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Business Recovery Briefing

Autumn 07

Introduction

We are delighted to present the latest edition of our Business Recovery Briefing for Summer 2007.

As you will see from the range of articles included in the Briefing, we are now working in a number of new and exciting areas.

Business recovery and insolvency remains our core practice area, and we are pleased to report we remain busy with traditional insolvency work, in what continues to be a quiet market. We are also increasingly

instructed to deal with restructuring and turnaround assignments for under-performing businesses, a trend we hope will continue.

We are delighted that our specialist teams are also performing well, and in particular our Proceeds of Crime Act restraint and confiscation team under the leadership of David Ingram.

We would welcome any feedback you may have on the contents of this Briefing and indeed any thoughts

you have on topics for further editions. Additionally, please note we are always happy to present seminars for your staff or clients, so please do let us know if we can assist.

We look forward to working with you in the near future.

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The Vexed Issue of Restraint Orders versus Insolvency

When I was first asked to pen this article my knee-jerk reaction was that it should be short and sweet; whoever gets in first, wins. However, since being asked and putting pen to paper, I have had some direct experience of the potential conflict that arises between a Restraint Order and a competing Insolvency proceeding, both as the Insolvency Practitioner and also as an officer of the Court seeking to manage assets under a Restraint Order through a Receivership, and appreciate that this is not a straightforward area at all.

Background

Before considering the conflict it is perhaps worth reminding ourselves of what precisely a Restraint Order is. A Restraint Order is made in a Crown Court, typically on the application of the Crown Prosecution Service ("CPS"), HM Revenue & Customs ("HMRC"), or the Assets Recovery Agency ("ARA"). It is normally (but not always) made at the start of a criminal investigation in circumstances where the prosecution might, if they secure a conviction, ask the Court to make a Confiscation Order. A Restraint Order prevents an individual from dealing with property

and is made when there is concern that there may be dissipation of assets. In some ways it is similar to a conventional Freezing Order but, unlike a Freezing Order, grants the prosecution priority over the defendant's creditors (see below).

Prior to the introduction of The Proceeds of Crime Act in 2003 ("POCA"), an application for a Restraint Order could only be made once an individual had been or was about to be charged with a criminal offence. Since the introduction of POCA an application for a Restraint Order can be made as soon as a criminal investigation has started, provided there is reasonable cause to believe that the defendant has benefited from his/her criminal conduct. It should be remembered that a Restraint Order, like a Freezing Order, does not in itself produce a proprietary right; it merely prevents the assets in question from being depleted by the restrained individual or anybody in control of his assets. Similarly, a Restraint Order cannot affect the rights of legitimately secured creditors and will normally expressly state that.

Position Prior to the POCA

Prior to the introduction of POCA, applications for a Restraint Order were made under The Drug Trafficking Act and The Criminal Justice Act. Indeed, applications can still be made for restraint under these pieces of legislation if the investigation into the unlawful conduct started prior to the introduction of POCA. The leading case in this matter is Compton, which first considered the conflict between restraint and insolvency. In this case the defendant was found guilty of possession of illegal drugs with intent to supply in 2001. Both he and his wife were adjudged bankrupt in 2000. Mr Compton was the sole director of a company and his wife the company secretary. The company's profits had risen dramatically since 1996 and were used to purchase various properties. The Judge in this case refused to make a Restraint Order under The Drug Trafficking Act because the defendant had been adjudged bankrupt. The decision was appealed and the Court of Appeal ruled that where a Bankruptcy Order preceded a Restraint Order the Bankruptcy Order should take precedence.



Position under the POCA

Since the introduction of the POCA the potential conflict between insolvency and restraint has been regularised in that the POCA deals with corporate insolvencies under Sections 311, 418 and 425. These sections effectively formalised the decision in Compton as detailed above. As already noted, it is now possible for an application for a Restraint Order to happen at a far earlier stage, possibly even before an individual is aware he is under investigation!

The Conflict

The nature of individuals who may be subject to Restraint Orders is such that they are perhaps more likely to be susceptible to insolvency proceedings than most, either individually or through a corporate vehicle. Where criminals use companies as part of their criminal activity the Courts are quite willing to pierce the corporate veil, even if there is an element of legitimate business mixed in with the criminality. The effect of this piercing is that the assets of the company are treated as being the assets of the individual. As such, an awareness of the priority of the respective proceedings is essential.

It is common ground that the relevant date for insolvency is the presentation of the Bankruptcy Petition in personal cases and the presentation of a Winding-up Petition in compulsory cases. This potentially gives rise to some

ambiguity when looking at POCA which makes reference to a person being “adjudged bankrupt”, and with regards to a company “when an Order for the winding-up of the company is made”. By strict interpretation of the POCA it would appear that in the interim period between the issue of a winding-up or bankruptcy petition and the making of those orders, the granting of a Restraint Order might still defeat that insolvency proceeding. As far as I am aware this matter has not yet been tested in the Courts although a further reading of POCA makes reference to those assets falling into a bankruptcy/liquidation. One might therefore conclude that the normal insolvency rules apply. Thus, if a bankruptcy or winding-up petition had been presented prior to the application for a Restraint Order, the insolvency proceeding would win over the restraint.

Individual Voluntary Arrangements

A further effect of a Restraint Order is that it prevents the defendant from making himself subject to an IVA. In a case called *Re M*, a defendant subject to a Restraint Order purported to make himself subject to an IVA. The Judge in the restraint proceedings made it clear that the IVA did not prevent the Court from exercising its normal restraint powers and appointed a receiver to take control of the defendant’s assets, thereby effectively overriding the IVA

Compensation

It should be remembered that a Restraint Order is not a conclusion in itself. If an individual subject to a Restraint Order is subsequently found not guilty, or no proceedings are pursued, it is likely that the Restraint Order would be discharged. However, a Restraint Order is usually sought in anticipation of a subsequent Confiscation Order and it is possible for victims to make an application for compensation under the POCA or for their interests to be taken into account when dealing with the Confiscation Order. It is unclear whether a Court would regard a creditor as a victim.

Conclusion

The above is a thumbnail sketch of what is a fairly complicated area of law and whilst it might be used to provide an overview of this area, I would strongly urge appropriate professional advice if the issue of restraint and insolvency comes across your desk. It is likely to become an increasing problem for both Insolvency Practitioners and Receivers dealing in restraint and confiscation work, and for those lucky few who deal with both (such as myself), a real challenge.

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New Business Finance Centre for SMEs

In response to growing demand by our clients and contacts, we are pleased to announce that we have established a dedicated resource to help small businesses raise funding. Please feel free to contact us if you have a client seeking funding of between £25,000 to £3m, particularly where traditional bank lending is not available or difficult to secure.

Examples of situations where we can be of real help in raising the finance include where the business:

- Has reached its overdraft limit and requires additional funding but the bank said no.
- Is growing and existing working capital facilities are inadequate to finance growth.
- Is facing serious cash flow constraints and unless additional funding is raised the business will collapse.
- Obtains a large profitable order from a good quality buyer and the business needs to fund the purchase of raw materials.
- Wishes to acquire another business or the same business from an Administrator and security is not available to facilitate raising the funds from traditional bank sources.
- Wishes to acquire a commercial property or to remortgage its existing property and the bank said no or the bank's offer of funding in terms of LTV ratio is not sufficient.
- Requires a bridging loan to complete a property project.
- Has a property development project where up to 100% is required.

For further information, please contact:

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Appraising Financial Statements - the impact of IFRS

Most publicly traded companies now present their financial statements using International Financial Reporting Standards. Private companies are generally still using United Kingdom Generally Accepted Accounting Principles (GAAP).

The recent change of reporting framework should not really have an impact upon the solvency of a company. The method of presentation of financial statements has no impact upon the cash flows or the underlying state and obligations of a business. However, when appraising financial statements there are a few matters that a reader should consider. Some points for thought are given below:

As mentioned above, a change in GAAP has no impact upon cash flows or the underlying business. In practice, many companies have seen only marginal changes in their profit or net assets;

Gearing has increased in some companies because the standards now require instruments like preference shares to be classified as liabilities;

The profitability of property companies is more volatile because revaluation gains and losses on the property portfolio now appear in the income statement;

The profits of companies with share options are reduced by a new concept of fair valuing the options awarded and including a charge for the options in the income statement; and

Where there is goodwill on a balance sheet it is not routinely amortised meaning that the value of net assets is higher than it would have been had amortisation continued.

In addition, whether UK or International Standards are being used, where the company supports

a defined benefit pension fund the full net liability to the fund now appears in the balance sheet together with extensive disclosures about the condition and future obligations of the fund. The reader must consider how the company is addressing a fund deficit and the disclosures will help explain the consequent risks.

Readers will also find that many listed companies are now presenting a new and more detailed recommended format of accompanying narrative – the Operating and Financial Review. This will better help readers understand the condition of the business.

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Pensions: Employer Covenant Reviews



Our pensions group and business recovery division continue to work closely in providing solutions for trustees of defined benefit pension schemes seeking advice on the strength of the sponsoring employer.

Although the recent Pension Regulator's survey on scheme governance suggested that 37% of boards of trustees did not carry out any form of review on the strength of the sponsoring employer, we have been contacted by numerous boards of trustees who are taking their responsibilities seriously and seeking independent advice to supplement their knowledge.

Since this is a relatively new area for Trustees, we have identified below the three main triggers for Trustees to commission a review of the employer's covenant:

1. To meet requirements for Trustee knowledge and understanding

The Pensions Regulator requires Trustees to monitor the nature and strength of the employer's covenant and its ability and willingness to meet the costs of members' benefits. We can assist Trustees in this regard

and can help Trustees to review the potential risks to the scheme including those arising from the financial instability of the sponsoring employer or corporate restructuring.

2. To assess the impact of 'events'

The definition of an event of wide ranging and includes 'all transactions, acts or failures to act, and in some cases circumstances which effect a company'. Typically, this would include mergers, disposals of subsidiaries, granting security, paying large dividends, changes of control etc. We can advise Trustees on the implications for such events for the strength of the employer's covenant. If an event is likely to significantly weaken the covenant, the Regulator can step in to protect the scheme.

3. To assist Trustees negotiate a Recovery Plan

Where an actuarial valuation reveals a funding deficit (i.e. a shortfall in assets compared to the funding target), the Trustees and employer are required to agree a recovery plan to bring the scheme up to the target level of funding.

The timescale for any recovery plan is a matter for negotiation but the view of the Regulator is that Trustees should aim to eliminate the deficit as soon as the employer can reasonably afford, taking into account the employer's financial position and its ongoing business plans. The Regulator has stated that deficits should ideally be eliminated within a 10-year period.

We are able to assist Trustees obtaining information regarding the likely future free cashflows which will be generated by the employer and can advise on the employers' proposed plans for spending the cash (e.g. dividends, capital expenditure, repayment of debt etc).

We are more than happy to meet with Trustees to discuss their requirements – and the initial meeting would be free of charge.

For further information please contact:

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Accelerated Business Sales

Our corporate finance department and business recovery departments are increasingly working together to assist distressed business well before any formal insolvency procedure.

For larger businesses, we are getting more and more involved in trying to sell businesses before any insolvency using a conventional (albeit accelerated) disposal process.

However, this process can be used to sell a business following an insolvency appointment where trading continues.

In our experience, the use of corporate finance techniques has important advantages over the traditional route of marketing and selling a business following an

insolvency appointment. Insolvency sales are historically more asset focused (as opposed to cashflow based), and often have a 'forced sale' atmosphere. This means it is often more difficult to generate the competitive tension between prospective purchaser which is required to maintain the value of offers.

Using a combination of corporate finance and business recovery skills, we are able to maximize the value of offers by creating the impression of a 'normal' disposal process, but in a much shorter timescale. By way of example, the Information Memorandum in an accelerated disposal will usually focus much more on future prospects, new

markets, new products etc whereas a traditional insolvency information pack would focus on assets.

Clearly a more traditional (albeit accelerated) approach is not appropriate in all cases, and is dependent upon the availability of adequate funding to continue trading, the retention of key staff, the support of key customers and suppliers, and not least the future prospects of the business.

However in cases where we have been able to use this approach, the results are often remarkable.

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Fraud Response Plan

"The first and worst of all frauds is to cheat one's self"
- Philip James Bailey

We hear so much about fraud but do we understand the real consequences and are we victims?

Fraud is regarded as a 'victimless' 'white-collar' corporate crime – nothing could be further from the truth. Fraud should be regarded as a pyramid with the tip representing corporate fraud. The remainder is largely the work of professional criminals and organised crime groups who regard fraud as a highly profitable segment of their wider business interests. These individuals and groups use funds obtained from fraud to finance other forms of high-income crime such as illicit drugs production and importation. In recent months there has been increasing concern that charity sector is being targeted far more as opportunities are identified to exploit

this sector and those who provide donations.

The true impact of fraud largely goes unnoticed by the general public unless they are directly on the receiving end as victims, particularly in relation to identity fraud. However, the hidden cost is passed onto the public through increased bank charges, insurance premiums or product pricing. It is also reflected through the number of jobs that are lost as result of falling profits caused by fraud.

Responsibility of business in the fight against fraud

There is a strong social responsibility upon business to invest in measures to prevent fraud even if these impact on the overall profitability. Fraud can be minimised through carefully designed and consistently operated management procedures, which deny opportunities for

fraud. Therefore more effort needs to be focused on developing or updating fraud response plans with increased awareness from both the management and their staff.

It is a sad but true fact that fraud response plans are considered after an incident has occurred leaving the victim exposed to a chaotic reaction strategy rather than the controlled preventative and organised approach of the fraud response plan.

If you would like to learn more on developing or updating a Fraud Response Plan please contact Stephen Hill or Mark Kinsella at our London office.

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And finally...

Just in case you have not seen the decision in *Sands v Clitheroe* which was handed down late in 2006, we have included brief details below, as it relates to a subject close to many of our hearts.

This was a bankruptcy case and relates to a solicitor who transferred his interest in the matrimonial home to his wife in 1988 but was subsequently made bankrupt some 15 years later. The transfer was challenged by the trustee in bankruptcy under S423 of the Insolvency Act as a transaction defrauding creditors by putting

assets out of reach of "a person who is making, or may at some time make, a claim".

To succeed in a S423 claim, the Court has to be satisfied that there was an intention to put the assets out of reach of future creditors. Amongst the novel arguments put forward by Mr Clitheroe was that there was no intention to defraud creditors as he had been obliged to transfer his interest in the property to his wife on entering partnership as this was one of the terms of the partnership agreement. He further argued that there was never any

contemplation that the partnership would be anything other than successful.

I am afraid that Mr Clitheroe failed miserably in his arguments and the Court ordered his 50% interest in the property to be restored. It should be noted that the Statute of Limitations does not apply as the "clock" only starts to run on the making of the bankruptcy order, not when the transfer took place.

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Our Business Recovery Services

Services to lenders

- Pre-lending reviews
- Financial health checks
- Book debt reviews
- Independent business reviews

Turnaround services

- Providing support to the management of underperforming companies
- Advice on balance sheet restructuring
- Working capital management and modelling
- Negotiation with creditors
- Sourcing new funding

Formal appointments

- Administrations
- Company voluntary arrangements
- Receiverships – including administrative, fixed charge and court-appointed
- Creditors' voluntary liquidations
- Members' voluntary liquidations
- Schemes of arrangement
- Trustee in bankruptcy
- Individual voluntary arrangements

Specialist services

- Expert witness
- Forensic accounting
- Advice to creditors and attendance at creditors' meetings
- Advice to directors on wrongful trading, disqualification etc
- Business valuations
- Restraint and confiscation

Who to Contact

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This newsletter has been written for the general interest of our clients and contacts. It is essential to take advice on specific issues. We believe that the facts are correct as at September 2007 but there may be certain errors or omissions for which we cannot be held responsible.

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