



Insolvency Issues

Charities - challenging times ahead

With the ongoing difficult financial conditions and the implementation of austerity measures, charities whose fortunes are tied to the public sector can expect more turbulent and challenging times ahead.

A recent survey carried out by the National Council for Voluntary Organisations suggests that the 'perfect storm' that hit charities over the past few months (falling income, higher costs, higher levels of demand from beneficiaries) is still a real issue. The majority of organisations saw their financial position worsen last year and expect it to get even worse over the next year; and almost all still think the economic conditions facing charities will be negative for the next twelve

months. Despite this, the survey finds signs of some confidence in that charities expect to maintain or increase the services they provide over the next quarter despite decreasing or static expenditure.

Charities who have prepared for these ongoing tough economic conditions and have acted decisively may find themselves better placed to weather the storm. Unfortunately, however, despite cutting jobs and costs there will still be charities facing insolvency. In an insolvent situation it becomes the responsibility of the Trustees to put the interests of creditors ahead of the charity itself and seek professional advice, most likely from an Insolvency Practitioner.

We give a recent example of an innovative solution utilised by the Restructuring and Insolvency team at Mercer & Hole to rescue a charity and avoid disruption for 300 vulnerable people.



Charity Rescue – a case study

The charity was already being turned around.

A variety of issues had been addressed, not least those relating to financial information and cost management. There was even a fall-back plan, but the trustees were still concerned about the risks of insolvency. Rightly so as it happened.

Substantial ongoing losses on one major contract were the biggest threat: the charity had underpriced its services. Then the takeover bidder withdrew. Mercer & Hole's first workstream, a solvency analysis for the board, established that without the takeover safety net there was no reasonable prospect of avoiding formal insolvency.

So far this is not an uncommon distressed business scenario, but let's consider the specific and sometimes unusual features of the case. As a charity, the entity was not untypical in

having a wholly non-executive board (the trustees), but both the CEO and the Finance Director worked part time. Also this was not a registered charity or a company registered under the Companies Act: it was an Industrial and Provident Society, giving a very different legal framework for restructuring and insolvency.

Critically, the Industrial and Provident Societies Act 1965 and related legislation makes no provision for the members to meet or act on short notice unless specifically allowed by the society's rules, which in this case required a minimum of 14 clear days' notice for a members' resolution. Also, and most significantly, only those parts of the Insolvency Act relating to liquidation apply to an Industrial and Provident Society. So, there could be no CVA or administration rescue here¹, and there were no charges enabling the appointment of a receiver and manager.

Now for some statistics. The charity was turning over £11m p.a., employing almost 400 staff to provide care to over 300 vulnerable people in over 40 various residential settings in five local authority areas. Its net liabilities of £1m and the ongoing losses of £¼m p.a. would be dwarfed by the contingent claims crystallising on abrupt cessation of activity.

A smooth – and swift – transition to alternative care provision for the vulnerable people being cared for, often 24/7, was vital. And, of course, the reputational risk attaching to all those involved in maintaining (or not) such care heightened anxiety. Fortunately, therein lay part of the solution. The care service was in essence an outsourced statutory responsibility of the local authorities. Not only did they share the reputational risk but, given the charity's insolvency, they bore much of the financial risk in the event of its failure.

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Against that backdrop we advised the trustees to implement a three-pronged strategy. Stakeholder management was central, both to maintain stability during the crisis and to bring together the participants who would at least avoid care disruption, if not save the charity. There also needed to be a mechanism for formal insolvency. And finally, we conceived a bold plan to go back into the market to seek to sell the society, as a whole entity, in the days before liquidation, failing which we would at least give ourselves a head start on liquidating the assets.

At this stage, our best guess as to outcome was some form of partial pre-pack liquidation, but let's look at the three aspects of strategy separately.

The constitutional challenges outlined above, together with the urgency the situation demanded, meant that a creditors' voluntary liquidation (possibly using the accelerated Centrebind procedure) was not an option: we could not wait for the 14 clear days' notice required before passing a members' resolution. The board could however petition the court to wind up the charity compulsorily. We thought we should be able to persuade the court to appoint provisional liquidators immediately to effect an appropriate transaction, all with a view to maintaining care services through the charity or otherwise and thereby maximising the potential return to creditors. Fortunately, counsel agreed and the applications were prepared. Having identified a fairly abrupt insolvency mechanism, of which we

were in control (not least because the provisional liquidators' powers were likely to be – only – what we applied for), we were well placed to start dangling stakeholders over the insolvency precipice, in the nicest possible way. We just didn't have time for protracted debate. People had to realise that there had to be a quick solution.

One particular challenge we faced was that the charity and the local authority with the loss-making contract had such a poor relationship that there was no meaningful high level communication between them. To break the impasse we used a PR house and had a journalist contact the authority, whilst the charity set out its position in writing, emailed and hand delivered to all the relevant councillors and local MPs, explaining what was required. It worked and within 48 hours we were meeting with the local authority's Deputy Chief Executive, engaging in constructive planning and determining what the art of the possible was in the challenging circumstances they had to address.

The accelerated M&A play was attractive to the local authorities because it offered a glimpse of the solution that would involve them in least pain. They were very keen to introduce their other service providers, generating a total of 25 expressions of interest, that were narrowed down within a week to a handful of bids for all or part.

At this stage the stakeholder management proved its worth as we were able to persuade two of

the major local authorities to be sufficiently concessionary to the final bidder to enable the risks inherent in the acquisition of an insolvent and loss-making entity to be mitigated sufficiently to meet the bidder's strategic objectives.

The result was that within three weeks and with absolutely no disruption to the 300 vulnerable people and their carers, the charity's shares were sold for £1 and it continues under new ownership and management. Formal insolvency proceedings were not necessary, although they were less than 48 hours away at one point. Managing the stakeholders was crucial, but so too was a well prepared insolvency plan and the ability to promote and execute an accelerated distressed M&A transaction.

Dealing with insolvent charities can be a complex matter as demonstrated by our case study.

Early intervention by the Trustees, which should include seeking professional advice, is critical. The Trustees should be mindful of their responsibilities and duties to employees, stakeholders and creditors, as well as their own personal positions.

If you would like us to provide you with any help, guidance or assistance in dealing with a charity in financial difficulty, then please contact us on **01727 869141**.

** If we'd been in Northern Ireland, the relevant secondary legislation has been introduced to allow administrations and CVAs, but not yet elsewhere in the UK!*

About Mercer & Hole

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Our personal, partner-led service extends far beyond the UK, as Mercer & Hole is a founding member of TIAG (The International Accounting Group), a global alliance of high quality, independent accounting firms, which has more than 100 member firms based in over 60 countries. We use the Group, or its sister network, TAGLaw, whose members include over 150 law firms based in nearly 100 countries, at least once a week responding to both the business and personal issues of our clients.

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