Charity Governance and Solvency: A Coronavirus Guide

This is a quick guide for charity trustees concerned about solvency and wondering how to approach it in the immediate crisis caused by the coronavirus shutdown.

1. Legal form matters - insolvency and personal liability

1.1 Charities fall into two broad types of legal structure:

1.1.1 Corporate charities such as companies limited by guarantee, charitable incorporated organisations, royal charter bodies, statutory corporations and community benefit societies.

1.1.2 Unincorporated charities, namely trusts and unincorporated associations.

1.2 The difference is vital in the case of insolvency; a corporate charity is a legal 'person' and has its own debts and liabilities. Its trustees will not be personally liable for the charity's debts unless they behave in any of the ways described in paragraph 6 below. Unincorporated charities are not legal persons and so the debts of the charity are the debts of the people who incurred them – the trustees. If there is not enough money in the charity to pay the debts, the trustees may be personally liable.

1.3 Most of what is said in this brief guide about managing solvency applies to all types of charity but the personal liability stakes are much higher for trustees of unincorporated charities.

2. Insurance

2.1 Although liability to creditors is different for corporate and unincorporated charity trustees, liability to the charity itself for breach of duty is the same; all trustees owe fiduciary duties to their charities.

2.2 Trustees will want to be reassured that, when they are taking difficult decisions, they are covered by trustee indemnity insurance. Check what the charity's insurance policy covers, that the premium has been paid, and that you have reported (and continue to report) candidly to the insurer as required by the policy.

3. Governance

3.1 Create a crisis team to lead the way. If you have a large board, planning cannot be done effectively with all trustees closely involved and the full board will not be able to grapple with all the detail quickly enough to reach quick decisions. Not all decisions can or should be made quickly but be sure that some will need to be.

3.2 Board meetings need to become more regular (probably at least weekly for many organisations) and those meetings need to be presented with clear options, recommendations and reasoning in order to make their decisions. That is the job of the crisis team. Trying to manage complex and fast moving issues over video or telephone conferences is otherwise too difficult.

3.3 The crisis team will be closer to the detail and will have had much more time to form opinions. Steps and outcomes may appear more obvious to the team than to other trustees because their thinking is further ahead. This can be difficult for the Chair to manage, especially as very hard decisions may need to be taken in relation to staff, beneficiaries and services, and resistance may, quite naturally, be strong. Also, emotions may be running high.

3.4 If you are unsure about how you can hold board meetings, please see our separate guide here: https://bateswells.co.uk/2020/03/charity-trustee-meetings-a-coronavirus-guide/

3.5 Minute meetings carefully. See the above guide.

3.6 Not every decision you take will be taken at a board meeting. Keep a short diary each day reminding yourself of the important decisions taken and the reasons why. You might find this very useful later.

3.7 Overall, remember that while your charity is solvent, your duty is to act in the way you consider, in good faith, most likely to achieve the purposes of the charity. In doing that, you are expected to act with reasonable care, skill and diligence; you are not required to be perfect. Other people might make decisions differently from you but that does not mean your decision is wrong or (even if it turned out to be wrong) that you were in breach of duty. Make the best decisions you can based on the best information you can get. And be ready to explain why.

3.8 Review the Charity Commission's excellent guide on trustee decision-making: 'It's your decision' (www.gov.uk/government/publications/its-your-decision-charity-trustees-and-decision-making), which provides a very good framework for reaching decisions, however difficult.

3.9 If the charity is a company or CIO and is insolvent then your duty might change; instead of seeking to achieve the purposes of the charity, your duty may switch to protecting the interests of creditors – see paragraph 6.1 on wrongful trading below.

3.10 Keep in mind the need to report serious incidents to the Charity Commission and OSCR (if registered in Scotland). Insolvency and risks to beneficiaries (especially vulnerable ones) will certainly be reportable. Our guidance on SIRs in the current crisis is here: https://bateswells.co.uk/2020/03/80015/

3.11 Take professional advice from lawyers and / or accountants, particularly if you are concerned the charity may be insolvent. It is an added cost but they may be able to help you save the charity and save you from personal liability.

4. Is your charity solvent?

4.1 The Insolvency Act 1986 provides two tests for solvency:

Cash flow test

4.2 Can the charity pay its debts as they fall due?

Balance sheet test

4.3 Is the value of the assets more than the value of the liabilities, taking into account contingent and prospective liabilities?

4.4 If the charity fails either test, it is insolvent.

5. Keeping on top of things

5.1 Getting the right information is vital. If you are lucky enough to have them in post, you are likely never to have needed your finance director, finance team, treasurer and CEO more than you do now.

Crisis plan

5.2 Create a plan based on the best information you can put together and taking account of the financial issues mentioned below. Your plan will change but it will help you to focus. Include milestones for anticipated decisions.

Cash flow forecast

5.3 Produce a cash flow forecast as soon as possible or review your existing one. This shows amounts and timings of anticipated inflows and outflows of cash and helps you work out if, and at what point, you may be insolvent on the cash flow test.

5.4 Your cash flow forecast will almost certainly be wrong. Do it anyway and keep it under constant review as the assumptions in it change.

Risk analysis

5.5 Review your risk matrix and prepare a short risk analysis based only on the vital current issues. Keep it updated as circumstances change.

Statement of affairs

5.6 Prepare a statement of affairs. This will be similar to a balance sheet except that it will include any realisable assets which are not necessarily on the balance sheet (for example intellectual property), and any liabilities (including contingent and prospective ones) which may also not necessarily appear on the balance sheet.

Income

5.7 Review all your funding streams, whatever their source. Charities that are reliant on trading income and certain types of fundraised income will most likely be more vulnerable than those reliant on grant income – many grant funders are changing their rules to allow project funding to be used as general funds and they are recognising the need to keep grantees afloat. Lots of trading income, however, will be hit by inability to trade and a lack of demand caused by people cutting back and hoarding cash.

5.8 What is your best guess for the income in each stream? Will the income be lost or just delayed?

5.9 Keep in close touch with funders to make sure they understand your situation, particularly if you have not yet heard from them about using project funding as general funds and about being relieved from other grant obligations.

5.10 If you have received advance contractual payments for services you must provide, speak to the contracting party about whether and when you may be able to perform the contract.

5.11 Review your contracts to consider whether they might be terminated or whether payment and service obligations might be suspended. See our separate guide here: https://bateswells.co.uk/2020/03/coronavirus-and-contractual-obligations/

5.12 If funders or contract counterparties call for a return of funds, you will need to resist this if the charity may be insolvent as it may amount to a preference payment. Advice is needed.

5.13 Review demand expectations: with businesses cutting expenditure and hoarding cash, what are your best guess income projections in relation to contractual income?

5.14 Keep an eye out for more Government announcements on its financial rescue packages. There will have to be more because many charities will not otherwise survive the current economic shock.

5.15 Consider how you can take advantage of the Government's loan scheme to cover cash flow. Start talking to your bank now.

5.16 Obviously, a loan is not a gift and must be repaid so it is only a cash flow support. Do not take out a loan if there is no reasonable prospect of repaying it.

5.17 Unlike other businesses, charities cannot seek equity investment cover their working capital in times of need. There are methods by which loan instruments for charities can be made to behave like equity investment but these are complex and beyond this brief guide.

Expenditure

5.18 Review all expenditure and work out what is essential and what is discretionary. Although everyone cutting expenditure is what makes the economy freeze up, making the financial crisis worse, if your income is not certain you will inevitably freeze or delay such expenditure as you can.

5.19 Consider the Government's furlough scheme to meet the costs of staff who might otherwise be redundant. For more guidance on this and on staff issues generally, please see our separate guidance.

5.20 Talk to creditors about having more time to pay.

5.21 Review your contracts to see what rights you have to terminate and whether your obligations to pay might be suspended if the other party cannot perform. See our separate guide here: https://bateswells.co.uk/2020/03/coronavirus-and-contractual-obligations/

5.22 Talk to HMRC about having time to pay. There is a formal process. Do not treat HMRC as an informal lender or a creditor that can afford not to be paid.

5.23 If you think the charity may be insolvent, take great care in paying creditors to ensure that you do not make unlawful preference payments (see below).

6. Using assets

Reserves

6.1 This moment is, obviously, what your reserves are for. It's time to plan to use them. However, bear in mind that you may need them in order to wind up the charity solvently if all else fails. And you need to bear in mind that the asset : liability ratio may look very different on a winding up than it looks on a business as usual basis. For example, it may not be possible to liquidate all the assets quickly; debts (eg redundancy costs and pension liabilities) may increase; and assets may become less valuable if a quick sale is needed.

Designated and restricted funds

6.2 Note the difference between designated funds and restricted funds. Designated funds are those that the trustees have designated for a particular purpose. They can be undesignated and used for the charity's general purposes. Restricted funds have been given to the charity for a particular purpose and the trustees cannot derestrict them. Please see our separate guide on removing restrictions from restricted funds.

Separate trusts

6.3 Some assets (and probably restricted funds) will be held on separate trusts and cannot be used for general purposes. Again, please see our separate guide.

Permanent endowment

6.4 Permanent endowment assets are those that cannot be spent on your charity's purposes; the capital must be retained. Please see our separate guide on releasing permanent endowment.

7. Companies and CIOs – things you must not do

Wrongful trading

7.1 You engage in wrongful trading if you know (or ought to know) that there is no reasonable prospect of avoiding the charitable company or CIO going bust (going into insolvent liquidation) and from that moment you do not take all steps to protect the interests of creditors.

7.2 Essentially, your duty to further the purposes of the charity in the interests of beneficiaries is trumped by your duty to protect creditors. If you fail in that duty, you can be required by the Court to contribute to the assets of the charity on winding up. This can be particularly difficult if you have to balance other duties that the charity owes to protect vulnerable beneficiaries, for example. Note, however, that the government has recently announced proposed changes to insolvency law that are expected to relax these rules. Please keep an eye out for our updates.

7.3 You should take professional advice if you have any concern that the charity might go bust.

7.4 Wrongful trading liability will generally be covered by trustee indemnity insurance policies. Check the policy wording. And keep insurers informed if the charity might be insolvent.

Preferring creditors

7.5 You must not prefer one creditor over another by paying one but not the other. Such payments can be set aside by the Court and can be a ground for disqualification as a director.

7.6 That does not mean you have to suddenly stop paying all creditors or only pay them the same proportion of the debts. For example, you can choose to pay a creditor whose continued support is vital to the survival of the charity (where that survival is genuinely in prospect). You can also pay for professional advice to guide you through the situation.

Transactions at undervalue

7.7 Certain transactions at undervalue (e.g. selling an asset to someone at less than market value) can also be set aside by the Court and can be a ground for disqualification as a director.

8. Rescue mechanisms and moratoria

8.1 Please see our separate guide here which covers our updates on the new draft insolvency legislation, the Corporate Insolvency and Governance Bill 2020.

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