Financial difficulties: considerations for charities

Charities are facing unique financial challenges.

Simon Steeden and **Livia Cullens** summarise the warning signs and advise how to respond.

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Whether influenced by unique global factors (like the coronavirus pandemic), a loss of funding, unexpected expenditure or otherwise, charities, like other organisations, are vulnerable to financial difficulties. By having an awareness of the warning signs and how to respond, boards can ensure that they are in a position to navigate the organisation through these difficulties, while complying with their legal duties.

Legal form

It is vital to know whether an organisation is incorporated or not. The board of an unincorporated organisation may well be personally liable for its debts. An incorporated structure, on the other hand, has its own 'legal personality' and therefore its own debts and liabilities.

Warning signs

In normal circumstances, it is unusual for an organisation to deteriorate immediately from being in a financially healthy position to being in serious distress – insolvency or the need to wind up the organisation will typically follow a longer period of financial decline.

By way of example, an organisation may first notice broad underperformance, leading to the board having to reduce costs or – if those are insufficient to plug the gap – undertake broader organisational restructuring. It may then look at financial restructuring, including negotiating with creditors. As a last resort the organisation may have to consider winding up.

Boards should be alert to any preliminary warning signs that finances are taking a downturn – for example, the organisation owing increased amounts to suppliers, or decreasing income compared with the organisation's budget – and act accordingly.

The coronavirus pandemic has brought unique challenges, with many organisations seeing a dramatic change in their financial position in a very short space of time. This means that boards need to be particularly alert to warning signs and be prepared to act very quickly.

Trustees/directors should be equipped with all financial information necessary to take fully-informed decisions. The outcome of any decision making (and the rationale behind it) must be properly recorded. The board should formulate a crisis plan and update it as circumstances change. Other useful tools include a statement of affairs, cash-flow forecast and risk analysis.

Insolvency – charitable companies and charitable incorporated organisations (CIOs)

The boards of charitable companies and CIOs need to be aware of the point at which their charity is at risk of insolvency. The Insolvency Act 1986 provides two tests for solvency for these organisations:

- **The balance sheet test:** A charitable company or CIO is solvent if the value of its assets exceeds its liabilities. Liabilities must include any contingent or prospective liabilities.
- **The cash-flow test:** A charitable company or CIO is solvent if it can pay its debts as they fall due. If it does not have enough cash to pay its creditors on time, then it will be insolvent.

If the charitable company or CIO fails either of these tests it is insolvent. There is a significant change in the board's duties on insolvency.

For example, for as long as a charitable company or CIO is solvent, its trustees must safeguard any assets in order to further the purposes of the charity and must ensure that they are, among other things: acting in the best interests of the charity; managing the charity's resources responsibly; complying with the charity's governing document and the law; acting with reasonable care and skill; and ensuring that the charity remains accountable.

If insolvent, boards of charitable companies or CIOs should avoid:

Wrongful trading
The board must ensure that the organisation does not continue incurring credit at a time when they knew or ought to have known that there was no reasonable prospect of the organisation avoiding being wound up insolvent. The consequence of wrongful trading is that the board could be required to contribute personally to the organisation's liabilities.

Note, however, that it is expected that the Corporate Insolvency and Governance Bill 2020, which is passing through Parliament at the time of writing, will diminish the threat of personal liability should the organisation ultimately fail to avoid an insolvency procedure. Liquidators and administrators will not be able to take account of any losses incurred during the period from 1 March to 30 June in any wrongful trading action that might be brought against the board. Please check our **coronavirus hub** for the latest on the status of the legislation.

Preferring some creditors over others
Boards must not prefer one creditor over another. However, an organisation could continue to pay a creditor whose support is vital to the organisation's survival. The organisation can also pay for professional advice relating to the situation.

Transactions at an undervalue
If the board sells the organisation's assets for less than they are worth or for no consideration to the detriment of creditors, this will be considered a transaction at an undervalue.

The consequence of making a preference or entering into a transaction at an undervalue is that the liquidator or the administrator can apply to the court to have the transaction set aside.

Fraudulent trading
Trustees/directors also need to ensure that they do not engage in fraudulent trading – deliberately defrauding creditors. Fraudulent trading is a criminal offence, as well as carrying civil liability.

If the charitable company or CIO becomes insolvent, the duties of the trustees may change: trustees are no longer holding charity money but, instead, dealing with creditors' money. This means that their first and primary duty may now be to the charity's creditors. In this case, the trustees' main aim is that of improving the creditors' situation (or, at the very least, stopping it from worsening).

A board reaching this point would be strongly advised to take professional advice. This will help them explore the options and plan a way forward.

Role of the Charity Commission

Charity boards also need to be aware of when to inform the Charity Commission of any difficulties. For instance, where financial issues stem from a 'serious incident' in the charity – such as a loss of the charity's assets, or damage to the charity's reputation that results in a loss of income – the trustees should consider whether a serious incident report ('SIR') should be made to the commission. Further information on this can be found in the commission's SIR guidance and the article on page 20 of this update.

The Charity Commission also has useful guidance for charities facing financial difficulties that can be circulated to trustees to assist in informing or guiding any discussions. There is bespoke guidance relating to financial difficulties caused by coronavirus which includes guidance on when a serious incident report may be required.

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FIND OUT MORE

Our experience is that prompt professional advice can make a significant difference to an organisation facing financial problems, particularly where insolvency is a risk. Please get in touch with your usual Bates Wells contact for more information about the issues in this article.

See our coronavirus guide to charity insolvency and rescue mechanisms here **https://bateswells.co.uk/2020/03/charity-insolvency-and-rescue-mechanisms-a-coronavirus-guide/**

See our latest update on the Corporate Insolvency and Governance Bill 2020 **https://bateswells.co.uk/2020/05/corporate-insolvency-and-governance-bill-2020/?hub=coronavirus**