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RUSSELL-COOKE | SOLICITORS

Event report

UNDERSTANDING INSOLVENCY

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Russell-Cooke Solicitors

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It is a sad fact that funders these days find themselves up close to voluntary and community organisations facing closure for involuntary reasons, i.e. becoming insolvent and being obliged to cease operations. This two-hour seminar offered essential background and information to help funders understand the trail that can lead to insolvency and spot the points where there might be some way of helping in a survival strategy or at least an orderly closure – the warning signs, practical steps that reduce risk, points where turnaround or rescue can kick in, the order of events where it cannot, and what can happen to a funder’s money or the services and intellectual property it has funded.

Andrew Studd, Partner at Russell-Cooke Solicitors, and Ian Oakley-Smith, Director and Insolvency Practitioner at Pricewaterhouse-Coopers, kindly offered their expertise in a session tailored for funders. [Summary slides are available on London Funders website [here](#)]

Andrew noted some current trends in funding which can prove hazardous for the voluntary and community sector (VCS): continued tightening of government spending; increasing size of contracts and the move to payment by results; aggressive contract procurement; falls in individual and corporate giving and in foundation income; low interest rates and no or low growth.

In addition, the combination of public expenditure shrinkage and significant changes in, for example, social security and housing-related benefits has increased demand for many VCS services. Funders attending this event included London borough grantmakers and commissioners and people from a variety of independent funders. All wanted to understand the process of insolvency at a number of different levels:

- which are the most appropriate mechanisms for groups to use at a time of crisis?
- are there early warning signs that should be triggers for action to avoid the risk of closure?
- are there ways of assisting funded organisations to avoid closure further down the line?
- can specific areas of funded work be preserved if things go wrong for an organisation?
- in what circumstances can money be clawed back?
- are there precautionary measures to be taken in adapting future contracts for funding?

Our speakers noted many actions that can help a group avoid a crisis or, if closure proves unavoidable, how to make a “tidy” transition, e.g. preserving elements of their services in some way. If there is time, these can include mergers, income diversification, renewed fundraising, restructuring, staff contract changes and redundancy, and project closure or transfer. All of

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these need time, most at least six months, so an organisation's realistic awareness of its current financial situation at all times is critical.

One of the elements in this is an assessment of liabilities (the time needed to end a lease and thus rent commitments; terms in a lease on the condition of premises when handed back to the landlord; whether some grants could be clawed back; restructuring/ redundancy costs, pensions liabilities and more).

Another is trustees' understanding of their own duties and responsibilities. Even for those organisations with a structure where liability is limited, trustees making inappropriate decisions, failing to act or continuing to trade without taking into account the interests of creditors can be held personally liable to make a contribution.

There are two main tests for insolvency:

The **cash flow, short term liquidity or going concern** test where an organisation cannot pay its debts when they fall due, or is unable to do so within the foreseeable future.

The **balance sheet test** where total assets are less than total liabilities (taking into account current and contingent liabilities and prospective liabilities). If liabilities are not likely to be crystallised, then a charity can in these circumstances discount these liabilities for the purpose of the assessment.

It is vitally important that an organisation learns how to recognise the point of insolvency: staff and trustees need to review the current balance sheet (with emphasis on the word "current", not information six months old); understand contingent liabilities; budget well for future income and expenditure and use forecasting to analyse different future scenarios, anticipating how they would manage if optimistic assumptions about income are not realised. "The better the information, the better the decisions".

If staff and trustees are equipped with up to date information (and funders cannot emphasise enough to applicants that they need to maintain cash flow analysis in these tough times), and potential insolvency is looming, then there are questions for trustees to ask: in the going concern test, the question is whether the charity is going to run out of cash and can this be funded? The balance sheet test asks what the likely position on a cessation/ winding down would be - whether the position is likely to worsen, whether a return to solvency is possible and, if so, over what period and what risks remain. At this stage, trustees need a robust turnaround plan and it is also the point at which a funder could assist, given a shrewd assessment of the situation, and help buy the organisation some time and turn the corner.

A key issue for funders at this point can be around restricted funds and the risk that these might be "borrowed" for other purposes and lost for their intended purpose. Grant documentation may not always be clear and failure to comply with the terms can give rise to a risk of breach of trust. Professional advice may be needed to ensure restrictions are clear and unambiguous.

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In the midst of a crisis it can be hard for the organisation to recognise the point of insolvency: Ian shared the “corporate demise curve” © which shows with clarity the point where trustees lose control of the situation as problems hit. There is a point when the move into insolvency gathers speed. Advisers and funders can assist so long as trustees retain control of their situation.

How can trustees and staff reduce risk of their organisation’s insolvency?

- robust and current financial information
- external advice from a solicitor, auditor or insolvency practitioner (whether advice is sought and taken can be a factor in a later decision about whether trustees acted reasonably). Trustees taking advice will be best supported by a professional who understands the charity sector as well as insolvency
- regular board meetings (maybe more frequent than normal to respond to the crisis) and with written minutes that record the grounds for decisions (not verbatim reports but sufficient to see what factors were taken into account).
- avoid incurring additional creditors (when wrongful trading could result)
- negotiate new repayment terms for loans and other liabilities
- formulate a plan

Once insolvency is a reality, trustees’ duties change radically from advancing the objects of the charitable company to owing a duty to act in the best interests of the creditors (and not the objects or the members). It is therefore very important to find ways to put off this pivotal moment and aim to extend the “twilight” period when turnaround or rescue is still possible. It should be noted that acting in the interests of creditors does not mean an automatic cessation of the business.

Trustees can use a straightforward test to see how prudent their decisions are: what would they do if it were their money? Where possible, they are well advised to communicate with their major creditors, not least because those creditors may be willing to help in some way. The best advice is for trustees to make full use of all the time they have, and especially to start addressing issues as soon as they are aware of them and make time available right through the process. So much more can be accomplished positively if guidance and action are taken as carefully and as promptly as possible.

Ian noted too that in this rather complex period, staff and trustees need to understand all the options available to them and set them running as soon as they can, not tackle them as a series of separate steps: timing is critical so overlapping action on options will be needed. For example, an organisation should start simultaneously to find ways of increasing income and streamlining costs. Options for structural change could be collaboration, merger or restructuring (e.g. shedding projects, or shrinking the staff group) but again, all need to be explored at the same time, not sequentially.

“Once insolvency is a reality, trustees’ duties change radically”

“...timing is critical so overlapping action on options will be needed”

Trustees need to be aware of their responsibilities and personal liability (an area that needs attention at all times, of course, rather than only in an emergency). Of importance, however, is that trustees/ directors need to take every reasonable step to minimise the loss to creditors and to act appropriately as soon as it is evident that the organisation might become insolvent. This can include maintaining activities, if continuing to operate will improve the cash or balance sheet position.

There are areas of special consideration when implementing a plan to reorganise or restructure, e.g. care being needed to avoid any favouritism towards specific creditors or transfers at an undervalue. For example, if as part of a reorganisation of services certain contracts are to be transferred to a third party, then a liquidator may expect a value to be assigned to contracts which generate a surplus. This can be difficult for charities to value compared with commercial companies able to value commercial goodwill, so professional advice may be helpful.

The ideal, of course, is for the turnaround to result in a revived and more manageable organisation; a merger to create a more viable organisation; or a solvent closure – i.e. an orderly closure where some services and resources are passed on to other organisations. Funders could have a role in all of these options: organisations in difficulty are well advised to alert funders at an early stage and to ask for supportive intervention well before the funder could be forced to exercise legal rights to clawback.

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If these possibilities fail, the insolvency process options are:

- liquidation (which irrevocably means winding up the organisation)
- formal arrangements which can be a S.425 Scheme of Arrangement (useful where there is a “long tail” of liabilities), or a **company voluntary arrangement** (CVA). There were some 600 CVAs in the last year and these allow for part payment to creditors – if 75% by value of those creditors who vote agree to the arrangement the CVA must be applied.
- receivership (fixed charge or administrative receivership), or
- **administration**: this is currently the most typical route, and allows an organisation to carry on its activities. It provides a breathing space as it stops creditors acting while a plan is developed. Administration can avoid liquidation or it can lead to a CVA.

In discussion

There was a query about whether advisers and funders were seeing organisations preserving services by **packaging up parts of their work** and finding other agencies to take these on, looking for relevant organisations by geographic or thematic area or finding similar services run elsewhere. There seemed to be the beginnings of a trend. This is a helpful crossover from business practice where it is more prevalent. It can be a simpler and less costly approach than trying to broker a full-scale merger.

The idea of a funder helping by **buying time** seems positive but how can a funder avoid sending good money after bad? There's no simple answer to this – each case needs careful analysis and the quality and immediacy of financial and management information from the organisation under scrutiny is very important. Where the funder needs to make a decision about clawing back, for example, capital assets, it is highly likely that they may prefer to find a way of securing property for the purpose intended, albeit run by a different organisation, rather than claw back funding. There may be scope for sharing some real examples in detail between funders.

Pension liabilities are in everyone's mind since the closure of People Can, essentially triggered by the crystallising of long term commitments to the staff in the scheme. The Charity Commission offers some guidance on defined benefit pension schemes [here](#).

There was more discussion on the stage **when the interests of creditors becomes paramount**. At that point, how could a funder help if their money might just go to creditors rather than the work itself? There are opportunities to help before insolvency is inevitable. For example, a funder might be able to support wages specifically and help preserve the going concern status of the organisation long enough to avert crisis.

Payment by results: what happens to these contracts in an insolvency situation? In accounting terms, expenditure is shown as recoverable and income is assumed. The arrangement would need to be disclosed in any planning for recovery or closure and the risk assessed for work not being completed.

All of the solutions discussed depend on the organisation in trouble **keeping its funders informed** but this of course is not always what happens and the first a funder might discover is that an organisation has disappeared. The organisation has a responsibility to inform a named contact in each financial relationship. If liquidation is enforced through the courts (where a government official is appointed as a default liquidator) then the funder could appeal to them to recover the unspent portion of their funds. Lenders in particular are advised to talk to experienced advisers (i.e. professional advisers who know the charity field well) as they become aware of problems arising.

Participants shared experience of different situations and often the problem was that hard-pressed organisations failed to ask funders to review the situation at an **early enough stage**. Increasingly it is seen as important to spell this out with groups at the start of funding. At the same time, funders may be becoming more reluctant to take risks with groups. The lack of strong finance and management skills, especially in smaller groups, was noted. The Arts Council is known to have become quite interventionist to protect the value of its investment in projects, services and buildings: they have an insolvency practitioner on the staff and there are instances of their paying for insolvency advice for funded organisations.

“The lack of strong finance and management skills, especially in smaller groups....”

Sources of information

Charity Commission, Managing Financial Difficulties and Insolvency in Charities (CC12): [here](#)

Charity Finance Group (CFG)/ Institute of Fundraising: [Managing in a downturn](#)

CFG's Insolvency helpline: www.cfg.org.uk/resources/insolvency-helpline.aspx

NCVO, online guidance on how to recognise and avoid financial difficulties: [here](#)

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Attendance

Sally-Ann Bell, BBC Children in Need

Jaishree Mistry, Charity Bank

Jemma Grieve Combes, The City Bridge Trust

Sophie Hulm, City of London Corporation

Hajra Daly, Comic Relief

Ian Beason, Community Development Foundation

Amanda Tincknell, The Cranfield Trust

Jane Stancliffe, Heritage Lottery Fund

Samantha Rennie, Homeless Link

Cathryn Pender, John Lyon's Charity

Simrit Sandhu, Local Trust

Reehan Mirza, London Borough of Brent

Ann Wynne, London Borough of Camden

Lola Akindoyin, London Borough of Hackney

Áine Hayes, London Borough of Hounslow

Joanna Eve, London Borough of Islington

Sandra Jones, London Borough of Lewisham

Melissa Watson, London Borough of Richmond upon Thames

Andrew Matheson, London Borough of Southwark

Marina Svistak, New Philanthropy Capital

Gülten Fedayi, Royal Borough of Greenwich

Lucy Ashall, Royal Borough of Kensington & Chelsea

Gordon Muir, The Social Investment Business

Lekan Ojumu, sported

Catriona Slorach, The Tudor Trust

Bas Ahsan, United St Saviour's Charity

Gaynor Humphreys, London Funders

Sharon Reid, London Funders