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APPEAL CASES

before

THE HOUSE OF LORDS

B

(English, Irish and Scottish)

and

THE JUDICIAL COMMITTEE

C

of Her Majesty's Most Honourable

PRIVY COUNCIL

D

[HOUSE OF LORDS]

HAZELL . . . . . APPELLANT

AND

E

HAMMERSMITH AND FULHAM LONDON BOROUGH COUNCIL AND OTHERS . . . . RESPONDENTS

HAZELL AND OTHERS . . . . . RESPONDENTS

AND

HAMMERSMITH AND FULHAM LONDON BOROUGH COUNCIL . . . . . APPELLANTS

F

[CONJOINED APPEALS]

1990 Oct. 10, 11, 15, 16, 17, 18, 22, 23, 25, 29; Nov. 5, 6, 8, 12;
1991 Jan. 24

Lord Keith of Kinkel, Lord Brandon of Oakbrook, Lord Templeman, Lord Griffiths and Lord Ackner

G

Local Government—Powers—Financial transactions—Council incorporated by Royal Charter entering into speculative financial transactions—Profitability depending on interest rates falling—Whether transactions within powers of council—Whether council's capital market fund valid—London Government Act 1963 (c. 33), s. 1—Local Government Act 1972 (c. 70), s. 111—Local Government Finance Act 1982 (c. 32), s. 19

H

The council was a London borough council which, pursuant to section 1(2) of the London Government Act 1963,[1] had been

[1] London Government Act 1963, s. 1(2): see post, p. 41F–G.

incorporated by Royal Charter. During the fiscal years 1987–1988 and 1988–1989 substantial transactions of a speculative nature were conducted through a capital market fund in the name of the council with a view to making a profit. The capital market fund was established without a specific resolution of the council and the council members received no report on the transactions. For the year 1987–88 the council resolved, on the recommendation of its financial and administration committee, to borrow to meet its capital and revenue payments during the year, and authorised the director of finance to arrange and administer the council's borrowing on its behalf. By January 1988, the finance and administration committee had received a report that the director of finance had continued to arrange transactions in the London Money and Capital Market in order to maximise gains on favourable interest rate movements. No details in writing of the transactions were given. On 24 February 1988 the council resolved to authorise the director of finance to arrange transactions in the London Money and Capital Market in order to take advantage of favourable interest rate movements. By 31 July 1989, the council had entered into a number of transactions of which the majority were ones in which the council would benefit if interest rates fell and lose if interest rates rose. The auditor appointed by the Audit Commission of Local Authorities in England and Wales to audit the accounts of the council questioned the legality of the transactions with the result that the council's director of finance closed all the transactions save those where the council would incur a loss if he did so. From August 1988 to 23 February 1989, the council continued to carry out transactions but as part of an "interim strategy" designed to reduce the extent of the council's exposure to loss which arose from a rise in interest rates. The council obtained its own legal opinion in which it was advised that if the transactions were undertaken as part of the proper management of the council's funds, they would be intra vires section 111 of the Local Government Act 1972[2] but if the council was carrying on a business in transactions it would be ultra vires. The council was not advised however as to what action it should take at that stage and at a meeting on 22 February 1989 the auditor advised the director of finance that the council had to desist from further activity unless supported by legal opinion. Later that day, the council was advised by counsel that the scale of the transactions was outside acceptable parameters and was therefore unlawful. After 23 February, the council was involved in only seven transactions consequent upon other parties exercising options. The auditor applied, pursuant to section 19 of the Local Government Finance Act 1982,[3] for a declaration that the items of account appearing in the capital market fund for the financial years 1987–1988 and 1988–1989 were contrary to law, and an order for rectification of the accounts. A number of banks involved in the transactions were granted leave to intervene in the proceedings in order to oppose the grant of a declaration and to defend their commercial interests. The Divisional Court of the Queen's Bench Divison made the declaration and granted the order sought. On appeal by the banks, the Court of Appeal allowed the appeal in part, holding

[2] Local Government Act 1972, s. 111(1): see post, p. 28G–H.
[3] Local Government Finance Act 1982, s. 19: see post, p. 43E–G.

(i) that the declaration should stand save in so far as it related to transactions entered into as part of the interim strategy, and (ii) that there should be no order for rectification.

On appeals by the auditors and the council:—

Held, allowing the appeals, (1) that there was no express statutory power entitling the council to enter into financial transactions although it had an implied power under section 111 of the Local Government Act 1972 to do anything which was ancillary to the discharge of any of its functions, which included borrowing; but that, having regard to the provisions and limitations of the Act of 1972, in particular Part I of Schedule 13 thereto, regulating that function, it could not be said that the transactions were calculated to facilitate, or were conducive or incidental to the discharge of, the council's function of borrowing within the meaning of section 111, and, therefore, the transactions were ultra vires and unlawful (post, pp. 21G–22A, 29E–30A, 31F, 33H–34A, 37C, 44E, 46F–G, 47E–F).

Dictum of the Earl of Selborne L.C. in *Small v. Smith* (1884) 10 App.Cas. 119, 133, H.L.(Sc.) and dicta of Lord Loreburn L.C. and Lord Macnaghten in *Attorney-General v. Mersey Railway Co.* [1907] A.C. 415, 417, H.L.(E.) applied.

(2) That any power to carry out the interim strategy activities had to be derived from section 111 of the Act of 1972 and therefore a function had to be identified to which the interim strategy activities were incidental; but that the only underlying function to which the transactions carried out pursuant to the interim strategy were incidental was that relating to the original ultra vires transactions; and that, accordingly, they fell into the same category and were themselves unlawful (post, pp. 21G–22A, 37F, 39B, 44E, 46G–47A, E–F).

Per curiam. It may not follow that, as between the council and the banks, payments made by the council before or after the period of interim strategy can be recovered by the council. Nor does it follow that payments received by the council before or after that period cannot be recovered by the banks. The consequences of any ultra vires transaction may depend on the facts of each case (post, p. 36D–E).

(3) That although the council had been incorporated by Royal Charter, that charter had been granted in accordance with section 1 of the London Government Act 1963, and therefore the council could not rely on its charter as giving it the capacity of a natural person to enter into contracts, but was confined to the powers conferred on it by statute; and that, accordingly, the council had no power to carry out the transactions either in its own name or in the name of the borough (post, pp. 21G–22A, 41B, 42E, 43A, 44E, 47E–F).

Decision of the Court of Appeal [1990] 2 Q.B. 697; [1990] 2 W.L.R. 1038; [1990] 3 All E.R. 33 reversed.

The following cases are referred to in the opinion of Lord Templeman:

Attorney-General v. Great Eastern Railway Co. (1880) 5 App.Cas. 473, H.L.(E.)

Attorney-General v. Mersey Railway Co. [1907] A.C. 415, H.L.(E.)

Bonanza Creek Gold Mining Co. Ltd. v. The King [1916] 1 A.C. 566, P.C.

Cotman v. Brougham [1918] A.C. 514, H.L.(E.)

Holsworthy Urban District Council v. Holsworthy Rural District Council [1907] 2 Ch. 62

Norwich Provident Insurance Society, In re (Bath's Case) (1878) 8 Ch.D. 334, C.A.
Riche v. Ashbury Railway Carriage and Iron Co. Ltd. (1874) L.R. 9 Ex. 224; (1875) L.R. 7 H.L. 653, H.L.(E.)
Rutter v. Chapman (1841) 8 M. & W. 1
Small v. Smith (1884) 10 App.Cas. 119, H.L.(Sc.)
Sutton's Hospital Case (1612) 10 Co.Rep. 1
Wenlock (Baroness) v. River Dee Co. (1885) 10 App.Cas. 354, H.L.(E.)

The following additional cases were cited in argument:

Associated Provincial Picture Houses Ltd. v. Wednesbury Corporation [1948] 1 K.B. 223; [1947] 2 All E.R. 680, C.A.
Attorney-General v. Fulham Corporation [1921] 1 Ch. 440
Attorney-General v. Leeds Corporation [1929] 2 Ch. 291
Attorney-General v. London County Council [1901] 1 Ch. 781, C.A.; [1902] A.C. 165, H.L.(E.)
Attorney-General v. Manchester Corporation [1906] 1 Ch. 643
Attorney-General v. Newcastle upon Tyne Corporation (1889) 23 Q.B.D. 492, C.A.; [1892] A.C. 568, H.L.(E.)
Attorney-General v. Smethwick Corporation [1932] 1 Ch. 562, C.A.
Attorney-General for Ceylon v. Silva [1953] A.C. 461, P.C.
Ayers v. South Australian Banking Co. (1871) L.R. 3 P.C. 548, P.C.
Bar Hill Developments Ltd. v. South Cambridgeshire District Council (1979) 252 E.G. 915, D.C.
Beauforte (Jon) (London) Ltd., In re [1953] Ch. 131; [1953] 2 W.L.R. 465; [1953] 1 All E.R. 634
Bell Houses Ltd. v. City Wall Properties Ltd. [1966] 2 Q.B. 656; [1966] 2 W.L.R. 1323; [1966] 2 All E.R. 674, C.A.
City Index Ltd. v. Leslie, The Times, 10 October 1990
Cudgen Rutile (No. 2) Pty. Ltd. v. Chalk [1975] A.C. 520; [1975] 2 W.L.R. 1, P.C.
Cunliffe Brooks & Co. v. Blackburn and District Benefit Building Society (1884) 9 App.Cas. 857, H.L.(E.)
Deuchar v. Gas Light and Coke Co. [1925] A.C. 691, H.L.(E.)
Dickson v. Pharmaceutical Society of Great Britain [1970] A.C. 403; [1968] 3 W.L.R. 286; [1968] 2 All E.R. 686, H.L.(E.)
Dundee Harbour Trustees v. D. & J. Nicol [1915] A.C. 550, H.L.(Sc.)
Great Eastern Railway Co. v. Turner (1872) L.R. 8 Ch.App. 149
Introductions Ltd. v. National Provincial Bank Ltd. [1970] Ch. 199; [1969] 2 W.L.R. 791; [1969] 1 All E.R. 887, C.A.
McDowell v. Standard Oil Co. (New Jersey) [1927] A.C. 632, H.L.(E.)
Manchester City Council v. Greater Manchester Metropolitan County Council (1979) 78 L.G.R. 71, C.A.; (1980) 78 L.G.R. 560, H.L.(E.)
Moffat v. Eden District Council (unreported), 8 November 1988; Court of Appeal (Civil Division) Transcript No. 919 of 1988, C.A.
National Telephone Co. Ltd. v. Constables of St. Peter Port [1900] A.C. 317, P.C.
New, In re [1901] 2 Ch. 534, C.A.
Provident Mutual Life Assurance Association v. Derby City Council [1981] 1 W.L.R. 173, H.L.(E.)
Reg. v. Greater London Council, Ex parte Burgess [1978] I.C.R. 991, D.C.
Reg. v. Greater London Council, Ex parte Westminster City Council, The Times, 27 December 1984
Reg. v. Reed (1880) 5 Q.B.D. 483, C.A.

Reg. v. Richmond upon Thames London Borough Council, Ex parte McCarthy & Stone (Developments) Ltd. [1992] 2 A.C. 48; [1990] 2 W.L.R. 1294; [1990] 2 All E.R. 852, C.A.

Reg. v. Wirrall Metropolitan Borough Council, Ex parte Milstead (1989) 87 L.G.R. 601, D.C.

Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation [1986] Ch. 246; [1985] 2 W.L.R. 908; [1985] 3 All E.R. 52, C.A.

Seagram v. Knight (1867) L.R. 2 Ch.App. 628

Sinclair v. Brougham [1914] A.C. 398, H.L.(E.)

Smith v. Croft [1987] B.C.L.C. 355

Stockdale v. Haringey London Borough Council (1989) 88 L.G.R. 7, C.A.

Swain v. The Law Society [1983] 1 A.C. 598; [1982] 3 W.L.R. 261; [1982] 2 All E.R. 827, H.L.(E.)

Triggs v. Staines Urban District Council [1969] 1 Ch. 10; [1968] 2 W.L.R. 1433; [1968] 2 All E.R. 1

Turner v. Shearer [1972] 1 W.L.R. 1387; [1973] 1 All E.R. 397, D.C.

Wenlock (Baroness) v. River Dee Co. (1887) 36 Ch.D. 674

Westminster City Council, In re [1986] A.C. 668; [1986] 2 W.L.R. 807; [1986] 2 All E.R. 278, H.L.(E.)

Wheeler v. Leicester City Council [1985] A.C. 1054; [1985] 3 W.L.R. 335; [1985] 2 All E.R. 1106, H.L.(E.)

APPEALS from the Court of Appeal.

This was an appeal by the appellant, Anthony John Hazell, from the judgment dated 22 February 1990 of the Court of Appeal (Sir Stephen Brown P., Nicholls and Bingham L.JJ.) allowing in part appeals by Midland Bank Plc., Security Pacific National Bank N.A., Chemical Bank, Barclays Bank Plc. and Mitsubishi Finance International Plc., the second, third, fourth, fifth and sixth respondents respectively, from the judgment dated 1 November 1989 of the Divisional Court of the Queen's Bench Division (Woolf L.J. and French J.). The appellant was the auditor appointed by the Audit Commission of Local Authorities in England and Wales to audit the accounts of the first respondent, Hammersmith and Fulham London Borough Council from 1 April 1983.

The Divisional Court pursuant to its judgment granted the auditor a declaration that the items of account appearing within the capital markets fund account of the first respondent for the financial years beginning on 1 April 1987 and 1 April 1988 were contrary to law and ordered that the accounts of the first respondent for those financial years be rectified with liberty to the parties to apply if what was required to rectify those accounts was not agreed. On appeal by the banks, the Court of Appeal ordered that the declaration made by the Divisional Court should stand save in so far as it related to transactions entered into in, on or after 25 July 1988 and that there should be no order for rectification. It was further ordered that questions relating to the enforceability of the transactions reflected in the accounts should not be decided in those proceedings. There was also an appeal by the council in respect of the variation made by the Court of Appeal to the declarations made by the Divisional Court. The two appeals were conjoined.

The facts are stated in the opinion of Lord Templeman, and more fully in the judgment of the Divisional Court of the Queen's Bench Division [1990] 2 Q.B. 697.

Michael Barnes Q.C. and *John Howell* for the auditor. All the transactions with which the appeals are concerned are outside the powers of any borough in England and Wales.

It is pertinent to point out at the outset that the principle propounded in *Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation* [1986] Ch. 246, even if it be correct as a matter of private law, has no application in public law. For the powers of the auditor for present purposes: see sections 11(1), 12(1) (2), 13(1), 15(1) (2) (3), 19(1) (2) (3) (4) (5) of the Local Government Finance Act 1982.

There are two basic propositions regarding the powers of local authorities. (i) A corporation has only the powers, express or implied, which are granted by statute. (ii) Where an express power is applicable under the statute there is by implication a power to do that which is incidental to that express power: section 111 of the Local Government Act 1972. The present case comes within the ambit of these two general powers: see *Attorney-General v. Great Eastern Railway Co.* (1880) 5 App.Cas. 473, 478, 481. It is common ground that there is no express power to enter into the swap transactions and therefore the question is whether they come within the ambit of section 111.

As to the powers of borrowing of the local authorities at the relevant time see the Local Government Act 1972, Schedule 13, paragraphs 1 to 3, 7, 10 and 20. For the power of local authorities to enter into fixed or variable rate borrowing transactions see the Local Authority (Mortgages) Regulations 1974 (S.I. 1974 No. 518), regulations 2 to 8, 10 and 20.

Section 111 provides for incidental powers, i.e. powers incidental to a function. Therefore to ascertain whether a particular activity falls within the section it is necessary, first, to identify the function, and then, to ask whether the activity in question is incidental to it. Borrowing itself is not a function. Similarly, expenditure of money is not: see *In re Westminster City Council* [1986] A.C. 668, 714c. Borrowing only has meaning when it takes place as the exercise of a power in order to assist the discharge of some function which the authority has. Section 111 accordingly has no application in the present case.

Swap transactions are not different from any other commercial transaction which gives rise to profit. The question therefore is not whether it is prudent for a local authority to enter into them but whether the authority has express power to do so or whether to do so is incidental to some power that the local authority has. The judgment of the Divisional Court [1990] 2 Q.B. 697, 723c–g is a correct statement of the law.

In approaching the question whether swap transactions are incidental to a function of borrowing it is of assistance to consider the strict regulation of borrowing under Schedule 13 to the Local Government Act 1972, because the stricter the regulation under the express power the less likely it is that some activity, such as a swap transaction, can be brought in as an activity which can be carried out on the ground that it is incidental or ancillary to that power: see *Reg. v. Reed* (1880) 5 Q.B.D. 483. In the present case there is a limited power of borrowing and it follows that there is no implied power to enter into the present swap transactions. *Reg. v. Greater London Council, Ex parte Westminster*

A *City Council*, The Times, 27 December 1984 and *Moffat v. Eden District Council* (unreported), 8 November 1988; Court of Appeal (Civil Division) Transcript No. 919 of 1988, which were referred to by the Court of Appeal, do not assist on the meaning of "functions" in section 111 of the Local Government Act 1972 because there was there no argument that the language of section 111 does not lead to the conclusion that all duties and powers which are found in the legislation constitute a B function of the local authority.

The generation of an income or the making of a profit to augment the coffers of a local authority is not a function vested in it for it to discharge. Section 111 does not (and powers which might otherwise be implied would not) authorise the doing of something to obtain a profit even if there is an intention to apply it in reducing the authority's costs C and expenses in a particular way. Were it otherwise a local authority could do anything for the purpose of obtaining a profit provided only that the proceeds were applied in the discharge of its functions: see *Dundee Harbour Trustees v. D. & J. Nicol* [1915] A.C. 550, 561, 570–571; *Deuchar v. Gas Light and Coke Co.* [1925] A.C. 691 and *Attorney-General v. Smethwick Corporation* [1932] 1 Ch. 562.

A local authority has no implied functions: functions must be D specifically vested in an authority. Moreover, not every power or duty is a function of a local authority. Thus a local authority has no function comprising (a) a duty to take reasonable care to arrange its borrowing or investments prudently in the best interests of the ratepayers and those for whom the authority provides services or (b) a power in certain circumstances to limit or reduce loss to its ratepayers or community E charge payers, although as part of the requirement to act reasonably to which it is subject in exercising its powers it is required to have regard to the interests of such persons.

The Court of Appeal erred in defining any lawful activity of a local authority as being a function of it: see *In re Westminster City Council* [1986] A.C. 668, 714c. A function is not an activity but something which, as the statutory language makes plain, is "vested" in an authority F for it to "discharge." It is therefore an object or task set for the authority. Further, it was wrong for the Court of Appeal to hold that all the powers and duties of an authority might each be a function of it. In the field of local government "functions" are defined either to include powers and duties or to mean powers and duties where Parliament intends each power or duty to be treated as a function: see, for G example, section 134 of the Local Government Act 1929; section 66(1) of the Local Government Act 1958; section 57(1) of the Town and Country Planning Act 1959 and section 44(1) of the Local Government (Miscellaneous Provisions) Act 1976. The Act of 1972 contains no such definition. If the Court of Appeal was correct, section 111 would itself constitute a function which, given the terms of the section, cannot be the case, as Parliament recognised in section 101(12) of the Act.

H The Court of Appeal erred in seeking to imply functions which a local authority might have. The principle in *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473 is irrelevant for that purpose. At common law the rule was that the objects that a statutory body could

lawfully pursue had to be ascertained from the Act itself. Only powers to achieve those express objects could be implied. Thus there were no implied objects or functions at common law: see *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.* (1875) L.R. 7 H.L. 653, 693–694 and *Baroness Wenlock v. River Dee Co.* (1887) 36 Ch.D. 674, 682; (1885) 10 App.Cas. 354, 363. The implication of a power (and a fortiori the implication of a function or object) would be inconsistent with the existence and terms of section 111: the principle in *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473 is now expressed in that section and that section only provides, as the Divisional Court held [1990] 2 Q.B. 697, 722, "a subsidiary power which authorises an activity where some other statutory provision has vested a specific function or functions in the council." Moreover, Parliament assumed that to be the case in other provisions of the Act: see, for example, section 179 of the Act of 1972.

The Court of Appeal was also wrong in confusing rationality with legality. A statutory body must exercise its powers reasonably, but it does not follow that it has a power (or a function) to do whatever may be reasonable. Thus it is a limitation on the manner in which a local authority exercises its powers (such as borrowing or investment) that it should act prudently, having regard to the interests of those who pay for its services and of those who may require the services it is obliged or empowered to provide. The requirement to have regard to the interests of the local taxpayers is referred to as the authority's "fiduciary duty" and is a part of the requirement to act reasonably. Such requirements are implied *limitations* on the manner in which an authority discharges its functions. They are not themselves functions which provide a source of power to do that which an authority otherwise has no power to do. The possession of a right or asset does not confer a power to protect or enhance its value even if that was a reasonable way for a statutory body to manage its affairs: see *Small v. Smith* (1884) 10 App.Cas. 119. Nor does the existence of a need to meet liabilities confer a power of "cash flow management" on a statutory body authorising temporary borrowing even if that be a reasonable method of managing its affairs: see *Reg. v. Reed*, 5 Q.B.D. 483.

On "interest rate risk management," the Court of Appeal found that it was fairly to be regarded as incidental to or consequential upon a local authority's powers of borrowing and investment and the attendant duty resting upon it to manage its borrowings and investments prudently in the best interests of the ratepayers and those for whom the authority provided services. Entering into interest rate swap transactions was said to be an ancillary power to that duty (not of borrowing or investment themselves). The duty was said to arise out of, and in connection with, an authority's borrowing and investment functions. These conclusions are disputed for the following reasons.

(i) Borrowing and investment are merely powers of a local authority. They are not themselves objects or functions of the authority: cf. *Introductions Ltd. v. National Provincial Bank Ltd.* [1970] Ch. 199, 209–210. An authority may have certain tasks or functions with respect to borrowing, for example, determining the amount to be borrowed and

A the methods to be employed to raise the money. But if its powers to borrow were of themselves functions of the authority section 101(4) and (6) and paragraph 12 of Schedule 13 to the Act of 1972 would be in conflict.

(ii) Even if borrowing and investment were functions of an authority, the transactions are not calculated to facilitate or incidental or conducive to borrowing or investment so as to be authorised by section 111 of the B Act of 1972. In the case of "interest rate risk management," borrowing or investment is assumed to have occurred before the transaction is entered into. Nor are the transactions incidental to (or consequential upon) the discharge of a power of borrowing or investment. In this context "incidental" merely means involved in doing that which is authorised and it does not extend to a transaction independent of, and C separate from, that which is authorised: see, for example, *Small v. Smith*, 10 App.Cas. 119 and *Reg. v. Wirrall Metropolitan Borough Council, Ex parte Milstead* (1989) 87 L.G.R. 611. If the Court of Appeal was correct that the discharge of the duty to take reasonable care to manage borrowings and investments prudently by entering into such transactions by way of "interest rate risk management" was not the discharge of a function with respect to borrowing, then "interest rate D risk management" cannot be incidental to or consequential upon borrowing.

(iii) The transactions, in any event, do not manage any borrowing or investment; they leave each untouched. Nor do they manage any risk associated with the movement in the market rate of interest in relation to an increased cost of borrowing or a lesser rate of return on an E investment: such risk remains unaltered.

(iv) The existence of a power under section 111 is dependent on the objective effect of what is done, not on the purpose for which it is done. Moreover, the Court of Appeal has failed to distinguish the subjective motivation for, and possible financial results of, a transaction from its legal nature and effect.

On the question whether local authorities have power to sell certain F transactions, interest rate swap options, caps, floors and collars, gilt options and cash options are written for the purpose of deriving a profit from the premium received. The sale of such instruments is ultra vires a local authority.

It does not follow that if a particular instrument may be bought, a local authority has power to sell such instruments. Further, the sale of a G "mirror" or "reciprocal" instrument (that is an instrument enabling the purchaser to require the authority to do that which the authority is entitled under another instrument to require another party to do) does *not* involve the sale of what an authority has previously acquired. Such a "mirror" or "reciprocal" instrument is sold to enable the seller to derive a profit from writing it. The only significance of a pre-existing instrument which the seller may have purchased and which is otherwise identical is H that, if the instrument he has sold is exercised or relied upon against him, he may exercise or rely upon the instrument he has purchased. In other words, the exposure he has incurred by writing the instrument (in order to obtain the premium) is already covered. The risk is not

eliminated as the counter party to the instrument the vendor has purchased may default.

The sale of an option by an authority which enables the purchaser to require the authority to do something at a later date is an unlawful fetter on the exercise of any discretion to do that which the exercise of the option requires the authority to do. For the authority is bound to do that which, when the option is exercised, it may have chosen not to do had it then had the choice: it cannot therefore exercise its discretion in the public interest as it conceives it to be when the option is exercised against it: see *Cudgen Rutile (No. 2) Pty. Ltd. v. Chalk* [1975] A.C. 520, 532H–534C. [Reference was also made to *Reg. v. Richmond upon Thames London Borough Council, Ex parte McCarthy & Stone (Developments) Ltd.* [1992] 2 A.C. 48; *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.* (1874) L.R. 9 Ex. 224; *Stockdale v. Haringey London Borough Council* (1989) 88 L.G.R. 7 and *Wheeler v. Leicester City Council* [1985] A.C. 1054.]

Howell, following, referred to *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473 and *Cunliffe Brooks & Co. v. Blackburn and District Benefit Building Society* (1884) 9 App.Cas. 857, 864, 868, 869.

Peter Scott Q.C., *Catherine Newman* and *Nigel Giffin* for the council. The main question is based on the assumption that there is a distinction in the law relating to local government between capacity and power. This is not so: see *Wade, Administrative Law*, 6th ed. (1988), pp. 39, 40, 41. The matters there referred to are not confined merely to the application of the principles of judicial review. Further, *Attorney-General for Ceylon v. Silva* [1953] A.C. 461, 479 shows that consideration of the powers conferred on local authorities by Parliament must necessarily be based on the precise wording of the statute and, also, on the functions of the local authority. The fundamental distinction between local authorities and banks is that the local authority does not exist for the purpose of trade but to provide local services as stipulated by Parliament. Local authorities only have such powers or capacities as are conferred by statute. Any relevant power (that is, capacity) must be found in section 111 of the Local Government Act 1972. There is none to be found elsewhere. No power to enter into the transactions has ever been expressly conferred either before or since the transactions.

Section 111 is merely a subordinate provision fulfilling an interstitial role. Further, local authority borrowing is closely controlled by statutory provisions of an extremely detailed and precise character. Section 101 of the Act of 1972 requires the local authority's functions with respect to borrowing to be discharged by the local authority itself. Borrowing includes activities incidental to borrowing.

The Court of Appeal was wrong to assume that, if Parliament had considered it, it would have made provision to enable the local authority to participate in the swap market. Participation in the swap market is not an activity necessarily or even ordinarily carried out in conjunction with borrowing. It is a distinct activity from borrowing and accordingly it is outwith section 111.

A The transactions are not calculated to facilitate or conducive or incidental to borrowing. The performance of the transactions will not assist the council to borrow. Like any other profit-making activity it will (merely) assist the council to pay interest. Nor are swaps "incidents" of borrowing in the sense of normally and naturally forming part of that function.

B There is no "interest rate risk management" function for the purposes of section 111. "Functions" means the sum of the express powers and duties conferred and imposed on a local authority. There must be a connection between such powers and duties and the transaction in question: see the judgment of the Divisional Court [1990] 2 Q.B. 697, 724E.

C The doctrine propounded in *Great Eastern Railway Co. v. Turner* (1872) L.R. 8 Ch.App. 149 is concerned only with such capacity as is *necessarily* to be implied from that which is expressed. Speculation as to what Parliament might have provided is fallacious and unhelpful and ignores special considerations applicable to local government.

Section 111(3) exhaustively lists for the purposes of section 111 how local authorities may raise money (rates, precepts or borrowing). The

D Court of Appeal was wrong to state that these transactions did not constitute raising money.

The banks' case is that the transactions are authorised by section 111(1). That can only be correct if (a) borrowing or the management of interest risk arising from borrowing is a "function" for the purposes of section 111 *and* (b) to enter into the transactions is incidental or conducive to or calculated to facilitate the discharge of that function.

E But if that is the case, then the power to enter into the transactions could only be exercised by the council itself (see section 101 of the Act) and could not validly be delegated to an officer or committee.

There is no suggestion that the council itself ever took a decision to enter into any of the present transactions. It follows that all the transactions were unlawfully entered into and were in breach of the express terms of section 101(6). The Court of Appeal [1990] 2 Q.B. 697,

F 784H–787C rejected this conclusion. It is only on the assumption that the council might have been (though in fact it was not) acting with respect to its borrowing in entering capital market transactions that the banks' argument can get off the ground at all. The Court of Appeal referred to *Bar Hill Developments Ltd. v. South Cambridgeshire District Council* (1979) 252 E.G. 915 and *Provident Mutual Life Assurance Association v.*

G *Derby City Council* [1981] 1 W.L.R. 173 but on analysis it would seem that those cases do not really assist on the present question.

The solution to the problem is to read the Act of 1972 as a whole, and in particular section 101 with section 151. By section 151 an authority is authorised (and required) to make arrangements for the proper administration of its financial affairs. That necessarily entails delegation of authority to perform acts which are matters of financial

H administration. So long as the acts concerned are matters of mere administration, and thus properly within the scope of section 151, that ability to delegate their performance is not overridden by section 101(6) even when they relate to levying a rate, precepting or borrowing.

The position, therefore, is that, when dealing with matters relating to borrowing, it is necessary to distinguish between acts which are matters of policy, and thus non-delegable because caught by section 101(6) and not within section 151, and acts which are matters of mere administration and therefore ones which the authority can arrange to have performed pursuant to section 151. This entails the drawing of the same distinction as is made in cases where there is no express power of delegation but there is held to be an implied power to delegate matters of mere administration. It is also a sensible result which accords with the apparent statutory policy that important financial decisions should be made by members themselves. The question is: is the act one whose character is apt for a resolution of the council? If capital market transactions are incidental to borrowing and if decisions about the shape of the capital market transaction portfolio can be made by officers, then the borrowing policy set by the local authority itself can be subverted.

Protection is given to third parties by paragraph 20 of Schedule 13 to the Act of 1972 as part of the statutory code relating to borrowing. Thus, given, inter alia, the control over borrowing in Schedule 13 and the requirements in section 101(6), Parliament considered it appropriate to provide paragraph 20 protection for those who lend money to the local authority. The fundamental argument of the banks is that they are entitled, if unaware that the local authority was acting unlawfully, not to be prejudiced by that illegality. Yet it is common ground that the transactions are *not* borrowing. Paragraph 20 is solely concerned with the consequences of a borrowing: it gives no protection to a third party who claims to have entered into a transaction which is incidental to borrowing. In fact, it indicates the reverse. Yet if the banks are right, why should paragraph 20 be so limited? If the transactions are truly incidental, etc., to borrowing why should they not be treated as part of borrowing? The answer is not merely that the banks' argument does not accord with the statutory language, but that Parliament cannot have contemplated giving a local authority the capacity to enter into such transactions or anything like them when enacting section 101, section 111, section 151 or Schedule 13.

There is no difference between helping a local authority to borrow and doing something calculated to facilitate, etc., under section 111(1). The Divisional Court [1990] 2 Q.B. 697, 723D was therefore right both in its conclusions and reasoning. In a sense, any profitable activity helps to reduce the cost of borrowing, but it does not follow that local authorities have the authority to engage in any activity which may be profitable. Nor is it sufficient that in deciding to engage in a particular transaction, local authorities hope to limit the risks which would otherwise attend the performance of one or more of their functions.

All that the banks contend for (and more) can be justified on the basis that the council is merely managing its loan and investment portfolio and its other activities prudently. That construction is literally within the words in brackets in section 111 concerning acquiring or disposing of property and rights, but it is simply not consistent with the history, structure or language of the legislation. What is contemplated by section 111(1) is something much narrower than the banks contend

for. That is signalled by the relationship of "power" with "functions" in the subsection coupled with the words in brackets but also read with section 111(3). The effect of these considerations is to indicate or emphasise (a) the *subsidiary* nature of the subsection, (b) the need for nexus between power and function and, above all (c) that section 111 is not to be used to justify the raising of money except in the way specified in section 111(3).

A somewhat different approach is taken by the council to that of the auditor relating to the definition of "functions" but the council's approach leads to the same result as that of the auditor. One should not seek to equate functions with objects in the sense in which objects are set out in the memorandum of a company incorporated under the Companies Acts and which has no equivalent in local government law.

The discharge of functions in section 111 may include the exercise of powers, but *limitations* (for example, the obligation to act prudently) on the powers of a local authority do not give rise to duties which are "functions" for the purposes of section 111. The danger is that, by taking every word in section 111 and examining its meaning in terms of power and duty, sight may be lost of its overall intention.

The intention of section 111 is to enable local authorities to discharge their duties and exercise their powers without being inhibited by lack of power to do that which is reasonably incidental to what they are expressly authorised or required to do.

In determining whether or not a particular activity is authorised by section 111(1) the question to be asked is whether what the local authority is seeking to do is sufficiently closely linked to what it is expressly authorised or required to do to enable one to say that it is truly incidental. A good rule of thumb test is: is the activity something which in the ordinary course would be done by someone exercising a particular power or discharging a particular duty?

In testing linkage the relevant relationship is between the activity in question and that to which it is said to be incidental. It is quite possible to accept, consistently with the council's case and that of the auditor, that the function for present purposes is "borrowing." But this requires clear definition. It is not *any* borrowing: it is borrowing within statutory limits, for specific statutory purposes in the performance of the local authority's express powers and duties by means specified by statute, the money to be accounted for and repaid as specified by statute and carrying with it implications for third parties. It is quite unlike borrowing for a commercial organisation, whether it be a trading company, a bank or a building society.

Nor can the function to which the linkage must be shown be supplied by any one of a number of *constraints* which may attach to the exercise of powers. However it is expressed (acting prudently, reasonable care and skill, interest rate risk management, etc.) such limitations do not themselves qualify as "functions." They are descriptive of the manner in which the powers must be exercised. Duties such as prudence or maximising efficiency or return on assets are not in themselves functions for the purposes of section 111. Nor are incidentals themselves functions.

It is absurd to suggest that legislation containing a comprehensive code such as the Act of 1972 and limiting risks of borrowing must be taken to authorise an activity not existing at the time but subsequently developed which enlarges the risks of borrowing, unless an inconsistency subsequently arises from what Parliament has stated. It is for the banks to show that the legislation permits transactions of this nature: see *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.*, L.R. 7 H.L. 653, 694, *per* Lord Selborne. These provisions are designed to protect the ratepayer from what otherwise flow from a general power of borrowing coupled with section 111.

As to the fact that some companies do choose to engage in capital market transactions, that does not assist in construing section 111. The powers of a local authority to borrow are conferred by statute. In the case of a company the power to borrow is contained in the memorandum and articles of association of the company.

Gordon Pollock Q.C., Elizabeth Gloster Q.C. and *Rhodri Davies* for Midland Bank Plc., Security Pacific National Bank N.A., Chemical Bank and Mitsubishi Finance International Plc. The following propositions can be deduced from the auditor's argument. (1) The implication of powers under section 111 should be, as a matter of general rule, approached restrictively. (2) At common law a power is only to be implied where it can be shown to be incidental to an object (an object being a duty or purpose) and not where it is shown to be incidental to a power, even an express power; in other words, the argument which the auditor puts forward on the meaning of "functions" in section 111 is paralleled by the position at common law prior to the enactment of that section. (3) The word "functions" in section 111(1) was therefore intended to be restricted to objects or tasks and did not embrace powers. (4) No functions, in any sense, were capable of being implied in local authority legislation but only duties or tasks which could be equated with functions as express duties or tasks.

There is no support in the authorities for the view that the common law rule did not allow an implication of a power where what was incidental related to an existing, express power rather than to a duty. It is plain also from the consistent body of authority that the word "functions" in section 111 of the Act of 1972 was intended to have a similarly wide meaning. Further, there is no logical or rational reason why there should not be implied functions, whether in relation to local authorities or any other statutory body.

The first two propositions are supported by *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.*, L.R. 7 H.L. 653 and *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473, 479–487. Ever since 1879 Parliament has been taken to have legislated with the rule propounded in the *Great Eastern Railway* case as a background, and the rule was put into section 111 in order to avoid any possible doubt. In *Attorney-General v. London County Council* [1901] 1 Ch. 781; [1902] A.C. 165 it was held that merely because two businesses, which were independent and separate, could conveniently be run together did not mean that one was incidental to the other within the meaning of the rule.

A The following authorities establish the proposition that there is no rigid distinction between a function and a power and that a power can be exercised if it is incidental to a local authority's general functions: *Attorney-General v. Mersey Railway Co.* [1907] A.C. 415; *Dundee Harbour Trustees v. D. & J. Nicol* [1915] A.C. 550; *Attorney-General v. Fulham Corporation* [1921] 1 Ch. 440 and *Manchester City Council v. Greater Manchester Metropolitan County Council* (1979) 78 L.G.R. 71; B (1980) 78 L.G.R. 560. Whether a particular activity or contract is to be regarded as incidental may well require consideration of the purpose for which the activity is undertaken or the contract made: see *Deuchar v. Gas Light and Coke Co.* [1925] A.C. 691 and *Attorney-General v. Smethwick Corporation* [1932] 1 Ch. 562. The *Smethwick Corporation* case is strong authority for the proposition that the question whether a C certain function is incidental to the powers granted is to be considered in relation to the time when the activity in question is adopted. In none of the foregoing cases is it suggested that there is a different approach depending upon whether it is a local authority or any other form of statutory corporation.

As to the third and fourth propositions, section 111(1) was intended merely to reflect the common law. Thus, it would seem unlikely that D Parliament intended to limit the scope and approach to implied powers in connection with local authorities. Functions are not defined in the Act of 1972 but there are definitions to be found in other legislation: see the Local Government Act 1929, section 134; the Local Government Act 1958, section 66; the Town and Country Planning Act 1959, section 57 and the Local Government (Miscellaneous Provisions) Act 1976, section E 44. Nowhere is there to be found a statutory definition where the word "functions" in the context of local authorities is limited to anything less than powers and duties. There is nothing to suggest that section 111 of the Act of 1972 was intended to have the limited concept of function put forward by the auditor and the council. [Reference was made to the Local Government Act 1972, sections 2, 112(2) and 136 and Schedule 2, paragraph 2.] In *Moffat v. Eden District Council* (unreported), F 8 November 1988; Court of Appeal (Civil Division) Transcript No. 919 of 1988 Nourse L.J. and Sir Denys Buckley were both of the view that functions in the present context meant everything that a local authority did.

Section 101(3) of the Act of 1972 simply specifies that an authority has to comply with whatever codes there are relating to the manner or G means by which money may be raised for rates, precepts or borrowing or, indeed, may be lent, but this does not mean that money so raised or lent cannot be used for a purpose incidental to an activity that comes within section 111(1).

As to swap transactions, they are incidental if they are designed to hedge or produce a certainty of cost or reduce the cost of borrowing. For the meaning of "hedge" in relation to financial matters: see the H *Oxford English Dictionary*, definitions 6 and 7. In recent years interest rate swaps have become an accepted form of debt management: see the article entitled *Recent Developments in the Swap Market* by Miss G. M. S. Hammond in Bank of England Quarterly Review (1987), at

pp. 1188 et seq. It is pertinent to point out that prior to 1986 it was the general view that building societies were entitled to use interest rate swaps as incidental to their borrowing powers: see circular dated 5 March 1986, "Agreements for Interest Rate Swaps and Currency Swaps," issued by the Registry of Friendly Societies.

As to the validity of swap transactions, the banks' approach is first to ask whether or not the use of swaps as a tool of interest rate risk management can be regarded as fairly incidental to borrowing. It is a perfectly general question relating to all forms of organisation. If the answer is in the negative, that is an end of the issue. If the answer is in the affirmative, then two further issues arise. The first issue is whether local authorities are to be treated in some way differently, so that which would be regarded as incidental by the application of the general test in relation to local authorities produces a different answer. The second issue is whether or not that which has already been decided as normally incidental to the power of borrowing is excluded in that particular case because of some countervailing statutory prohibition.

As to the first issue, in general, local authorities are in no different position from any other statutory body. None of the authorities cited in any way suggest that the approach to the question of incidental powers in the case of a local authority is in any way different to the approach to that question in respect of other bodies. Since 1907 nearly every case dealing with incidental powers in relation to the application of the principle in *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473 has been a local authority case. Accordingly, it cannot possibly be right to adopt a more restrictive approach in this field because the organisation in question is a local authority.

Reliance is placed by the auditor on *Reg. v. Reed*, 5 Q.B.D. 483 and *Baroness Wenlock v. River Dee Co.*, 10 App.Cas. 354 for the proposition that where there is an express power to borrow there is no room for implying an additional power in respect thereof. That is to mis-state the principle deducible from those cases which is that if there is an express power to borrow conferred by statute there is no incidental or additional power to borrow. The implied power doctrine laid down in *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473 is that if a statutory body is given an express power it will be presumed that Parliament intended it to have those additional powers which are incidental or ancillary to that express power.

In relation to contrary intention, reliance has been placed on Schedule 13 to, and section 111(3) of, the Act of 1972. But Schedule 13 is only relevant if it can be said that in the absence of that Schedule the courts would already have come to the conclusion that interest rate swaps used in the limited ways for which the banks contend could fairly and reasonably be regarded as incidental to the exercise of the power to borrow. It is important to start with that assumption. The question then arises: is there anything in Schedule 13 which therefore indicates that Parliament wished to exclude that which would otherwise be regarded as incidental? A perusal of the Schedule shows that the answer is in the negative.

A Section 111(3) is intended to control the method of raising money empowered by section 111(1), and interest rate swaps are not the raising of money. The scope of section 111(3) as regards raising money is confined to rates, precepts or borrowing.

As to the council's submission in relation to section 111, that section has no impact at all on the question whether swaps are incidental to borrowing. [Reference was made to *Attorney-General v. Manchester* B *Corporation* [1906] 1 Ch. 643.]

Jonathan Sumption Q.C. and *Catharine Otton-Goulder* for Barclays Bank Plc. There are three questions which at some stage of these proceedings have to be decided between the parties. The first is whether the transactions are within the capacity of a local authority. It is common ground that if the answer to that question is in the negative C then no further questions arise and the transactions are nullities. The second question is: if the transactions are within the capacity of a local authority so that an authority is in principle empowered to do them, did this local authority abuse that power? The third question is: if the transactions are within the capacity of the local authority, but are an abuse of its powers, are they enforceable by a counter party and, if so, in what circumstances?

D The first and second questions are distinct reasons why the transactions must be unlawful: want of capacity and abusè of power. The reason why it is essential to distinguish between those two grounds of unlawfulness is that the extent of the statutory body's capacity to do certain acts is inherently a question of construction. On the other hand, the question of an abuse of power is not necessarily a question of E statutory construction at all. It is concerned primarily with the propriety of the statutory body's subjective motives and, on occasion, its internal procedures. The third question will depend on which kind of unlawfulness affected the expenditure in issue here.

It is no part of the bank's case to contend that the local authority is allowed to speculate or to engage in transactions for which it may be wholly ill-equipped. The question to be answered, certainly in the F period before the interim strategy period, is: on what particular ground are the transactions unlawful? It is important to remember that in the swap market the rates are determined by the market cost of borrowing money and not by a process of haggling for speculative advantage. The reason for an authority entering the swap market is, having examined its underlying debts to determine their term and the rate of interest, G whether fixed or floating, to consider in the light of those factors whether those underlying debts present unacceptable risks to the authority in the current economic conditions and to ascertain whether swap contracts could mitigate those risks.

It is unreal to consider swaps as being the purchase of an income in return for the assumption of a risk. The object is to bring about a state of affairs in which the combined effect of the swap and the underlying H debt will involve a risk which is less than one of them would produce on its own.

To the question, therefore, whether the risk of losing money in the swap market affects the analysis of a local authority's powers the answer

is that it does not, for three reasons. First, and most importantly, the risk is no different either in nature or extent from the risks which are inherent in borrowing. Parliament has expressly contemplated that local authorities will borrow and has left them the discretion whether they borrow at fixed or variable rates. Secondly, the fact that a judgment made in relation to borrowing may prove to be wrong in retrospect does not mean that it was not the appropriate judgment to make at the time, and certainly does not mean that there was no power to make such a judgment at all. Thirdly, in applying section 111(1) of the Act of 1972 it is necessary to consider the object of a transaction of the present nature; the fact that in certain cases that object may by ill luck or ill judgment not be achieved does not assist to identify what the object was.

As to whether a transaction falls within the ancillary powers conferred by section 111(1) of the Act of 1972, the test to be adopted is an objective test for two reasons. First, the words of the subsection themselves envisage the application of such a test. Secondly, in principle, questions relating to the capacities of a body should be decided in such a manner that a third party having dealings with it can discover its capacities solely from the terms of the Act or other incidental document.

Of the relevant expressions in section 111(1), the first is "calculated to facilitate." "Calculated" is a term of legal art which imports an objective test. The legal meaning of the word is contained in definition 2 in the *Shorter Oxford Dictionary*: "Fitted, suited, apt; proper or likely to." See also *McDowell v. Standard Oil Co. (New Jersey)* [1927] A.C. 632, 637 and *Turner v. Shearer* [1972] 1 W.L.R. 1387, 1389. Similarly, the expression "conducive or incidental to" must in this context likewise bear an objective meaning partly because of the association with the phrase "calculated to facilitate" and partly because the whole of the subsection is concerned with the characteristic that the "thing" in the third line of the subsection must have in order to be within the powers of a local authority.

The approach adopted in *Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation* [1986] Ch. 246 that it is necessary to ascertain whether the transaction in question is capable of having the purpose which is expressed or implied in the clause which confers the power applies equally to a statutory body with limited powers or, as in that case, to a limited company. A similar approach to that in the *Rolled Steel* case was adopted by the Divisional Court in relation to a local authority in *Reg. v. Greater London Council, Ex parte Burgess* [1978] I.C.R. 991.

In applying the objective test it is pertinent to ask the question: for what purpose can this transaction with these characteristics be reasonably expected by an objective observer to serve on the assumption that there is propriety of motive?

As to what constitutes a function, Barclays Bank Plc. adopts Mr. Pollock's submissions. As to the phrases ("calculated to facilitate" and "conducive or incidental to") in section 111(1), they are used disjunctively and it is obvious that some may be more appropriate in some cases than others. Swaps fall within section 111(1) for two distinct reasons. (1) A swap is calculated to facilitate borrowing if it makes it

easier for the council to borrow or easier to borrow on particular terms. They render the risks of borrowing more acceptable than they otherwise would be. This is the main answer to the appellants' case. (2) Swaps are incidental to borrowing because they are part of what has been called debt management.

On behalf of the auditor it has been contended that swaps could never come within section 111 for two reasons. First, that there is no legal connection between the swap and the underlying borrowing or debt; the swap does not affect the legal nature of the underlying borrowing or debt. Secondly, in the absence of the legal connection the only connection arises from the intention, directly or indirectly, to apply the profits of one in discharge of the liabilities under the other. Those two points lie at the heart of the auditor's submissions. The first of them is irrelevant and the second false.

The appellants have taken such cases as *Dundee Harbour Trustees v. D. & J. Nicol* [1915] A.C. 550 and *Attorney-General v. Smethwick Corporation* [1932] 1 Ch. 562 as the foundation of the relatively uncontroversial proposition that a local authority cannot engage in a wholly distinct and autonomous trade and have restated as a rule of law that a local authority needs specific statutory authority to do anything whatsoever that involves the receipt of money.

On the analogy between swap contracts and contracts of insurance, the council contended that it had the power to enter into insurance because such a power was part of the ownership of property. If there is a power to insure a property, it can only exist upon the basis that it is incidental to the ownership of the property and, therefore, justified by the terms of section 111(1); yet if the appellants are right on the principle for which they contend insurance is impermissible because it has the same vices as swaps; in other words, it is a transaction which is a legally autonomous transaction, and its effect is to produce a sum of money which goes into the general funds of the council by way of compensation for an event causing the council loss. It follows, therefore, on the principle for which the appellants contend that there is no intellectually respectable ground on which local authorities can be regarded as being empowered to insure at all.

It is necessary to add footnotes on three matters raised in Mr. Pollock's argument, which in other respects is adopted by Barclays Bank Plc. in its entirety.

(1) The dictionary definitions of "functions" do not appear to import any notion of duty. A function is an activity proper to some person having regard to what he is doing and what he is meant to be doing. The natural meaning of the word does not import any limitation to duty or purpose. Nor does the fact that the verb used in section 111(1) is "discharge" indicate that what is intended is a duty or purpose rather than a power. Thus in section 101(6) use of the word "functions" in that context necessarily connotes a power. It would be extraordinary if a word had wider meaning in some parts of the Act of 1972 than in others: compare section 101(3) and (6) of, and Schedule 2, Part I, paragraph 1(2) to, the Act. There is nothing in section 111(1) that compels a construction of the word "functions" as used in a sense that is

narrower than the ordinary meaning and that is narrower than the meaning that is to be found in every other part of the Act. Accordingly "functions" in section 111(1) should be read as including both powers and duties.

(2) The purpose of section 111(3) is not to limit the scope of section 111(1) by excluding from it activities involving borrowing, levying rates and precepts. The purpose is simply to ensure that, so far as section 111(1) authorises that which involves borrowing, rates or precepts, those three activities are carried out in accordance with the enactments relating to those specific matters. It follows that the argument for the appellants has to be, and indeed is, that the inclusion of the word "whether" in subsection (3) has brought about the accidental result, in a section which is directed to an entirely different problem, that nothing is allowed which involves the receipt of money apart from those three specific activities. That would be a most extraordinary result, not least because an examination of subsection (1) shows that it expressly contemplates that that which is authorised by the subsection may involve the disposal of any property or rights. Unless subsection (1) is regarded as being confined to a power of disposal of property or rights, it must follow that the subsection expressly permits doing that which is incidental and involves the disposal of property or rights notwithstanding subsection (3). Raising money, as that term is used in subsection (3), is a term which is used to describe the foregoing three particular methods of obtaining money but it is not intended to suggest that no other method of obtaining money is permitted.

(3) There are no policy considerations which should require the House of Lords to hold that the particular ground on which the council acted unlawfully was abuse of its powers. On the contrary, policy considerations, so far as they entered into this matter, militate very strongly in favour of a principle of law which distinguishes between the use and abuse of the market and against a rule of law which would operate indiscriminately. If the basis of the policy is that there is potential for abuse then the rule of law that would best reflect that policy is one that restrains the abuse and not one that avoids all the contracts without exception.

Barnes Q.C., in reply, referred to the Act of 1972, sections 101(6) and (12), 111, 174 and Schedule 13, paragraphs 7, 12 and 19(1); the Local Government (Miscellaneous Provisions) Act 1976, section 19; the Building Societies Act 1986, section 23; the Financial Services Act 1986, section 63; the Companies Act 1989, section 110; the Local Government and Housing Act 1989, section 45(1) to (5); the Local Authority (Stocks and Bonds) Regulations 1974 (S.I. 1974 No. 519), regulations 2 and 3; the Local Authority (Stocks and Bonds) (Amendment) Regulations 1983 (S.I. 1983 No. 529), regulation 3; *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.*, L.R. 7 H.L. 653; *Associated Provincial Picture Houses Ltd. v. Wednesbury Corporation* [1948] 1 K.B. 223; *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473; *Reg. v. Reed*, 5 Q.B.D. 483; *Small v. Smith*, 10 App.Cas. 119; *Deuchar v. Gas Light and Coke Co.* [1925] A.C. 691; *Reg. v. Greater London Council, Ex parte Burgess* [1978] I.C.R. 991; *Rolled Steel Products (Holdings) Ltd. v.*

British Steel Corporation [1986] Ch. 246 and *Reg. v. Wirrall Metropolitan Borough Council, Ex parte Milstead*, 87 L.G.R. 611.

Scott Q.C., in reply, referred to the General Rate Act 1967, section 2(1); the Act of 1972, sections 101, 111(1), (2) and (3), Schedule 13, paragraphs 1(*b*), 3, 4, 7, 15 and 20; the Building Societies Act 1986, sections 23, 118(2), Schedule 2, Part I, paragraph 4, Part III, paragraph 27; the Local Government and Housing Act 1989, section 43(3); *Attorney-General v. Great Eastern Railway Co.*, 5 App.Cas. 473; *Small v. Smith*, 10 App.Cas. 119; *Baroness Wenlock v. River Dee Co.*, 10 App.Cas. 354; *McDowell v. Standard Oil Co. (New Jersey)* [1927] A.C. 632; *Attorney-General v. Smethwick Corporation* [1932] 1 Ch. 562; *Reg. v. Greater London Council, Ex parte Burgess* [1978] I.C.R. 991; *Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation* [1986] Ch. 246; *In re Westminster City Council* [1986] A.C. 668 and *City Index Ltd. v. Leslie*, The Times, 10 October 1990.

The submissions relating to the interim period strategy and the municipal corporation issue sufficiently appear in the opinions of Lord Templeman and Lord Ackner. [Reference was made, in relation to the interim period strategy, to *Ayers v. South Australian Banking Co.* (1871) L.R. 3 P.C. 548; *In re Jon Beauforte (London) Ltd.* [1953] Ch. 131; *Bell Houses Ltd. v. City Wall Properties Ltd.* [1966] 2 Q.B. 656; *Great Eastern Railway Co. v. Turner* (1872) L.R. 8 Ch.App. 149; *Great North-West Central Railway Co. v. Charlebois* [1899] A.C. 114; *Holsworthy Urban District Council v. Holsworthy Rural District Council* [1907] 2 Ch. 62; *National Telephone Co. Ltd. v. Constables of St. Peter Port* [1900] A.C. 317; *In re New* [1901] 2 Ch. 534; *Seagram v. Knight* (1867) L.R. 2 Ch.App. 628; *Sinclair v. Brougham* [1914] A.C. 398; *Smith v. Croft* [1987] B.C.L.C. 355 and *Triggs v. Staines Urban District Council* [1969] 1 Ch. 10. Reference was also made, in relation to the municipal corporation issue, to *Attorney-General v. Leeds Corporation* [1929] 2 Ch. 291; *Attorney-General v. London County Council* [1908] 1 Ch. 781; *Attorney-General v. Manchester Corporation* [1906] 1 Ch. 643; *Attorney-General v. Newcastle upon Tyne Corporation* (1889) 23 Q.B.D. 492; *Attorney-General v. Smethwick Corporation* [1932] 1 Ch. 562; *Bonanza Creek Gold Mining Co. Ltd. v. The King* [1916] 1 A.C. 566; *Dickson v. Pharmaceutical Society of Great Britain* [1970] A.C. 403; *In re Norwich Provident Insurance Society (Bath's Case)* (1878) 8 Ch.D. 334; *Rutter v. Chapman* (1841) 8 Sm. & W. 1; *Swain v. The Law Society* [1983] 1 A.C. 598 and *Baroness Wenlock v. River Dee Co.* (1885) 10 App.Cas. 354.]

Their Lordships took time for consideration.

24 January 1991. LORD KEITH OF KINKEL. My Lords, I have had the advantage of considering in draft the speech to be delivered by my noble and learned friend, Lord Templeman. I agree with it, and for the reasons he gives would allow the appeals and restore the orders of the Divisional Court.

LORD BRANDON OF OAKBROOK. My Lords, I have had the advantage of reading in draft the speech prepared by my noble and learned friend,

Lord Templeman. I agree with it and for the reasons which he gives I would allow the appeals and make the orders proposed by him.

LORD TEMPLEMAN. My Lords, by the Local Government Act 1972, England was divided into local government areas consisting of counties, districts, London boroughs and parishes. The local authority charged with the administration of local government in a local government area consists of an elected council which "shall have all such functions as are vested in them by this Act or otherwise:" sections 2(1) and (2) and 14(1) of, and paragraph 1(2) of Schedule 2 to, the Act of 1972. A local authority, although democratically elected and representative of the area, is not a sovereign body and can only do such things as are expressly or impliedly authorised by Parliament. The functions of a principal council, defined by section 270 of the Act of 1972 as a county, district, or London borough council, extend under many statutes to public health, housing, planning and highways and other environmental matters and to education, housing and social and welfare services including the care and protection of children, the sick and the elderly. The expenditure incurred by a local authority in the discharge of its functions is funded partly by grants from Parliament, derived from the taxpayer, partly by rates and community charges derived from local residents and partly by income lawfully generated by the council in the due performance of some of its functions, for example, rents from council houses. Authorised expenditure by a local authority may be short-term or long-term. The authority will require revenue to pay its employees periodically and revenue to finance the capital cost of a housing or property development which may cost millions of pounds and produce revenue for a century. The receipt of revenue never coincides with expenditure because grants and rates are received at intervals which do not coincide with outgoings. Moreover the burden of long-term expenditure is in fairness spread over future generations of taxpayers and ratepayers and not imposed entirely on those who pay when the expenditure is incurred. Accordingly Parliament has conferred on a local authority controlled power to borrow short-term and long-term.

The borrowing powers of a local authority are defined and controlled by the provisions of Part I of Schedule 13 to the Act of 1972 to which I must hereafter refer in detail. Those provisions limit the purpose and method of borrowing by a local authority and dictate internal accounting for repayment. A local authority which is lawfully borrowing may choose to borrow at a fixed or variable rate of interest. The advantages of a fixed interest rate are certainty and protection against increases in current interest rates from time to time. The disadvantage of a fixed interest is that no benefit can be derived from a fall in interest rates.

In exercise of their borrowing powers, the appellant Hammersmith and Fulham Borough Council ("the council") borrowed sums which on 31 March 1989 amounted to £390m., largely representing borrowings incurred to undertake capital projects over many years. Each borrowing had its own terms of repayment. The interest rate differed from one loan to another, some loans were at fixed rates of interest and some at

A variable rates of interest. The council when taking up a loan must have considered that its resources would be adequate to meet its obligations under the terms of the loan. No doubt has been cast on the legality of any of the council's borrowings. Each outstanding loan remains payable with interest according to its terms which cannot be altered without the consent of the lender.

B From December 1983 onwards and principally between April 1987 and 23 February 1989 the council entered into numerous interest swap contracts. The council was in each contract anticipating a rise or fall in interest rates generally and if its anticipation was fulfilled would derive from the contract a profit which could then be employed, but was not bound to be employed, by the council in meeting the interest burden of its borrowings. The question is whether the council possessed power to

C enter into any swap contract.

To determine this question it is necessary to consider the statutory powers of local authorities and the nature and effect of the swap transactions which have been carried out by the council. These transactions are alleged by the appellant district auditor ("the auditor") to have been unlawful. Some of the transactions were carried out with the respondent banks ("the banks"). A decision that all the transactions

D were unlawful could have serious financial repercussions on the banks and other parties to unlawful transactions. The banks have therefore joined in these proceedings. The banks concede that the swap transactions carried out by the council between April 1987 and July 1988 were unlawful but contend that some of the transactions carried out after July 1988 were, or may on investigation prove to have been,

E lawful. All the transactions were held by the Divisional Court (Woolf L.J. and French J. [1990] 2 Q.B. 697, 707H) to be unlawful. The Court of Appeal (Sir Stephen Brown P., Nicholls and Bingham L.JJ. [1990] 2 Q.B. 697, 762) held that some of the transactions may have been incidental to the statutory functions of the council and therefore lawful.

The auditor appeals to this House against the decision of the Court of Appeal that some of the transactions entered into by the council

F could and may have been lawful. The council feel obliged to support the auditor and to argue that all the swap transactions entered into by the council were unlawful.

The evidence discloses that about 1981 there appeared in the world of international finance a new swap market comprising interest rate swaps, currency swaps and, recently, asset swaps. An illuminating

G article entitled "Recent developments in the swap market" by Miss G. M. S. Hammond in the Bank of England "Quarterly Review" of February 1987, explains that the swap market assists traders to solve financial problems arising out of variations in interest rates and currency exchange rates, different taxation regimes and rates of inflation and different creditworthiness. In the simplest case a bank which found it easy to raise fixed finance would swap its interest obligations with a

H company which could only borrow at variable rates but for good commercial reasons needed the certainty and security of fixed rates. In a more complicated case an American company creditworthy in the United States might build a ship in Italy for an English subsidiary

claiming capital allowances and would require short-term and long-term borrowings and payments in Italian and British currency. A European trader creditworthy in his country might need to expend and borrow dollars. Through the intermediation of a bank the American company and the European trader could by swap transactions ensure that fluctuations in interest rates and exchange rates did not have disastrous consequences. The swap market enables a borrower to raise funds in the market to which the borrower has best access but to make interest and principal payments in its preferred form of currency. The swap market has provided a valuable method of carrying on international trade and finance. Swaps may involve speculation or may eliminate speculation. In most cases the advantage sought by a user of the swap market is the elimination of speculation and uncertainty.

The transactions in the swap market which are now impugned were not carried out in order to enable the council to borrow or to enable the council to choose to borrow at a fixed rate rather than at a variable rate or vice versa. The transactions were undertaken in the hope that the burden of interest payable in respect of borrowings by the council would be mitigated by profits from swap contracts whereby the council successfully forecast movements in interest rates. If the council swapped from a fixed interest to a variable interest the council gained if, after the swap, interest rates went down. The council lost if, after the swap, interest rates rose. Similarly, if the council swapped from variable interest to fixed interest the council gained if, after the swap, interest rates went up and lost if interest rates went down.

Swaps employed by the council and said by the banks to be available to all local authorities are lucidly and comprehensively described in the judgment of the Divisional Court and in particular in Appendix A to that judgment: [1990] 2 Q.B. 697, 739–740. The simplest form is a swap contract described as:

> "an agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the 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. For example, one rate may be fixed at 10 per cent. and the other rate may be equivalent to the six month London Inter-bank Offered Rate ('LIBOR'). If the LIBOR rate over the period of the swap is higher than 10 per cent. then the party agreeing to receive 'interest' in accordance with LIBOR will receive more than the party entitled to receive the 10 per cent. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a 'net payment basis' under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other."

LIBOR is the interest rate at which major banks offer to lend funds to other major banks in the London Interbank Market. It may correspond to the rate of interest being offered on Eurodollar deposits. Eurodollars are United States dollars held outside the United States.

A LIBOR has been used in these proceedings to demonstrate the operation and effect of swap transactions. LIBOR is not the only basis for swaps. The fixed rate agreed for a short-term swap transaction may differ from the rate agreed for a long-term swap. In a swap transaction the winning party to a contract relies on the financial ability and integrity of the loser. All these complications have led to a swap industry which includes brokers advising clients and banks acting as B intermediaries or guaranteeing performance by their clients of their swap operations. These complications do not affect the principle involved in these proceedings but emphasise that swap transactions are not free of cost and emphasise the degree of speculation inherent in a swap transaction which is undertaken solely for the purpose of obtaining a profit by forecasting future interest trends.

C If a local authority borrowed £10m. in 1986 for five years at 10 per cent. per annum and LIBOR in 1987 was 12 per cent., the local authority would be unlikely to contemplate a swap. But if in 1987 LIBOR was 10 per cent. and the local authority believed that LIBOR would fall to eight per cent., the local authority might be minded to enter into a swap. In that event the local authority would agree to pay a bank LIBOR every year and the bank would agree to pay interest at D 10 per cent. on a notional sum of £10m. until 1991. If in 1988 LIBOR fell to eight per cent., the bank would pay the local authority £200,000 being the difference between the LIBOR of eight per cent. and the fixed rate of 10 per cent. on £10m. The local authority must still pay interest at 10 per cent. on the sum of £10m. actually borrowed in 1986 but the gain of £200,000 from the bank would be available to meet the interest E payment. If in 1988 LIBOR instead of falling to eight per cent. rose from 10 per cent. to 12 per cent., the local authority would pay the bank £200,000 and would also be bound to discharge the interest at 10 per cent. due on the sum borrowed in 1986. The success of the swap "replacing" the fixed rate of 10 per cent. by LIBOR would depend on LIBOR falling below 10 per cent. and on average remaining below 10 per cent. until 1991.

F If a local authority correctly forecast a fall in interest rates, the authority could protect itself against a subsequent rise. If, in the example given, the local authority borrowed £10m. in 1986 for five years at 10 per cent. and in 1987 thought that interest rates would fall, the local authority could enter into a swap transaction to pay LIBOR and receive 10 per cent. If in 1988 LIBOR fell to eight per cent. the local G authority could enter into another swap to pay eight per cent. and receive LIBOR. The effect of the two swaps would be to guarantee two per cent. to the local authority and this gain could be used to help pay the 10 per cent. on the actual borrowing. If in 1988 or thereafter the local authority thought that interest rates were likely to fall below eight per cent. the local authority could enter into another swap which if successful would provide a further gain indirectly reducing the burden of H interest payments and that gain could again be consolidated. A swap transaction is successful if a rise or fall in interest rates is correctly forecast; once the forecast has been proved to be accurate the local authority can consolidate the gain thus made by a reverse swap. But if

after any swap transaction entered into in anticipation of a fall in interest rates there is a rise in LIBOR or if after any transaction anticipating a rise in interest rates there is a fall in LIBOR the local authority will suffer a loss which will be payable in addition to the net interest payable under the terms of the original borrowing. For a local authority the swap market provides the opportunity of reducing indirectly the burden of interest on its borrowings at the risk of increasing that burden. The only evidence presented by a local authority (other than the council) was the evidence of the treasurer of Westminster City Council. He deposed that Westminster City Council entered into approximately 12 swap transactions between 1983 and 1989; on investigation by the auditor it appeared to him that only nine transactions had been entered into. The treasurer of Westminster City Council does not vouchsafe any details. He says that:

> "By way of example the council might enter into a swap contract under which a 11 per cent. per annum fixed rate of interest is swapped for, say, a variable interest rate of 10 per cent. This gives an immediate benefit to the council of a one per cent. difference in interest rates. Were market rates of interest to rise above 11 per cent. I would enter into another reverse swap contract to return to a position of paying the fixed rate of 11 per cent. again."

The treasurer does not explain why a bank would be willing to accept a variable rate of 10 per cent. while agreeing to pay a fixed rate of 11 per cent. Nor does he explain why a bank would be willing to accept a fixed rate of 11 per cent. after market rates of interest had risen above 11 per cent. As I understand it, the treasurer begins by exploiting the favourable rate of interest obtainable by a local authority on its borrowing from public sources. The fact remains that a swap transaction depends for its success on interest rates rising or falling in conformity with the expectation of the local authority at the date of the swap.

From investigations made by the auditor it appears that 77 local authorities out of 450 principal local authorities entered into about 400 swap transactions, nearly all between 1987 and 1989. Only 10 local authorities (other than the council) entered into more than 10 swaps and only 18 (other than the council) entered into more than five. By 31 March 1989 the council had entered into 592 swap transactions and 297 of these were still outstanding. The total notional principal sum involved in all the transactions entered into by the council amounted in the aggregate to £6,052m. The transactions outstanding on 31 March 1989 involved notional principal sums amounting in the aggregate to £2,996m. These figures distort the position because some swap transactions were a hedge against others. But there is no doubt that the volume of swap business undertaken by the council was immense. The council's actual borrowing on that date amounted to £390m. its estimated expenditure for the year ending 31 March 1989 was £85·7m. and its quoted budget for that year was £44·6m. The auditor swore an affidavit on 30 May 1989, in which after exhibiting a summary of calculations, he said:

> "this indicates that at current interest levels and using the five year swap rate on 9 February 1989 (11 per cent.) as the basis for the

calculation for swaps, swap options, caps and floors (including collars), the result would be a loss of £74·3m. If interest rates fall, the council will still lose £12·8m. if the fall is by one per cent. If interest rates rose by one per cent., the council will lose £185·7m. If six month LIBOR on 9 February 1989 (13 per cent.) is used as the basis of the calculation for swaps, swap options, caps and floors (including collars) the result would be a loss of £292·7m. If interest rates fall, the council will still lose £193·5m. if the fall is by one per cent. If interest rates rise by one per cent. the council will lose £406·3m."

A local authority might wish to undertake swap transactions for three different reasons. First, a local authority which believed that interest rates were falling and that all swaps were lawful, could enter into swap agreements to pay LIBOR and receive a fixed rate of 10 per cent. If the swap transaction was affected by reference to a notional principal sum of £100m. and LIBOR fell to nine per cent., the local authority would make a profit of £1m. If LIBOR rose to 11 per cent. the local authority would lose £1m. This general speculation is admitted to be unlawful. The banks admit that the swap transactions by the council between April 1987 and July 1988 were unlawful because in that period the council were simply speculating. Secondly, a local authority which believed that interest rates were falling and that swaps designed to reduce the burden of interest payments on a particular borrowing were lawful, could enter into a swap for that purpose. Thus if the local authority had borrowed £10m. at a fixed rate of 10 per cent. and believed that interest rates were falling, the local authority could enter into a swap agreement to pay LIBOR and receive 10 per cent. If LIBOR fell to nine per cent. the local authority would make a profit of £100,000. If LIBOR rose to 11 per cent. the local authority would lose £100,000. This swap agreement is referred to as a "parallel contract" because the notional principal sum involved does not exceed a principal sum borrowed and because the effect of the contract and any subsequent swap transaction entered into for the same purpose is said to convert indirectly a fixed interest obligation into a variable interest obligation or vice versa. The swap agreement in these circumstances is said to be a "parallel contract" and to "replace" the interest payable under the actual borrowing. The banks contend that the local authority may lawfully enter into parallel contracts and the council may have done so. But a parallel contract does not in fact replace the interest under the original borrowing and the swap transaction is a speculation no different in quality though different in magnitude from a swap contract which is not entered into by reference to any existing borrowing.

Thirdly, a local authority might seek to increase the proportion which its variable interest rate obligations bore to its fixed interest obligations. If 90 per cent. of the local authority's borrowings were at fixed rates of interest and 10 per cent. at variable rates, the local authority might by swapped contracts agree to pay fixed interest and receive LIBOR and thus increase the proportion of its variable interest obligations. This process is known as "re-profiling." The banks contend

that a local authority may lawfully enter into swaps for the purpose of re-profiling and the council may have done so. But if there is any difference between re-profiling and general speculation the notional sums must be limited to notional sums corresponding to some existing interest obligations. Basically therefore "re-profiling" is only an extension of "replacing."

Swap transactions include swap contracts, swap options, caps and floors, gilt options and cash options and forward rate agreements, all of which are explained in Appendix A to the judgment of the Divisional Court [1990] 2 Q.B. 697, 739–741. All these transactions are said by the banks, with some hesitation so far as cash options are concerned, to be lawful if undertaken by a local authority provided the transactions are "replacement" or "re-profiling" exercises intended to provide profits to be employed in the reduction of interest on particular borrowings and are limited to profits and losses on amounts which do not exceed the principal sums borrowed. The most material distinction between swap contracts and other types of swap transactions is that swap contracts do not usually require the payment of a premium whereas swap options and other types of swap transactions usually provide for a premium to be paid. The rate of interest which will attract payment when an option is exercised is negotiated in the light of the size and date of the payment of the premium. Swap transactions which involve premiums and options exercisable at future dates may increase the element of speculation and distort the local authority's pattern of borrowing. A local authority should, so far as possible, spread the burden of capital borrowing evenly over present and future taxpayers and ratepayers. A premium which is received by a local authority in 1990 reduces the cost of the borrowing in 1990 but increases the annual cost if and when the option is exercised. A premium which is paid by a local authority in 1990 increases the immediate cost of the borrowing in 1990 in the hope that the cost will be reduced when the option becomes exercisable.

The banks concede that local authorities have no express power to enter into any swap transaction. The banks contend that local authorities have an implied power to enter into "replacement" and "re-profiling" swap contracts. The council may have entered into some lawful "replacement" or "re-profiling" swap contracts. In addition the banks contend that the council was entitled to enter into swap transactions after July 1988 in order to mitigate the effect of unlawful swap transactions previously undertaken.

These arguments of the banks are based on section 111(1) of the Act of 1972, which, so far as material, provides as follows:

> "(1) Without prejudice to any powers exercisable apart from this section but subject to the provisions of this Act . . . a local authority shall have power to do any thing (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."

A The banks contend that swap transactions which are intended to "replace" or "re-profile" existing interest obligations are within the words of section 111 "calculated to facilitate" or are "conducive to" or are "incidental to" the discharge by the local authority of its admitted function of borrowing or an alleged function of debt management.

Counsel for the auditor submitted that a local authority's power to borrow is not a "function" within the meaning of section 111 and that B the local authority can do nothing which only facilitates or is conducive to or incidental to the power of borrowing.

In *Attorney-General v. Great Eastern Railway Co.* (1880) 5 App.Cas. 473, Lord Blackburn said, at p. 481:

> "where there is an Act of Parliament creating a corporation for a particular purpose, and giving it powers for that particular purpose, C what it does not expressly or impliedly authorise is to be taken to be prohibited; . . ."

In the same case Lord Selborne L.C. said, at p. 478, that the doctrine of ultra vires:

> "ought to be reasonably, and not unreasonably, understood and applied, and that whatever may fairly be regarded as incidental to, D or consequential upon, those things which the legislature has authorised, ought not (unless expressly prohibited) to be held, by judicial construction, to be ultra vires."

In the same vein Lord Blackburn said, at p. 481:

> "those things which are incident to, and may reasonably and E properly be done under the main purpose, though they may not be literally within it, would not be prohibited."

Section 111 embodies these principles.

I agree with the Court of Appeal [1990] 2 Q.B. 697, 785c that in section 111 the word "functions" embraces all the duties and powers of a local authority; the sum total of the activities Parliament has entrusted F to it. Those activities are its functions. Accordingly a local authority can do anything which is calculated to facilitate or is conducive or incidental to the local authority's function of borrowing.

So the question is whether a swap transaction is "calculated to facilitate, or is conducive or incidental to," the discharge of the local authority's function of borrowing.

G Swap transactions could be said to "facilitate" borrowing if the prospect of being able to reduce the burden of interest by swaps encouraged the local authority to enter into a borrowing which it would otherwise decide against. But this approach is impermissible. A local authority when considering expenditure must carefully consider the amount required to be borrowed and the resources available for payment of interest and capital. A local authority which borrowed in reliance on H future successful swap operations would be failing in its duty to act prudently in the interests of the ratepayers.

Similarly, swap operations cannot be said to be "conducive to" borrowing because local authorities should not be encouraged to borrow

by the prospect of swap transactions. It was submitted that swap transactions are "incidental to" borrowing. The first difficulty is that a swap transaction is a separate collateral contract which may be undertaken long after a borrowing has been effected. The local authority hopes that by a successful forecast of future interest trends it will provide itself with an income which can be employed in paying the interest on a borrowing. Assuming that this objection is not fatal, it is then necessary to consider what kinds of operations have been held to have been incidental to the discharge of the functions of a statutory corporation.

In *Small v. Smith* (1884) 10 App.Cas. 119, a building society which had power to enter into a second mortgage was held not to have an incidental power to guarantee payment of a prior mortgage. The Earl of Selborne L.C. said, at p. 133:

> "But the argument really is that because the rules permit this kind of security to be taken, that is to say, give very large and general powers as to securities, which do not exclude the taking of a security on which there is a prior mortgage, therefore there is a potential necessity for entering into a transaction of this kind to protect that security, and therefore there is a reasonable implication that there is power to do it. But I wholly deny that there is any potential necessity at all. . . . there is no more potential necessity for doing this in order to meet a temporary inconvenience than there is for doing anything else in the world which in the opinion of the directors might tend to obviate that inconvenience."

The same reasoning could be applied to the argument that a local authority needs power to swap because it has power to borrow.

In *Baroness Wenlock v. River Dee Co.* (1885) 10 App.Cas. 354, a statutory river company possessed express power to borrow £50,000 secured by bond or mortgage. Any implied power to borrow was negatived by the express power to borrow not more than £50,000. Lord Watson said, at p. 362:

> "The qualification attached by the legislature to the borrowing powers sanctioned by the Act of 1851, was, in my opinion, fatal to the continued existence of any implied power which the company had under their previous statutes."

As will be seen, Part I of Schedule 13 to the Act of 1972 imposes restrictions on the borrowing powers of local authorities.

In *Attorney-General v. Mersey Railway Co.* [1907] A.C. 415, a railway company was held not entitled to run a number of omnibuses which it claimed were incidental to the railway enterprise itself. Lord Loreburn L.C. said, at p. 415:

> "The rule of law has been laid down in this House to the effect that it must be shown that the business can fairly be regarded as incidental to or consequential upon the use of the statutory powers; and it is a question in each case whether it is so or whether it is not so."

Lord Macnaghten said, at p. 417:

> "The question is this: Is the business of omnibus proprietors as the defendants were carrying it on when the action was brought reasonably incidental to their business as authorised by their special Act? The principle to be applied is perfectly clear. The difficulty is all in the application. Hundreds of cases may be suggested where the thing done comes very near the line and may fairly be open to a difference of opinion. . . . Here, I think, the respondents have transgressed the line. It may be in doing what they wish to do they cannot help it. But that, in my opinion, is no justification for their action. If they wish to extend their undertaking beyond the limits authorised by their charter, the proper course is to apply to Parliament for further powers. In my opinion a matter of this sort is much better left to Parliament. There everybody who has a right to be heard will be listened to, and there the interests of the public will be protected."

The same considerations apply in the present case.

Several other authorities were cited to illustrate incidental powers but each case turned on its own facts.

The authorities deal with widely different statutory functions but establish the general proposition that when a power is claimed to be incidental, the provisions of the statute which confer and limit functions must be considered and construed. The question is not whether swap transactions are incidental to borrowing but whether swap transactions are incidental to a local authority's borrowing function having regard to the provisions and limitations of the Act of 1972 regulating that function.

The authorities also show that a power is not incidental merely because it is convenient or desirable or profitable. A swap transaction undertaken by a local authority involves speculation in future interest trends with the object of making a profit in order to increase the available resources of the local authorities. There are many trading and currency and commercial swap transactions which eliminate or reduce speculation. Individual trading corporations and others may speculate as much as they please or consider prudent. But a local authority is not a trading or currency or commercial operator with no limit on the method or extent of its borrowing or with powers to speculate. The local authority is a public authority dealing with public moneys, exercising powers limited by Schedule 13.

Section 172 of the Act of 1972 directs that Part I of Schedule 13 "shall have effect with respect to the powers of local authorities to borrow and lend money and with respect to their funds . . ." Part I of Schedule 13, so far as material, provides as follows:

> "1. Without prejudice to section 111 above—(*a*) a principal council may borrow money for the purpose of lending money to another authority . . . (*b*) a local authority . . . may borrow money for any other purpose or class of purpose approved for the purposes of this sub-paragraph by the Secretary of State and in accordance with any conditions subject to which the approval is given."

The Secretary of State from time to time issues block borrowing approval and may give a specific approval. The block borrowing approval defines the purposes for which money may be borrowed, the period during which borrowings must be repaid and limits the aggregate amount which an authority can borrow. For example, money may be borrowed for a maximum period of 60 years for land purchase and house building, for 40 years for other building and landscaping works and for 20 years for some furniture and other equipment. The maximum periods relate roughly to the expected life of the asset for which the money is to be borrowed.

> "2(1) Where a local authority are authorised by or under this Act or any other enactment to borrow money, they may raise the money—" by mortgage, by the issue of stock, by the issue of debentures or annuity certificates, by the issue of bonds, by the issue of bills and "(*f*) by an agreement entered into with the Public Works Loan Commissioners under section 2 of the Public Works Loans Act 1965, or (*g*) by any other means approved by the Secretary of State with the consent of the Treasury."

Borrowings from the Public Works Loan Commissioners ("the P.W.L.B.") account for some 80 per cent. or more of local authority borrowings. The P.W.L.B. offer loans to local authorities at fixed or variable rates both of which are below the market rate because of the power of the government to negotiate its own borrowings. If a local authority borrows at a variable rate from the P.W.L.B. the local authority may elect thereafter on one occasion by the terms of the loan to change from a variable rate to a fixed rate without penalty. If, therefore, a local authority is compelled to borrow at a time when interest rates are thought to be abnormally high, the authority can borrow from the P.W.L.B. at a variable rate and then convert into a fixed rate when interest rates have fallen.

"4(1) The Secretary of State may by regulations made with the consent of the Treasury" prescribe the form of any mortgage deed, regulate the issue of stocks and bonds including the terms on which they may be issued, and regulate the manner of transfer dealing with and redeeming any mortgage deed, stocks or bonds. Thus the Secretary of State retains complete control over local authority borrowings.

"5(1) A local authority may borrow by the issue of bills, payable within 12 months from the date of issue," inter alia, such sums as may be required for the purpose of defraying expenses pending the receipt of revenue; but the amount so borrowed is limited to a specified proportion of the authority's estimated gross income derived from rates. It might have been thought that a similar power was incidental to the local authority's function of borrowing but any incidental power is negatived by this express provision.

> "7(1) Where expenditure incurred by a local authority for any purpose is defrayed by borrowing, the local authority shall . . . debit the account from which that expenditure would otherwise fall to be defrayed with a sum equivalent to an instalment of principal and interest combined such that if paid annually it would secure the

A payment of interest at the due rate on the outstanding principal together with the repayment of the principal not later than the end of the fixed period."

If a local authority borrowed at a fixed rate and entered into a swap contract to "replace" the fixed rate by a variable rate, paragraph 7 does not enable any variation to be made in the required annual debit and B does not take into account profits made or losses suffered as a result of the swap.

"8. A local authority who borrow money . . . may during the fixed period borrow further sums, without the approval of the Secretary of State under that sub-paragraph, for the purpose of repaying the money so borrowed."

C Paragraph 8 thus confers an express power on the local authority truly to replace a loan. This power could be exercised, for example, if a fixed loan of 15 per cent. could be replaced by a fixed loan of 10 per cent. if rates had fallen. Such a true replacement would not involve the local authority making gains or suffering losses associated with swap transactions.

D "10(1) A local authority may, without the approval of the Secretary of State . . . borrow by way of temporary loan or overdraft from a bank or otherwise any sums which they may temporarily require— (*a*) for the purpose of defraying expenses . . . pending the receipt of revenues."

Here again what might have been thought to be an incidental power is made the subject of express enactment.

E "20. A person lending money to a local authority shall not be bound to inquire whether the borrowing of the money is legal or regular or whether the money raised was properly applied and shall not be prejudiced by any illegality or irregularity, or by the misapplication or non-application of any of that money."

F The banks concede that this paragraph cannot be construed so as to afford protection to persons who enter into swap transactions with local authorities.

When a local authority considers whether to expend money and if so whether to borrow and on what terms, the local authority must have regard to the provisions of Schedule 13, the method of borrowing and terms of repayment, the prevailing interest rates and the possibility that G interest rates may rise or fall during the period of the loan. If the local authority finds that after it has borrowed that there has been a violent change in interest rates which affects a particular borrowing, the local authority is not without remedial action. It can convert a loan taken out with the P.W.L.B. from variable rate of interest into a fixed rate of interest. It can pay off an expensive loan and take out a new loan. It is said that the cost of paying off an old loan and taking out a new loan H would be greater than the cost of entering into swap transactions. But this fact alone cannot render swap transactions legal.

Schedule 13 establishes a comprehensive code which defines and limits the powers of a local authority with regard to its borrowing. The

Schedule is in my view inconsistent with any incidental power to enter into swap transactions.

There is a further difficulty. If swap transactions are incidental to the function of borrowing, it would appear that swap transactions can only be entered into by the local authority and not by a committee or officer. Section 101(6), before its amendment by section 45(5) of the Local Government and Housing Act 1989 provided that:

> "A local authority's functions with respect to levying, or issuing a precept for, a rate or borrowing money shall be discharged only by the authority."

The Court of Appeal found that section 111 applied but that section 101(6) did not. The court managed to reach this conclusion by accepting the argument that swap transactions are not so much incidental to the function of borrowing as incidental to the function of debt management, defined as a duty to take reasonable care to manage its borrowing prudently in the best interests of the ratepayers. Before this House, counsel for the banks, repeated the submission that swap transactions, if not incidental to borrowing, were nevertheless incidental to debt management.

Debt management is not a function. Debt management is a phrase which has been coined in this case to describe the activities of a person who enters the swap market for the purpose of making profits which can be employed in the payment of interest on borrowings. The expression debt management could be employed to describe the duty of a local authority to consider from time to time whether it should change a variable P.W.L.B. loan into a fixed interest loan; whether it should redeem one loan and take out another; whether when a new borrowing is contemplated, the borrowing should be at a variable or fixed rate taking into account all the other borrowings of the local authority. Debt management is a phrase which describes prudent and lawful activities on the part of the local authority. If swap transactions were lawful a local authority would be under a duty to consider entering into swap transactions as part of its duty of debt management. But if a swap transaction is not lawful then it cannot be lawful for a local authority to carry out a swap transaction under the guise of debt management.

The Divisional Court [1990] 2 Q.B. 697, 725 came to the conclusion that it would be inconsistent with the structure of the Act of 1972 as a whole, to which the provisions of section 111(1) are expressly made subject, to regard swap transactions as falling within that subsection. I agree.

For the banks it was argued that swap transactions are akin to insurance which enables provision to be made for possible risks. By insurance, an assured sacrifices a premium which when aggregated with premiums from other assured, will form a pool from which the insurer will indemnify the unfortunate victim (if any) who suffers from the risk insured against. A swap contract based on a notional principal sum of £1m. under which the local authority promises to pay the bank £10,000 if LIBOR rises by one per cent. and the bank promises to pay the local

authority £10,000 if LIBOR falls by one per cent. is more akin to gambling than insurance.

The Court of Appeal were impressed by the argument that if swap transactions were unlawful a local authority could not take advantage of reductions in interest rates. But the sucess of swaps depends on a successful forecast of future interest rates. The power of a local authority to choose between long-term and short-term borrowings and to choose between variable and fixed interest rates, and the power of a local authority to borrow from the P.W.L.B. on favourable terms and to change from variable to fixed rates of interest and the power of the local authority to replace a borrowing with another borrowing, provide opportunity for the local authority to consider whether the overall rate of interest paid by the local authority is reasonable and is protected against volatility of interest rates. The greater the volatility of interest rates, the greater the risk of loss to a local authority as a result of swap transactions. Despite the urgings of counsel for the banks to the contrary, it seems to me there are substantial risks. There is no evidence that local authorities which have abstained from the swap market have forfeited substantial profits. These are all matters for Parliament to consider and the banks are not debarred from impressing upon Parliament the advantages to local authorities of a power to enter into swap transactions.

In the case of a building society Parliament has conferred express power to enter into swap transactions but that power was only conferred after the building societies had been given wide powers of entering into commercial transactions. The powers to enter into swap transactions were at first limited and when extended, Parliament continued to insist that the power should be subject to the approval of the members of the society who will suffer if the power is ineptly exercised.

The Building Societies Act 1986 conferred power on a building society to provide, inter alia, banking, investment and insurance services. Section 23 authorised a building society to effect contracts of a description to be prescribed by the building society's commission with the consent of the Treasury for the purpose of reducing the risk of loss arising from changes in interest rates, currency rates, or other forms of prescribed risk which affects its business. Section 23(5) directed that this power to hedge should only be exercisable if adopted by the society. The Building Societies (Prescribed Contracts) Order 1986 (1986 S.I. No. 2098) made by the commission pursuant to the Act of 1986 authorised a building society to enter into sterling interest rate swaps and capital and interest currency swaps but by article 3:

> "(2) A society may only effect a prescribed contract where it has borrowed or intends to borrow a principal sum and the prescribed contract relates to a principal sum equal to it or less than it. (3) No prescribed contract may be effected by a society save where another party is a bank authorised . . . to hold funds of societies . . ."

Thus in 1986 Parliament conferred on building societies, which by the Act of 1986 were given wide functions, a power to enter into swap transactions which were limited to parallel contracts, could only be

effected with leading banks, and only after the members of the society had approved the exercise of the power to hedge. In 1988 [by the Building Societies (Prescribed Contracts) Order 1988 (S.I. 1988 No. 1344)] Parliament extended the hedging power so as to apply to all the forms of swap transactions which are specified in Appendix A to the judgment of the Divisional Court in these proceedings [1990] 2 Q.B. 697, 739–741. Parliament, however, retained the requirement of approval by members of the society of the exercise of the power to hedge. It is for Parliament and not the courts to decide whether there should be conferred on local authorities unlimited power to hedge or a power limited for the protection of taxpayers and ratepayers. Parliament might decide that it was unnecessary or unwise to confer power on local authorities to enter the swap market at all.

Counsel for the banks contended that the application of the ultra vires doctrine in the present circumstances is so harsh that if swap transactions entered into by local authorities are unlawful, the swap market and the banks and other parties to swap transactions will be involved in great difficulties, the creditworthiness of local authorities would be impaired and there would be an increase in taxation. The major problem concerns the activities of the council which indulged in speculation on a vast and admittedly unlawful scale. It may not follow that, as between the council and the banks, payments made by the council before or after the period of the interim strategy can be recovered by the council. Nor does it follow that payments received by the council before or after the period of interim strategy cannot be recovered by the banks. The consequences of any ultra vires transaction may depend on the facts of each case. The banks have expressly reserved the right to argue in any proceedings arising out of a swap transaction that the banks are not tainted by illegality and that, for a variety of reasons which cannot now be canvassed, payments made pursuant to swap transactions can be retained by the banks or recovered from the council. The creditworthiness of local authorities has nothing to do with swap transactions. Paragraph 20 of Schedule 13 to the Act of 1972 is a complete protection for any person who lends money to a local authority. The object of the doctrine of ultra vires is the protection of the public. In *Cotman v. Brougham* [1918] A.C. 514, Lord Parker of Waddington referring to a company whose functions were defined by its memorandum of association said, at p. 520:

> "The question whether or not a transaction is ultra vires is a question of law between the company and a third party. The truth is that the statement of a company's objects in its memorandum is intended to serve a double purpose. In the first place it gives protection to subscribers, who learn from it the purposes to which their money can be applied. In the second place it gives protection to persons who deal with the company, and who can infer from it the extent of the company's powers. . . . Even a power to borrow money could not always be safely inferred, much less such a power as that of underwriting shares in another company."

A In the same case Lord Wrenbury said, at p. 522, that the memorandum of association:

> "must delimit and identify the objects in such plain and unambiguous manner as the reader can identify the field of industry within which the corporate activities are to be confined. The purpose, I apprehend, is twofold. The first is that the intending corporator
B who contemplates the investment of his capital shall know within what field it is to be put at risk. The second is that anyone who shall deal with the company shall know without reasonable doubt whether the contractual relation into which he contemplates entering with the company is one relating to a matter within its corporate objects."

C In the result, I am of the opinion that a local authority has no power to enter into a swap transaction. The banks nevertheless argued that swap transactions entered into by the council after July 1988 were lawful because they were intended to eliminate or reduce the risks inherent in earlier swap transactions. At the end of July 1988 the council was advised by the auditor that swap transactions which were not parallel contracts were of doubtful validity. For the purpose of this appeal, I
D assume, without deciding, that the council thereupon adopted a policy, now described as "the interim strategy" of refraining from entering into swap transactions save for the purpose of reducing the potential loss which might be suffered as a result of earlier swap transactions. The interim strategy came to an end on 23 February 1989 when the council determined to take no further action with regard to existing or future
E swap transactions until the law had been clarified.

The interim strategy took the form of fresh swap transactions designed to hedge the risks of earlier transactions. In addition, some swaps were terminated by cash payments, some swap contracts may have been assigned thus putting an end to the obligations of the council thereunder, and financial obligations under existing swap contracts were honoured. Since I have concluded that a local authority has no power
F to enter into swap transactions, it must follow that a swap transaction entered into pursuant to the interim strategy was also unlawful.

Any power to carry out the interim strategy activities must be derived from section 111 of the Act of 1972; a function must be identified to which the interim strategy activities were incidental. Miss Gloster on behalf of the banks submitted that the iterim strategy activities were incidental to the
G duty of the council to take such reasonable steps as were very desirable or necessary to preserve and protect the ratepayers' funds from the adverse consequences of a previous act of the local authority, in circumstances where there were doubts at the time that the protective steps were taken as to whether the previous act was ultra vires or an abuse of power. In the alternative, Miss Gloster submitted that the interim strategy was carried out in discharge of or was incidental to the duty of the council to
H make arrangements for the proper administration of their financial affairs. My Lords, a local authority owes a duty to its ratepayers to preserve ratepayers' funds and to arrange for proper administration. But the reasonable steps and arrangements carried out by the council for the

purpose of discharging its duties must be lawful. No authority was cited which suggested that in certain circumstances an ultra vires transaction could be remedied by another ultra vires transaction, possibly with different parties.

A large number of authorities were cited by way, it was said, of analogy. The first batch of authorities established the right of a corporation to compromise an ultra vires claim; but in each case the compromise did not involve the corporation in performing any unlawful act.

In *In re Norwich Provident Insurance Society (Bath's Case)* (1878) 8 Ch.D. 334, 340 Sir George Jessel M.R. said that a corporation has under the general law the same right to compromise claims brought against it as individual persons have:

> "It would be a startling proposition that, whereas an individual may always avoid having to resort to litigation by compromising a claim against him, a corporation can never avoid it, but must either fight out the claim or make arrangements sanctioned by the order of a court of justice; yet such would be the result of holding that a corporation has no such general power."

In my opinion it would be a startling proposition that an individual or a corporation may always avoid having resort to litigation by agreeing, by way of compromise, to carry out an unlawful act.

The position was made abundantly clear by Warrington J. in *Holsworthy Urban District Council v. Holsworthy Rural District Council* [1907] 2 Ch. 62. He decided that a compromise agreement entered into bona fide by two councils, was not rendered invalid by the fact that one of the claims included in the compromise subsequently proved to be unfounded in law. Warrington J. said, at p. 73:

> "a compromise, if entered into bona fide, and *if it does not involve the doing of an act by one of the parties which is itself ultra vires*, may be made by and may be binding on a corporation just as on an individual." (I have emphasised the important words.)

In this House, Miss Gloster also cited, by way of analogy, the well recognised authorities which established the jurisdiction of a Court of Equity to sanction a breach of trust by trustees. Such sanction may be granted retrospectively after the unauthorised transaction has been carried into effect. But while a court has jurisdiction to sanction any transaction which the settlor could have authorised and which all beneficiaries being sui juris could sanction, the court has no jurisdiction to extend the powers conferred on a corporation by Parliament or to approve an unlawful transaction by a corporation. The Court of Appeal in the instant case summarised the authorities cited by Miss Gloster by way of analogy and observed [1990] 2 Q.B. 697, 794 that:

> "it is sometimes necessary to accept that 'What's done is done' and, even if it should not have been done, the law should lean in favour of such solution as enables the situation to be so far as possible rectified with minimum loss and inconvenience to all involved."

A The Court of Appeal therefore held that the interim strategy transactions were lawful. I do not believe that the Court of Appeal would have reached the same conclusion if they had not, erroneously in my opinion, already held that a swap transaction which is a parallel contract was within the power of a local authority. No authority is needed for the proposition that the law should lean in favour of such *lawful* solution as enables the situation to be so far as possible rectified with minimum loss B and inconvenience to all involved. No authority satisfies me that the law should lean in favour of such *unlawful* solution as enables the situation to be so far as possible rectified with minimum loss and inconvenience to all involved.

Accordingly swap transactions undertaken during the period of the interim strategy are no different from swap transactions entered into at C any earlier period.

Finally, the banks deployed an argument, described by the Court of Appeal [1990] 2 Q.B. 697, 770A as "a somewhat arcane point." The argument proceeds on the basis that though the incorporated Hammersmith and Fulham Borough can only act by the unincorporated Hammersmith and Fulham Borough Council and though the powers of the council are limited by the Act of 1972, the borough acting by the D council has all the powers of a natural person and is not confined by the Act of 1972. Therefore any swap transaction entered into by the borough was lawful. It is conceded that neither the borough nor the council could lawfully devote moneys held as part of the general rate fund in order to comply with swap transaction obligations because the general rate fund may only be expended by the council and solely for E purposes authorised by the Act of 1972 and other statutes. But it is contended that there might be some property perhaps generously donated to the borough which was in some way not held by the borough acting by the council for the benefit of the ratepayers or which, although held for the benefit of the ratepayers was not subject to the same inhibitions as the general rate fund and other property held for the benefit of the ratepayers. This argument strikes me as being not so F much arcane as absurd.

The argument starts with the year 1612 and the report of *Sutton's Hospital Case* (1612) 10 Co.Rep. 1. That report, although largely incomprehensible in 1990, has been accepted as "express authority" that at common law it is an incident to a corporation to use its common seal for the purpose of binding itself to anything to which a natural person G could bind himself and to deal with its property as a natural person might deal with his own: *Riche v. Ashbury Railway Carriage and Iron Co. Ltd.* (1874) L.R. 9 Ex. 224, 263. The doctrine applies only to a corporation created by an exercise of the Royal Prerogative. A corporation created by or under a statute has no power except the powers granted expressly or by implication by that statute. As will appear, the corporation in the present case was a hybrid, created by H Royal Charter issued pursuant to a statute. *Sutton's Hospital Case* did not deal with this situation.

There is a long history of the incorporation of municipalities. The Municipal Corporations Act 1835 (5 & 6 Will. 4, c. 76) and the

Municipal Corporations (General) Act 1837 (7 Will. 4 & 1 Vict. c. 78) regulated boroughs already incorporated by Royal Charter and provided that upon the petition of the inhabitant householders the Crown might create a new municipal borough, incorporate the inhabitants and extend to that municipal borough and the inhabitants the provisions of the Municipal Corporations Acts. In *Rutter v. Chapman* (1841) 8 M. & W. 1, it was decided *per* Patteson J., at p. 74, that the effect of the Act of 1837 was:

> "not in derogation or abridgment of the power of the Crown to grant charters of incorporation at common law, which it may still do without any petition; but it is to enable the Crown, in case of any such petition, to extend to any new corporation, when created, the powers of the Municipal Corporations Act, some of which, as for instance the taxing of the inhabitants by a borough rate, may not have been grantable by the Crown at common law. The Act does not profess to enable the Crown to grant charters, but only, if it shall think fit to grant them upon petition, to extend to the grantees, by those charters, certain powers and provisions."

In *Bonanza Creek Gold Mining Co. Ltd. v. The King* [1916] 1 A.C. 566 the Privy Council considered the effect of a Royal Charter granted pursuant to statute. The British North America Act 1867, by sections 12 and 65, transferred to the Lieutenant Governor of Ontario the prerogative power of incorporation in relation to the province. Section 92 of the Act of 1867 conferred exclusive power upon the provincial legislature to make laws in relation to the incorporation of companies with provincial objects. The Ontario Companies Act passed pursuant to section 92 authorised the incorporation of companies by the Lieutenant Governor. Viscount Haldane, delivering the advice of the Board, said, at p. 577:

> "that it is wrong, in answering the question what powers the corporation possesses when incorporated exclusively by statute, to start by assuming that the legislature meant to create a company with a capacity resembling that of a natural person, such as a corporation created by charter, would have at common law . . ."

It must not be assumed, at p. 588:

> "that the legislature has had a common law corporation in view, whereas the wording may not warrant the inference that it has done more than concern itself with its own creature. Such a creature, where its entire existence is derived from the statute, will have the incidents which the common law would attach if, but only if, the statute has by its language gone on to attach them. . . . The question is simply one of interpretation of the words used. For the statute may be so framed that executive power to incorporate by charter, independently of the statute itself, which some authority, such as a Lieutenant Governor, possessed before it came into operation, has been left intact. Or the statute may be in such a form that a new power to incorporate by charter has been created,

A directed to be exercised with a view to the attainment of, for example, merely territorial objects, but not directed in terms which confine the legal personality which the charter creates to existence for the purpose of these objects and within territorial limits. The language may be such as to show an intention to confer on the corporation the general capacity which the common law ordinarily attaches to corporations created by charter."

B

In my opinion where a statute authorises the grant of a Royal Charter, then, the extent of the powers exercisable by a corporation created by a charter granted pursuant to the statute will depend on the true construction and intent of the statute.

Under the London Government Act 1939, consolidating earlier C legislation, the administrative county of London included 28 metropolitan boroughs. By section 17:

"(1) For every metropolitan borough there shall be a metropolitan borough council consisting of the mayor, aldermen and councillors, and the council shall have all such functions as are vested in it by this Act or otherwise. (2) A borough council shall be a body corporate . . . and shall have perpetual succession and a common D seal with power to hold land for the purposes of its constitution without licence in mortmain."

A London metropolitan borough council being created by statute could only exercise the powers conferred by statute. Neither the council nor the borough, so far as it existed apart from the council, had the E powers of a natural person.

By section 1(1) of the London Government Act 1963, the metropolitan boroughs of the county of London were enlarged, re-organised and converted into London boroughs forming part of the administrative area of the Greater London Council. Section 1 of the Act of 1963 continued as follows:

F "(2) If in the case of any London borough, on representations in that behalf made to the Privy Council by the minister, Her Majesty by the advice of her Privy Council thinks fit to grant a charter of incorporation of the inhabitants of that borough, Her Majesty may by that charter—(*a*) make provision with the respect to the name of the borough; and (*b*) subject to the provisions of this Act, make any provision such as may be made by virtue of section 131 of the G Local Government Act 1933 by a charter granted under Part VI of that Act; and any charter which purports to be granted in pursuance of the Royal prerogative and this subsection shall be deemed to be valid and within the powers of this Act and Her Majesty's prerogative and the validity thereof shall not be questioned in any legal proceeding whatever. (3) In the case of any London borough whose inhabitants are not incorporated by such a charter as is H referred to in the last foregoing subsection, provision for their incorporation shall be made by the minister by order (hereafter in this Act referred to as an 'incorporation order') which may include any such provision as is mentioned in paragraph (*a*) or (*b*) of that

subsection . . . (6) The Municipal Corporations Act 1882 shall apply to every London borough and . . . the expression 'borough' when used in relation to local government . . . shall . . . include a London borough; and the council of a London borough shall be a local authority . . ."

The Act of 1963 did not confer and showed no intention of conferring on London boroughs or their councils any power exceeding the statutory power formerly exercised by metropolitan borough councils. Under the Act of 1963 every London borough was bound to be incorporated, either by the Crown under section 1(2) or by the minister under section 1(3). Nevertheless the banks argue that it is possible that some swap transactions were entered into by the council and that other swap transactions were entered into by the borough acting by the council. Swap transactions entered into by the council would be unlawful for the reasons I have already indicated but, say the banks, swap transactions entered into by the borough acting by the council would be lawful because the borough which was, in 1964 incorporated by the Crown, possessed all the powers of an actual person. If the argument for the banks is correct, the Act of 1963 had the effect of dividing London boroughs into two classes. The first class incorporated by the Crown upon the representations of the minister would have all the powers of a natural person. The second class, incorporated by the minister, would have only the powers conferred by statute. Yet both classes of London boroughs would fulfil exactly the same functions by exactly the same machinery. Councils of both classes whether or not acting on behalf of the borough would be constrained by the limitations on their powers imposed by statute. In my opinion the Act of 1963 intended and provided that every London borough should be constrained by statute. This does not mean that Parliament intended or provided for any restraint on the Royal Prerogative. The Crown retained the right, in theory at any rate, to incorporate a London borough otherwise than on the representation of the minister and in sole exercise of the prerogative. But if the Crown elected to incorporate a London borough pursuant to the Act of 1963 then in my opinion the combined effect of the statute and the Charter was to create a statutory corporation.

A Royal Charter dated 10 March 1964 referred to the Act of 1963 and recited that representations for incorporation had been made by the minister in accordance with the Act. The grant of incorporation was expressed to have been made "by virtue of our Prerogative Royal and in pursuance of the London Government Act 1963 and of all other powers and authorities enabling us in this behalf." The charter ordered and declared as follows:

"1. The London borough comprised of the areas of the existing metropolitan boroughs of Fulham and Hammersmith (hereinafter referred to as 'the borough') shall be named 'the London Borough of Hammersmith.' 2. The inhabitants of the borough shall be and are hereby incorporated by the name of 'the mayor, aldermen and burgesses of the London Borough of Hammersmith' with perpetual succession and a common seal. . . ."

A In my opinion that charter made pursuant to the Act of 1963 did not confer on the borough or the council any greater power than the statutory power exercisable by any other London borough. On 1 September 1979 the name of the borough was changed to the "London Borough of Hammersmith and Fulham."

There is a further obstacle to the argument of the banks. By Schedule 2, paragraph 1(2) of the Act of 1972:

B

> "For every London borough there shall be a council consisting of the mayor and councillors and the council shall exercise all such functions as are vested in the municipal corporation of the borough or in the council of the borough by this Act or otherwise."

The council is constrained by statute and cannot enter into swap C transactions. In my opinion the council cannot ignore their statutory constraints and lawfully exercise in the name of the borough a power which upon the true construction of the statutory powers of the council was not open to the council. For example, the council is restrained by Schedule 13, paragraph 1 of the Act of 1972 from borrowing in a foreign currency without the consent of the Treasury. The council could not lawfully without the consent of the Treasury borrow in a foreign D currency in the name of the borough. So in the present case the council has no power to carry out swap transactions either in its own name or in the name of the borough.

In the final result the council had no power to enter into the swap transactions which are recorded in the Capital Markets Fund Account kept by the council. By section 19 of the Local Government Finance E Act 1982:

> "(1) Where it appears to the auditor carrying out the audit of any accounts under this part of this Act that any item of account is contrary to law he may apply to the court for a declaration that the item is contrary to law except where it is sanctioned by the Secretary of State."

F The auditor is responsible for auditing the accounts of the council.

> "(2) On an application under this section the court may make or refuse to make the declaration asked for, and where the court makes that declaration, then . . . it may also . . . (*c*) order rectification of the accounts. (5) On an application or appeal under this section relating to the accounts of a body, the court may make G such order as the court thinks fit for the payment by that body of expenses incurred in connection with the application or appeal by the auditor or the person to whom the application or appeal relates or by whom the appeal is brought, as the case may be."

In the present case the Divisional Court on 1 November 1989 made certain orders and declarations. In particular:

H

> "It is ordered and declared that the items of account appearing within the capital markets fund account of the council of the London Borough of Hammersmith and Fulham for the financial years beginning on 1 April 1987 and 1 April 1988 are contrary to

law. It is further ordered that the accounts of the said council for the financial years beginning on 1 April 1987 and 1 April 1988 be rectified with liberty to the parties to apply if what is required to rectify the said account is not agreed."

These orders were varied by the Court of Appeal but in my opinion should now be restored in their original form.

The Divisional Court made certain orders with regard to costs and expenses. These orders were not varied by the Court of Appeal and should stand.

The Court of Appeal ordered that one half of the cost of the bank incurred in the appeal should be paid by the auditor. This order should be discharged.

The auditor having succeeded in this House against the banks is entitled to an order for his costs of the appeal to the Court of Appeal and the appeal to this House to be taxed and paid by the banks. The council must bear their own costs of the appeal to the Court of the Appeal and the appeal to this House.

The auditor seeks under section 19(5) of the Act of 1982 an order against the council for his expenses (so far as they exceed taxed costs) incurred in the appeal to the Court of Appeal and in the appeal to this House. These expenses if not paid by the council will form part of the general expenses of the audit and supervision of public authorities borne by the taxpayer. Since the council was not responsible for the appeal to the Court of Appeal or the appeal to this House and since the appeal dealt with questions of general importance, no order for the council to pay the expenses of the auditor should be made.

LORD GRIFFITHS. My Lords, for the reasons given in the speech of my noble and learned friend, Lord Templeman, I would allow these appeals and restore the orders of the Divisional Court.

LORD ACKNER. My Lords,

The legality of interest swaps by local authorities

The determination of the issue—are interest swap transactions capable of being within the powers of local authorities—depends, in my judgment, on the answer to a single question—are interest swap transactions incidental to the borrowing powers conferred upon local authorities by statute?

So expressed, it emphasises that which I consider so important, namely, that the word "incidental" must be construed in its context and not in isolation.

The question is so formulated by reason of the provisions of section 111(1) and (3) of the Local Government Act 1972 which provide:

"(1) subject to the provisions of this Act . . . a local authority shall have power to do any thing (whether or not involving the . . . borrowing . . . of money . . .) which is . . . incidental to the discharge of any of their functions. (3) A local authority shall not by virtue of this section raise money, whether by means of . . .

A borrowing, except in accordance with the enactments relating to those matters."

Since section 111 is expressly made "subject to the provisions of this Act," regard must be had to the other provisions of the Act and in particular to section 172 which provides:

B "Part 1 of Schedule 13 to this Act shall have effect with respect to the powers of local authorities to borrow and lend money and with respect to their funds . . ."

I accept that "functions" in section 111(1) covers the powers and duties of the local authority under the various provisions of the Act. The function with which your Lordships are concerned is the power to borrow. Schedule 13 of the Act contains extremely detailed provisions C dealing with the powers of the local authority to borrow money. The Schedule provides a high degree of limitation and control of those powers. Part I of the Schedule in effect contains a detailed code as to the powers of local authorities to borrow and lend money. Paragraph 8 is of particular significance since it provides:

D "A local authority who borrow money under paragraph 1(*b*) above may during the fixed period borrow further sums, without the approval of the Secretary of State under that sub-paragraph, for the purpose of repaying the money so borrowed."

It would thus appear that "debt or interest management" has been narrowly confined. Given this *express* limited power then I would expect to find that any additional such power would also need to be E given in express terms in the statute. No such power is to be found.

The purpose and function of swap transactions is not to facilitate, to help, or to make more easy the discharge by the local authority of its function of borrowing. The original underlying debt or debts continue in existence and are all unaffected by the swap transactions. In many cases the swap transactions are entered into long after the underlying F borrowing and probably were not even in contemplation when such borrowing took place. The function and purpose of the swap transactions is to alleviate the consequences of borrowing by the local authority purchasing what has been conveniently called "a stream of income" or "a cash flow" which will enable it to reduce the nett cost of its borrowing. In the words of Mr. Sumption, appearing for Barclays Bank, interest swap transactions are "a risk mitigating activity." They G are designed not to meet any specific loss but to seek to ensure that the local authority pays as little interest on its loans as can be achieved. In this respect they are indistinguishable from any other transaction which involves the hope of gain, which gain is intended to reduce a risk attendant on an underlying transaction. Although the phrase "debt management" may be a convenient one, swap transactions in fact leave the debt wholly unmanaged.

H Even in the most limited form of "hedging" the swap transaction involves the local authority incurring the following risks. (1) That the movement of interest rates will be contrary to what is anticipated, with the result that the local authority will have wasted the transaction costs,

that is the money paid to its brokers for arranging the swap. (2) The credit risk that the opposite party to the transaction may default.

The "parallel" swap doctrine propounded by the Court of Appeal, which is not espoused by Mr. Sumption, if it were to provide an appropriate limitation on what would otherwise be very extensive powers, needs careful definition, which is not to be found in the Court of Appeal's judgment. There are frequent references in the judgment to the need for "a linkage" with a particular debt or a particular borrowing. How close this linkage must be, is nowhere stated.

I have found the position of building societies helpful. The Building Societies Act 1986 conferred on building societies a power, which did not previously exist, to enter into a limited category of swap transactions. Subsequently in the Order of 1988 Parliament radically extended this power. It was clearly Parliament's policy to proceed gradually with this new market so as to ensure adequate public protection. Parliament's concern to protect ratepayers from excessive borrowing or lending by local authorities is clearly demonstrated by the restrictions imposed by Schedule 13. To leave ratepayers unprotected from unlimited resort to the swap market would clearly run counter to this policy. This litigation demonstrates forcibly the considerable risks involved in these transactions, and how serious wrong decisions can be. Whether or not local authorities should be empowered to use this market raises important questions of policy. Parliament may or may not be satisfied that there is sufficient need to justify the risks involved even in limited hedging operations. The evidence before your Lordships was that 80–90 per cent. of local authority borrowing was achieved through the Public Works Loan Board at advantageous fixed interest rates. To "hedge" such borrowing with variable rate interest swaps would be to move from certainty to uncertainty. Whether or not power should be given to local authorities to engage in interest swaps and if so the nature of those swaps, involves a balancing operation—balancing the advantages against the risks in the light of the overall need for such activity. This is essentially a matter that should be left to Parliament, which, as with building societies, may wish to proceed, if at all, by stages.

I therefore conclude that swap transactions are essentially speculative methods of raising money in the hope of reducing the burden of interest payable on money already borrowed. They are a separate and distinct activity—a form of diversification. In view of the circumscribed power of borrowing conferred by the statute (see in particular Schedule 13, Part I of the Act) interest swap activities cannot be treated as incidental to the function of borrowing conferred upon local authorities by the Act.

Interim strategy

It is common ground that the power to carry out the interest swap activities involved in the interim strategy must be derived from the statute. Thus once again your Lordships are brought back to section 111. Once more an underlying function must be identified, to which the interim strategy activities were incidental. However on this occasion the underlying function cannot be the original borrowing. The interim

A strategy activities were clearly incidental to the initial ultra vires activities of unlawful interest swapping, since the purpose and function of the interim strategy activities was to mitigate the damage done by, or the risks outstanding arising from, the unlawful interest swaps. Where then is the lawful underlying function to be found?

Miss Gloster, who appeared on behalf of the banks, other than Barclays Bank, in her able argument suggested that this function arose:
B (a) under section 111 of the Local Government Act 1972 and was comprised in the duties of a local authority to hold and preserve ratepayers' funds. Even were I to assume, and I am not persuaded that it would be right to do so, that the obligation of a local authority to exercise proper care with regard to these activities is a function within the meaning of section 111, that obligation can only be discharged by
C lawful means; (b) under section 151 by reason of the local authority's duty to "make arrangements for the proper administration of their financial affairs. . . ." Section 151 is however concerned with administrative matters and once again I am not persuaded it provides any "function" within the meaning of section 111. However were it to do so, then in discharging its obligations and duties under this section, the local authority is only entitled to have resort to lawful, as opposed
D to unlawful activities.

Miss Gloster accepted that all the interim strategy activities took place in the swap market. Indeed this was a part of the strategy, since otherwise it might have been disclosed that there was considerable doubt about the legal validity of the earlier transactions. Although there were clearly different categories of swap activities involved, as a
E matter of principle they could not be differentiated for the purpose of deciding the lawfulness of the transactions. I therefore conclude that the only underlying activity to which the interim swap activities were incidental was the original ultra vires interest swaps. Accordingly they suffered likewise from the same stigma of being unlawful.

For the above reasons and for those set out so much more fully by my noble and learned friend, Lord Templeman, I too would dismiss
F these appeals and make the identical consequential orders.

Appeals allowed.
Respondent banks to pay the costs of auditor in Court of Appeal and in House of Lords.

G *Solicitors: A. A. Child; Herbert Smith; Clifford Chance; Linklaters & Paines.*

J. A. G.

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