in England and Wales' (Committee of University Chairmen, 1998, available from the HEFCE). Guidance in relation to the role and responsibilities of governors at Scottish higher education institutions is available in the SHEFC Guide for Members of Governing Bodies.

Related companies

Institutions set up related companies for a variety of reasons. These include: to carry out activities of a commercial nature, which may protect the institution's charitable status and incidentally provide advantageous tax or estate planning; to reward, and retain, key academic personnel; to avoid demands on the institution's management resources; or as a means of conducting joint ventures.

There may also be less tangible reasons for establishing a related company, such as providing a focus for commercial enterprise in a culture different from that of the institution itself.

With the increased pressures on funding, institutions are seeking alternative sources of income and are looking to expand their commercial activities. It is likely, therefore, that related companies will play an increasingly significant role within the higher education sector in the future.

The activities of related companies can vary considerably. Some take advantage of specialist skills by selling training and consultancy expertise; others exploit the commercial potential from research and intellectual property. They may also help to attract private funders to share in the risks and rewards of ventures which institutions may not otherwise be able to fund.

By establishing a related company to undertake a commercial activity, an institution may be able to ensure that its powers are not exceeded, that its legal duties (specifically under the law relating to charities) are not breached, and that its governors reduce the risk of personal liability.

By carrying out activities through a company it may be possible to limit liabilities which may arise, for example through negligence or breach of contract claims. However, in certain circumstances (particularly where the institutional "parent" exercises a high degree of control) limited liability may not protect the institution: individual directors of the related company who are also institutional employees or governors may face personal liability. In each case, proper professional advice should be sought, both at the preliminary consideration stage (see Part III below) and at subsequent stages where problems may arise.

An example of the above point could be wrongful trading. The company and the directors (including the institution), which for this illustration are taken to control the company's activities, may be held liable to contribute to payment of the company’s creditors if they knew or ought to have known that the company was insolvent, and there was no reasonable prospect of avoiding insolvent liquidation, but they continued to trade taking no steps to minimise potential loss to creditors.

Important notice

Before embarking upon any particular project, institutions must examine their constitution (and, in cases of doubt, seek appropriate advice) to determine their powers to undertake the project and the administrative steps required to implement it. These Guidelines are solely for guidance: because of the diverse nature of the sector, they cannot claim to be definitive. In each case, reference should be made to and approval sought from the governing body.

The HEFCE welcomes inquiry on any particular matter and will endeavour where appropriate to give general and individual guidance. However, as institutions are independent bodies, it is ultimately for the governors to satisfy themselves that any particular project falls within the powers of the institution and that all appropriate safeguards are in place.

This document is a summary only of the relevant law and evolving practice in relation to related companies. Accordingly, neither RSM Robson Rhodes, nor the HEFCE, nor any other adviser or body accept any liability in relation to the contents and implementation of these Guidelines. In each case, appropriate advice on the project should be sought from properly qualified independent advisers.

Preliminary considerations

The decision to form a related company should be made with care. It commits an institution to a time-consuming course of action and may involve considerable direct and indirect costs. It is essential therefore to consider fully the commercial, legal and constitutional issues, and any potential tax or other implications (advantageous or otherwise).

Preliminary business plan

The reasons for forming or acquiring a company must be carefully evaluated, weighing up all the facts and options. In these Guidelines, this evaluation is called the preliminary business plan. At this stage, factors for consideration should include the objectives of the institution and the company, the financing arrangements, the potential risks, and the way in which the investment will ultimately be realised.

An institution must satisfy itself that the creation of a company is the best way to achieve its objectives. There are often alternatives to forming a company: the institution itself may be able to carry out the activity, or a joint venture (not involving the formation of a company) or partnership may be appropriate. Such an analysis, and the final decision, should be made by the governors in accordance with the institution's constitution.

Tax considerations

A company may be established to enable the institution to take advantage of tax planning opportunities in terms of both direct and indirect taxation.

Institutions are generally exempt from corporation tax to the extent that they apply their resources for charitable purposes. Similarly, institutions that supply education are generally exempt from VAT on such supplies. Commercial activities that are carried out by the institution itself, and are otherwise than for the institution's primary purpose, may (irrespective of constitutional issues) incur tax liabilities. The risk of a tax liability may be reduced and in many cases eliminated if such activities are undertaken through a properly constituted subsidiary.

There are several established methods whereby profits from related companies can be yielded up to the institution in a tax-efficient manner. The most common method is by gift aid, where the payment can be made within nine months of the end of the relevant accounting period of the related company, in order to claim a deduction for tax purposes in this company and avoid a tax charge incurring. As of 6 April 2000 there is no limit to the level of gift aid payment, and tax does not need to be withheld by the company making the payment. Any current deed of covenant payments will be treated under the same rules as the gift aid payments from this date.

Many institutions have used companies for VAT planning purposes, for example for the construction or refurbishment of buildings. In these cases, the institution would construct the property and enter into a lease and leaseback arrangement with the related company. By electing to charge VAT on the rentals, the institution was able to secure a significant up-front VAT recovery which would not otherwise have been available. Recent VAT anti-avoidance legislation has made such arrangements more difficult and may have reduced the potential advantages of a separate subsidiary company. It may still be technically possible to take advantage of such arrangements but institutions should take appropriate advice.

In all cases, institutions will need to satisfy themselves, usually with professional advice, that the tax implications are clearly understood.

Nominated Officer

The link between the institution and the company is critical. An officer should be nominated to be responsible for reporting to the institution on the performance and activities of the company and to represent the institution, as shareholder, in Extraordinary and Annual General Meetings. It will be the duty of the Nominated Officer to ensure that the interests of the institution are properly represented and to make decisions on its behalf, where necessary. The duties of the Nominated Officer are detailed in Appendix A.

The Nominated Officer should be appointed from the institution and be approved by the governors.

Key documents

Within these Guidelines we make reference to four key documents:

- Financial Memorandum between the HEFCE and the institution;
- Constitution of the company;
- Memorandum of Understanding between the institution and the company; and
- (where the institution does not have a 100% holding of a company) a Shareholders' Agreement.

Each of these documents has a specific role to play in the operation of both the institution and the related company. They should be considered as separate parts of the control and management system surrounding good practice.

Financial Memorandum

The Financial Memorandum between HEFCE and each institution sets out the financial framework in relation to funding and the conditions that govern the use of funds. A summary of the main provisions is set down in the 'Guide for Members of Governing Bodies of Universities and Colleges in England and Wales' (CUC, 1998, available from the HEFCE).

Constitution of the company

Each company is different. Where new companies are incorporated, or where existing ones are acquired, there is scope for tailoring their constitution to meet specific requirements, and building in whatever protections the institutions may assess to be relevant in the light of the given project. There is a great deal of flexibility.

In many cases, companies limited by shares or guarantee may be used. In most cases such companies' constitutions will take the form of a Memorandum and Articles of Association. Appendix D(i), which is not exhaustive, sets out a number of issues to be considered when assessing the constitutional requirements of institutions (and their partners in any venture).

Memorandum of Understanding

These Guidelines recommend a Memorandum of Understanding to ensure that all parties fully understand and agree on the purpose and control framework of the company.

The Memorandum of Understanding is intended to provide a clear and unambiguous interface between the company and the institution, and will be governed by the general law of contract. We believe that a properly drafted Memorandum of Understanding has a vital role to play in ensuring that the close relationship between the institution and the company remains harmonious. It allows the directors to maximise the company's performance and its contribution to the institution, while keeping within the bounds of good practice.

We set out at Appendix D(ii) a list of matters which it may be appropriate to include in a Memorandum of Understanding. In Appendix E we include a specimen document for illustrative purposes.

Shareholders' Agreement

Where the institution does not have a 100% holding of a company and the company constitutes a joint venture between the institution and one or more other shareholders, a Shareholders' Agreement recording the arrangements agreed between the shareholders will normally be required.

We set out at Appendix D(iii) a list of matters which it may be appropriate to include in a Shareholders' Agreement. (A Shareholders' Agreement might also cross-refer to a Memorandum of Understanding or include matters that would otherwise be dealt with in a Memorandum of Understanding.)

A company limited by guarantee may be an appropriate legal structure for a co-operative venture which is not intended to produce profit for distribution to its members and where a realisation of value through a sale of the company to a third party (or a flotation of the company) is not contemplated. Its Articles of Association will set out the respective rights of the members of the company.

Key commercial issues

In setting up a company the institution should consider whether the commercial risks which the company faces can adversely impact on the institution itself. We set out below key issues for consideration by the institution when establishing a company.

Capitalisation and working capital

The institution should examine carefully how the company is to be capitalised. A company with insufficient capital may have difficulties with, for example, obtaining credit with suppliers and paying employees.

In addition, the company may be unable to improve its capital value if it covenants all its profits back to the institution.

It may be that the company will require ongoing financial support. The form and extent of such support must be properly planned to ensure that it does not conflict with tax regulations. It is an area where suitable professional advice should be taken.

Close attention should therefore be paid to the business plan, and in particular to cash flow forecasts. Appropriate sensitivity analysis should be carried out to confirm the viability of the enterprise before a decision to proceed is reached.

Shadow directorships

Certain officers of the institution, because of their influential position, may be held to be directors (although not formally appointed) or shadow directors. Principals or Vice-Chancellors, for example, might come into this category if they exercise control (conspicuously or behind the scenes) over the running of the company.

Where an institution or its officers are held to be shadow directors of the company, there is a risk of personal liability. A shadow director will be treated in the same way as an appointed director and may therefore be held personally liable in certain situations – such as being guilty of the offences of fraudulent trading and wrongful trading under the Insolvency Act 1986, should the company become insolvent.

In most cases, the risk of being held to be a shadow director is the price an institution must pay for a position of control. The possibility of insurance cover against loss suffered by a company should be investigated.

Conflicts of interest

Where an official or employee of the institution also acts as a director of a related company, he/she will owe separate duties of care to the institution and to the company to act at all times in the best interests of each.

In particular, officers or employees of the institution should consider the conflicts which may arise when they are both directors of related companies and charged with the responsibility for overseeing those companies on behalf of the institution. In problematic cases, appropriate independent professional advice must be sought to safeguard both the institution and the individuals.

Other key issues

Other key issues which should be considered are:

- Is there any misuse of charitable funds? Any such misuse, without adequate justification, could put at risk the charitable status of the institution.
- Has the company been set up lawfully, and has due regard been given to the powers, roles and responsibilities of the directors?
- Is a control structure in place that enables the institution to monitor the performance of the company and ensure that the company performs with the best interests of the institution in mind?
- Is the company adequately capitalised and funded so that it avoids trading whilst insolvent?
- Are the key assumptions realistic, and have the risks and sensitivities affecting those assumptions been considered? Have alternative scenarios been modelled?
- Are the funds to be invested in the company available for the purpose?

Where the company is being set up to exploit the commercial potential of technology and intellectual property, particular consideration should be given to the protection and the means of transfer of that technology and those rights. We set out at Appendix G a list of matters that should be considered in any such case.

Warning signs

An institution which has related companies needs to be alert to the first signs of problems. Such signs may be:

- failure to achieve forecast targets;
- continual requests for further finance;
- liabilities exceeding assets;
- rapid staff turnover;
- failure to produce statutory accounts or regular management accounts throughout the year, or difficulty in doing so;
- negative comments from the auditors.

To ensure that any difficulties within the company are identified at an early stage it is important to have an effective management reporting system, both for the company and for the institution in overseeing the operations of the company. Failure to monitor and understand the performance of the company may prove costly.

Guidelines: checklists and appendices

The checklists and appendices set out in Parts II and III below are not intended to be prescriptive or exhaustive, but are tools to help both the institution and the company ensure that the relationship between them (and in the case of joint venture companies between the institution and its joint venture partners) operates on a sensible and sound basis.

Many of our recommendations draw on existing good practice. Others result from discussions with representatives of institutions. The checklists and appendices are designed to assist governors, officers of institutions and directors of companies in identifying and implementing good practice.