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**Local Public Entities in Distress – An English Perspective**

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*Introduction*

This is arguably one of the most difficult times in history for local authorities around the world. Authorities in developed countries like the UK are no exception. Councils in the UK face issues that are common to all types of local entities, such as inflationary costs for the provision of essential services (particularly social care) and reduced transfers and tax collection abilities due to the current global economic recession. In addition, they face unique challenges. These include increasing costs to service the commercial debt they had been encouraged to take in previous years, a dwindling and aging population, and increased demands of essential services from a more vulnerable population.

Building on a study funded by INSOL International and recently published in the [INSOL International Technical Library](https://insol.azureedge.net/cmsstorage/insol/media/document-library/books/when-liquidation-is-not-an-option-a-global-study-on-the-treatment-of-local-public-entities-in-distress.pdf?utm_campaign=1259736_LPEs%20Book&utm_medium=email&utm_source=INSOL%20International&dm_i=4WAM,R00O,4HZCIK,3C0KS,1), we discuss the treatment of financially distressed English authorities. The purpose of this short Inside Story is to uncover the causes of municipal failures, assess the remedies available under the law and discuss whether regulatory changes are needed to improve the *status quo*.

*Why Do Councils Fail?*

The short answer is: for a lot of reasons, and quite frequently for more than one reason. However, the recent experience of financially distressed local entities suggests that at least three triggering factors are recurring.

The first one is malpractice, and it is exemplified by the case of Liverpool. [In November 2022](https://www.publicfinance.co.uk/news/2022/11/finance-commissioner-appointed-liverpool?utm_source=Adestra&utm_medium=email&utm_term=), Rt. Hon. Michael Gove, Secretary of State for Levelling Up, Housing and Communities and Minister for Intergovernmental Relations, appointed a financial commissioner at Liverpool to oversee the council’s dire financial situation. This appointment follows a second critical [commissioners’ report](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1099138/100622_LCC_Commissioners_SoS_Second_Report.pdf). These commissioners were appointed in 2021 after an emergency inspection found a “serious breakdown of governance” and multiple failures to provide best value to taxpayers in the city. The inspection was triggered by the [arrest of the city mayor and other top civil officers](https://www.publicfinance.co.uk/news/2020/12/liverpool-mayor-arrested-bribery-probe) (December 2020) as part of a police investigation into allegations of fraud, bribery, corruption and misconduct in public office. Unfortunately, it does not seem that the changes introduced since 2021 have resulted in a marked improvement of the financial situation of the council. In October 2021, shortly after appointment, the commissioners [reported](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1035804/First_Report_on_Liverpool_Intervention.pdf) that Liverpool faced a £33m shortfall for the 2022-23 budget. By the time of the second report in June 2022, this figure had increased to £98.5m to 2025-26, thus justifying the urgent appointment of a financial commissioner.

The second “triggering factor” is poor governance. Poor governance and accountability are common elements in almost all the recent cases of distressed councils in the UK. However, they were probably the determining factors for some of the best-known municipal fallouts in recent times, such as Croydon and Nottingham.

The London Borough of Croydon – whose case was analysed in detail in a [report from the Housing, Communities and Local Government Committee](https://committees.parliament.uk/publications/6777/documents/72117/default/) – issued a section 114 notice (more on this in the next section) in 2020-21 after it emerged the authority was unable to balance its budget, effectively declaring itself bankrupt. A [public interest report](https://www.croydon.gov.uk/sites/default/files/2021-03/Report%20in%20the%20Public%20Interest%20-%20London%20Borough%20of%20Croydon.pdf) from the council’s external auditors (October 2020) highlighted that the council reported significant overspend in areas such as children’s and adult social care. However, the same report questioned the use of the flexibility granted by the government to deal with these issues. Finally, the report argued that the main factor for the council’s financial demise was its excessive corporate borrowing, which led the council to invest in under-performing companies and exposed future generations of taxpayers to significant financial risk. As a result of its financial difficulties, following a complete overhaul of its corporate structure, Croydon has received two capitalisation directions of £75m in 2020-21 and £50m in 2021-22 allowing the use of capital resources for revenue spending to cover budget deficits. Despite this, Croydon has received minded approval for a third direction in 2022-23 worth £25m.

The case of Nottingham is somehow similar to that of Croydon. The issues in the city became public knowledge after the council’s external auditors issued a [public interest report](https://www.nottinghamcity.gov.uk/media/2835756/report-in-the-public-interest-rhe.pdf) (August 2020). The report raised concerns on how a wholly-owned subsidiary of the council, Robin Hood Energy, was being run, and the lack of financial information shared with the external auditors and the council itself. This report was followed by the government’s appointment of an improvement and assurance panel (November 2020) and finally by the council being forced to issue a section 114 notice in December 2021 after it emerged that the authority unlawfully used funding earmarked for its housing on revenue spending.

Finally, the third triggering factor is failure in commercial investments. Several councils are struggling financially to either refinance or service their commercial debt, especially at a time of rising interest rates. Some of them, such as Slough and Thurrock, failed in their efforts to avert external intervention and “bankruptcy”.

The case of Slough hit the news in July 2021, when its [CFO issued a section 114 notice](https://www.publicfinance.co.uk/news/2021/07/finance-director-praised-over-section-114-notice) after some failed attempts to recapitalise the borough with funds from the government and financial investors. This procedure has led to the [sale of most of its properties and assets](https://www.publicfinance.co.uk/news/2022/05/slough-urged-sell-most-its-properties) at a loss – some of them bought just a few years before in an attempt to diversify and increase the revenue capacity generation of the authority.

This case shares some similarities with the demise of Thurrock. In May 2020, [a major investigation from the *Financial Times*](https://www.ft.com/content/7a01b39d-a5df-4e3f-b9a6-dfcf9339368f)unveiled that Thurrock, a local authority in Essex, borrowed almost £1bn from 150 other UK local authorities and pension schemes to fund its renewable energy assets. However, the case did not result in governmental actions until recently, partly due to the Covid-19 pandemic. Only in September 2022, the [government](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1102258/Thurrock_-__Letter_to_Thurrock_Chief_Executive.pdf) exercised its powers under [section 15(11) of the Local Government Act 1999](https://www.legislation.gov.uk/ukpga/1999/27/section/15) to nominate Essex County Council as a commissioner for Thurrock, due to the scale of the financial and commercial risks potentially facing the authority and the lack of proper, timely and radical intervention from the council. This intervention was shortly after followed by an [authorisation to borrow](https://www.publicfinance.co.uk/news/2022/10/thurrock-allowed-borrow-ps840m-help-pay-massive-debts) almost £840m from the [Public Works Loan Board](https://www.dmo.gov.uk/responsibilities/local-authority-lending/about-pwlb-lending/) (PWLB) – a body attached to the Treasury that funds councils’ infrastructure spending – to refinance some of the loans taken from other UK local authorities.

Slough and Thurrock are not isolated cases. Local authorities such as [Spelthorne](https://www.thetimes.co.uk/article/how-councils-blew-200-million-of-local-taxpayers-money-on-property-speculation-n2tkbzhz2) in Surrey have borrowed heavily from the PWLB to offset the cuts in direct transfers from the central government. The issue is that if and when these investments fail – a circumstance that is rendered more likely by the lack of commercial and financial expertise in the councillors running these entities – local and national taxpayers are left to deal with the huge financial consequences of these failed entrepreneurial activities.

*What Are the Remedies Available to Financially Distressed Councils?*

The general approach followed by English law is to provide a series of mechanisms to local authorities to deal with financial difficulties before they become insolvent. These preventive restructuring measures include reducing costs, sharing services with other local authorities, and mergers between local authorities. It is also possible for councils to rely on loans from PWLB, bonds, and loans, as well as raising local taxes.[[1]](#footnote-1) Should these measures fail, the framework for dealing with councils in financial distress is outlined by the Local Government Finance Act 1988 and the Local Government Act 1999. The key figures are the CFO of the local authority and the Secretary of State.

Uniquely across the public sector, CFOs have the power and legal responsibility to suspend a local authority’s spending for a period of time if they consider the council not to have a balanced budget or if there is an imminent prospect of default. In serious cases of financial distress, CFOs have a more general power to stop a local authority from entering into new transactions and performing some of the existing ones. This power is granted by [section 114(3) of the Local Government Finance Act 1988](https://www.legislation.gov.uk/ukpga/1988/41/section/114) (“section 114 notice”).

CFOs will only issue such a notice if they have formed the view that future expenses are out of control, to the point that the local authority to which they are appointed is likely to end the financial year with a budget deficit and that it is impossible to broker a solution without issuing a section 114 notice.

It is quite likely that the procedure will result in the appointment of new independent commissioners for the local authority in debt. Newly-appointed independent commissioners will deal with a local authority’s financial distress without liquidating it as, under English law, local authorities cannot be liquidated. They can only be rescued. Local authorities cannot be subject to other debt resolution mechanisms (for example, state oversight, active supervision, or financial assistance from other authorities) apart from those outlined in this section.

*What Else Can Be Done?*

Section 114 notices are late warning signals. The consequences of issuing such notices are severe for the councils that issue them. All but essential expenses are frozen, and councils may be forced to merge with neighbouring ones; for instance, Northamptonshire councils were forced to [merger in two unitary authorities](https://www.publicfinance.co.uk/news/2019/05/northamptonshire-councils-be-merged) in 2018.

The harshness of the consequences associated with section 114 notices have been designed to push councils to take timely decisions to avoid experiencing serious financial pressures. Yet, the changed policy and funding environment described in this paper coupled with a lack of expert auditors to supervise a council’s activities may lead to local authorities experiencing serious financial difficulties. If this happens, the consequences for councils, their workers, the services they provide and their existing procurement contracts are draconian.

This punitive approach towards failure has no equivalent in the English corporate or personal insolvency law framework, and it lacks proper theoretical justification. As mentioned in our paper submitted to INSOL International, reforms aimed at supporting local authorities experiencing financial difficulties, rather than punishing them for being indebted, are needed to realign the treatment of local public entities in distress with the rest of the English insolvency framework.

The UK’s legislative framework for dealing with local authorities in distress is inadequate. No day passes without news that other councils are likely to issue a section 114 notice – see, for instance, the recent [warning about the Tory-run councils of Kent and Hampshire](https://www.theguardian.com/society/2022/nov/14/two-tory-run-councils-warns-pm-of-possible-bankruptcy). These procedures have lasting impacts on local taxpayers and, especially, on vulnerable citizens. We believe that the time is ripe to discuss the implementation of a more mature, comprehensive framework aimed at addressing the causes of municipal failures. This framework should result in the implementation of an alert, modular system designed to take prudent fiscal measures at the first signs of crisis, without necessarily resulting in the displacement of the council’s existing management.

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1. For a clear outline of the preventive restructuring solutions, see Nick Gavin-Brown, “Restructuring Options for UK Local Authorities” (20 August 2018), available at: <<https://www.pinsentmasons.com/out-law/analysis/restructuring-options-uk-local-authorities>>. [↑](#footnote-ref-1)