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Asset finance in the education sector: the *ultra vires* predicament

By Thomas Evans

The ability of many state schools to enter into lease agreements (often for office equipment such as photocopiers) is limited by statute. Where a school exceeds its statutory power, the agreement will be void and unenforceable by the creditor. This article examines the issue of *ultra vires*, the consequences and potential remedies for both creditors and schools.

OVERVIEW

1. It is commonplace for schools to take equipment – ranging from photocopiers and security apparatus to interactive classroom whiteboards – under asset finance agreements. However, state schools which are maintained by their local education authority ("LEA") are subject to statutory restrictions which limit their power to enter into certain types of agreement. Whilst they may execute operating leases they have no power to execute finance leases. Where a school – usually acting through its governing body – exceeds its statutory power, the lease is void *ab initio*.

2. The problem is therefore a significant one and may result in large losses for the creditor or lessor. But it gets worse. Drawing the critical distinction between operating leases and finance leases is not an exact science and there is significant room for ambiguity, uncertainty and argument (and litigation). And not only are the consequences potentially dire for the creditor but – as explained below – individuals acting on behalf of the school may inadvertently expose themselves personally to the creditor for any loss or damage which it suffers.

STATUTORY BACKGROUND

3. The starting point is Part II of the School Standards and Framework Act 1998 ("the Act"), which imposes on LEAs a statutory duty to fund the maintained schools in their respective areas. Each such school is allocated a "*budget share*" which it can spend on behalf of the LEA pursuant to delegated powers.

4. However, a maintained school's delegated power is strictly limited in a number of ways, including (presently) by the School and Early Years Finance (England) Regulations 2013 ("the Regulations")[1] which proscribes certain expenditure. Regulation 7 of the Regulations lays down the prohibition that:

[1] The Regulations substantially remake previously revoked statutory instruments but care must be taken to refer to the correct subordinate legislation as was in force at the date of execution of the particular agreement in question.

> *A local authority's non-schools education budget or schools budget must not include the following classes or descriptions of expenditure—*
>
> *(a) capital expenditure other than [certain categories not relevant for present purposes];*

5. Capital expenditure is defined in the Regulations as:

> *expenditure of a local authority which falls to be capitalised in accordance with proper accounting practices, or expenditure treated as capital expenditure by virtue of any regulations or directions made under section 16 of the Local Government Act 2003*

6. Since an LEA cannot include certain capital expenditure within its schools budget, it follows that a maintained school cannot do so either under its delegated power to spend its share of the schools budget.

7. So what about monies expended under a hire agreement, or hire purchase agreement or contract of conditional sale? Do such sums "*fall to be capitalised in accordance with proper practices*"?

FINANCE AND OPERATING LEASES: THE TRANSFER OF RISK AND REWARD

8. Expenditure made pursuant to a lease falls to be capitalised in accordance with proper practices if the lease if classified as a "*finance lease*" as opposed to an "*operating lease*". This accounting terminology – strange as it is to lawyers – is explained in the Statement of Standard Accounting Practices 21 ("SSAP 21"):

> *An operating lease involves the lessee paying a rental for the hire of an asset for a period of time which is normally substantially less than its useful economic life. The lessor retains most of the risks and rewards of ownership of an asset in the case of an operating lease.*
>
> *A finance lease usually involves payment by a lessee to a lessor of the full cost of the asset together with a return on the finance provided by the lessor. The lessee has substantially all the risks and rewards associated with the ownership of an asset, other than legal title. In practice, all leases transfer some of the risks and rewards of ownership to the lessee, and the distinction between a finance lease and an operating lease is essentially one of degree…*
>
> *A finance lease is a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the*

> *minimum lease payments, including any initial payment, amounts to substantially all (normally 90 per cent or more) of the fair value of the leased asset. The present value of the leased asset should be calculated by using the interest rate implicit in the lease (as defined in paragraph 24). If the fair value of the asset is not determinable, an estimate thereof should be used.*

9. This is supported (and more succinctly put) by International Accounting Standard 17 ("IAS17"):

> *A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.*

10. As such, a lease will be considered a finance lease – and therefore *ultra vires* a school's power to execute – if it substantially transfers the risks and rewards of ownership. But how is this determined?

THE 90% PRESUMPTION

11. Under SSAP21, where the minimum lease payments (including any initial payment) amount to substantially all (90% or more) of the fair value of the asset being leased, it is to be presumed that the

agreement is a finance agreement. However, estimating the fair value of the asset may prove problematic.

12. Further, this presumption – where it is raised – is a strong one but it may be rebutted in exceptional circumstances.

EXCEPTIONAL CIRCUMSTANCES: INDICATIVE FACTORS

13. If the 90% presumption is not raised – or if a party is trying to rebut it – it is necessary to consider whether the "risks and rewards of ownership" are "substantially transferred". This is not a question of the title or even the form of a lease agreement but is a question of substance.

14. As to which party bears the substantial risks of ownership may be indicated by asking who is responsible for:

    a. Upkeep, repairs and maintenance;
    b. Security of the asset and its insurance;
    c. Liability for theft;
    d. Idle capacity;
    e. Devaluation due to technological obsolescence; and
    f. Fluctuations in returns due to changing economic conditions

15. Similarly, the party with the rewards of ownership may be the party which benefits from the:

a. Earning capacity generated by use of the asset;

b. Rental income generated by sub-letting the asset; and

c. Appreciation in the value of the asset.

16. Furthermore, IAS17 notes the following additional indicative factors:

> *the lease transfers ownership of the asset to the lessee by the end of the lease term*
>
> *the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised*
>
> *the lease term is for the major part of the economic life of the asset, even if title is not transferred...*
>
> *the lease assets are of a specialised nature such that only the lessee can use them without major modifications being made...*
>
> *if the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee*
>
> *gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, by means of a rebate of lease payments)*
>
> *the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent*

17. Accordingly, and in addition to the 90% presumption, perhaps the most persuasive factor is the period of hire: if the period lasts for all – or nearly all – of the economic lifetime of the asset (such that it is likely only to have a single user) it is highly likely that the agreement will be a finance lease.

18. It is therefore also clear that a hire purchase agreement or conditional sale agreement will be classed as a finance lease (and therefore beyond the power of a maintained school to execute). However, beyond these categories, it is rare that the factors above will all point uniformly in the same direction. A degree of judgment must be exercised and it must be accepted that there often be room for argument and uncertainty.

THE CONSEQUENCES

19. If a maintained school has executed a finance lease it will have done so *ultra vires* its statutory power. Such an agreement will therefore be void *ab initio*. Several consequences flow from this.

Unenforceability

20. The primary consequence is that the finance agreement will be unenforceable and the creditor will not be able to sue for breach of contract if the school ceases to make payment. It may, however,

sue for the return of the equipment as such a claim need not be based not on the creditor's contractual right to possession but upon the tort of conversation.

Restitution

21. In such circumstances, the usual remedy is for the parties to be put back in the position in which they were immediately prior to the finance lease being executed: the goods will need to returned and restitution may be claimed by the school for all the rental payments (which will have been paid by the school under a mistake). However, a claim to restitution is likely to face stiff opposition and four possible lines of defence:

    a. First, there can be no windfall. The creditor will be entitled to quantum meruit, i.e. a fair sum in respect of the school's use of the equipment. See, for instance, Craven-Ellis v Canons Limited [1936] 2 KB 403, CA. This sum may be equal to the rental payments already made. If so, no net rebate will be due to the school. If, on the other hand, the creditor hasd effectively grossly overpriced the rentals, then some rebate may be due;

    b. Secondly, the creditor may argue that it is not open to the school to take the technical point that the agreement was *ultra vires*. The school may, in effect, be estopped from relying on its own default. There is no clear authority on this point, which will make any litigation quite uncertain;

c. Thirdly, the creditor will likely argue "change of position" as a defence to restitution. It may say that it only purchased or manufactured the goods on the basis that it thought that the school had the power to execute the finance agreement. Thus, having changed its position, restitution may be barred. See Lipkin Gorman v Karpnale Limited [1991] 2 AC 548, HL;

d. Fourthly, if a school changes its status (e.g. to an academy) and ceases to be a school maintained by its LEA, it may acquire the power to execute finance agreements. If it then continues to make rental payments its conduct may amount to an affirmation of the agreement originally executed *ultra vires*.

A remedy for the creditor and a pitfall for the school?

22. Finally, if a school does succeed in its restitutionary argument (either as the basis of a claim for repayment or as a defence to a claim for damages), the creditor will suffer loss and could issue proceedings against an officer or agent of the school for breach of warranty of authority to execute the Agreement. Depending of the facts of the case, it might be open to the creditor to argue that such a person (perhaps the bursar) warranted or misrepresented that he or she had the authority to execute the agreement and that such warranty or representation was relied upon. In this way, an individual may expose himself to personal liability, for which he may seek an indemnity from the school.

CONCLUSIONS

23. The distinction between a finance and operational lease is critical but is one of fact and degree. There may therefore be a significant degree of risk for creditors in executing agreements with schools and for schools in seeking to resile from agreements.

24. Ultimately, therefore, any argument based on a lease having been executed *ultra vires* is likely to be fraught with danger. Even if such an argument succeeds, it will by no means hand to the school a panacea. The school will still have pay for the use of the equipment but the argument may provide a useful negotiating platform should the school wish to terminate the agreement early without paying contractual damages. As always, cases turn on the nuances of their facts and specialist advice should always be sought.

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Thomas' practise is focused on banking, asset finance and consumer credit. As a barrister familiar with the intricacies of the Consumer Credit Act 1974, the Financial Services and Markets Act 2000 and their subsidiary regulations and sourcebooks, he receives regular instructions on behalf of banks and other large financial institutions. He is presently instructed in a number of claims arising out of the alleged mis-sale of interest rate hedging products and has particular experience in the field of guarantees and mortgages.

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