The best bits by FAR

Autumn 2011

Dear All

It has been some time since we released the last edition of our newsletter, reflecting how busy we have been over recent months.

In this issue, we consider the following:

- POCA's potential impact following money-laundering offences committed by professional service firms;
- the damages potentially flowing from the early termination of contracts; and
- football's financial fair play rules.

We shall aim to get another edition of the newsletter out shortly before Christmas, when we shall look at shareholder valuations, the deduction of an owner's notional salary in valuations generally, and commercial agency disputes in particular, as well as cashflow forecasts and in particular their role in unlawful/wrongful trading disputes.

As ever, if you would like to have an informal chat on any financial implications of a case you are working on, please don't hesitate to give us a call.

Best wishes,

Greg Lacey, Managing Director

Numbers in the news... LSC delayed payments!

It was announced in the legal press recently that four high street banks have agreed to assist law firms that are experiencing cashflow difficulties resulting from the ongoing delays in payment from the Legal Services Commission. It is understood that the LSC is continuing to experience significant problems in processing payments. This reflects our own experience – although the delays of three to four months reported by the Law Society sometimes pale into insignificance compared with the hold-ups we have encountered.

Nevertheless, the Ministry of Justice considers that the LSC "performed strongly" in 2010/11. Apparently, the departing chief executive of the LSC, Carolyn Downs, cut the department's running costs by 11%. One can only speculate as to whether the above issues are linked, and what precisely is represented by the reported £135 million per annum administration costs.

Delays in payment add a further level of intensity to the difficulties being suffered by those operating in the legal marketplace. The Government appears to be moving forward with the proposed cuts to legal aid announced by Kenneth Clarke last year, with the aim to shave off around £350 million from the £2 billion per annum budget by 2015. This, combined with the impending implementation of Lord Jackson's reforms of litigation costs, represents a double-hammer blow to those seeking universal access to justice. Whilst the MoJ might believe that these reforms will modernise the civil justice system and combat the perceived current problems of spiralling legal costs, there is a real danger that the changes will reduce the standard of legal services delivered.

Perhaps the Government remains hopeful that the alternative business structures formed under the "Tesco Laws" that became operational this month will help plug the gap. The issue of whether this represents a sacrifice of quality for quantity will surely become clear in time.

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Solicitors: don't lose your house playing POCA

by Greg Lacey

Although I am sure that you do not need to be reminded, I would hope your money laundering procedures are robust and up to date. Recently, we have been asked to review a couple of matters where solicitors' practices have been prosecuted under anti-money laundering legislation, and then subsequently become subject to confiscation proceedings. The implications can be quite far reaching and serious.

In both the matters we have worked on, the seed of the allegation relates to conveyancing transactions undertaken on behalf of individuals who, it subsequently transpired, were criminals involved in drug-related activities. The cash funds used to part-finance the property transactions were presumed to arise from nefarious activities.

Whilst it is possible that the solicitors involved might have known that their clients were ne'er do wells (or, at least, were recklessly ignorant regarding the source of the funds) the confiscation amounts claimed by the Crown are enough to make your eyes water.

As you may be aware, the deemed benefit under confiscation proceedings under POCA is calculated by reference to "property transferred" and not the net profit or gain achieved by the lawbreaker. For example, it is well established that a drug dealer will be assessed based on the gross value of the drugs he has sold, with no deduction to reflect his costs of acquiring (or growing) them. As an illustration, let us assume that the dealer acquires cannabis for £1,000 from his "supplier", breaks it up into smaller amounts and sells it on the street for £2,500. He is later apprehended by the local constabulary with the cash proceeds in his pocket.

Under these circumstances, the benefit on which he would be assessed for confiscation relating to that single transaction is £2,500. "Not fair", you might cry. After deducting the £1,000 price he paid for the drugs, he only made a profit of £1,500. However, there is some logic to the POCA approach. Firstly, we might enquire as to the source of that initial £1,000 – perhaps it was the proceeds of earlier transactions. Secondly, drug dealers do not ordinarily deposit all their ill-gotten gains into the bank, so it is likely that there will be a limited financial trail to evidence earlier deals. Under these circumstances, assessing the benefit based on the gross sales value of the transaction identified might seem relatively fair.

However, indiscriminate application of this principle can lead to inequity.

Let us take a typical property acquisition transaction conducted by a conveyancing solicitor. The purchase price is, say, £500,000, of which a £100,000 deposit is paid by the buyer and the balance funded by a mortgage. We might expect all the funds to pass from the buyer and his lender through the solicitor's client account before being remitted to the vendor (or the vendor's representatives).

Unfortunately, and unbeknownst to our conveyancing solicitor friend, the buyer has a criminal background, and an element of the £100,000 deposit is paid in cash and has arisen from the proceeds of crime. Due to inadequate client acceptance and anti-money laundering policies, the solicitor has unwittingly "laundered" the cash into the banking system. The solicitor is convicted for the money laundering offence, and the matter proceeds to confiscation.

Common sense might suggest that the deemed "benefit" to the solicitor in these circumstances should be limited to the value of his fee – something around £1,000 excluding VAT might not be unreasonable here. However, in the cases in which we have been instructed to act, the prosecution has assessed the benefit based on the full value of the deposit.

Worse still, if the mortgage has been fraudulently obtained (perhaps the buyer misrepresented his occupation or earnings on the mortgage application form) then the whole purchase proceeds might, strictly, fall foul of POCA. Not only will the solicitor be forced to hand back his fee for the conveyance, he might also lose his own house into the bargain!

What is more, as money laundering qualifies as a "criminal lifestyle" offence under Schedule 2 of POCA, the prosecution has carte blanche to review all his financial records (both pertaining to him individually and his firm) over the previous six years. Any transaction which he is unable to definitively legitimately explain might then be presumed to stem from a criminal source. Poor financial record-keeping will be punished in the most extreme manner.

Clearly, this does seem immensely harsh – although those of you who have been following our articles on the application of POCA will surely not be surprised. Nevertheless, we remain hopeful that the judge/prosecution can be persuaded that common sense should prevail here – and that any assessment of benefit in excess of the fee charged will lead to a risk of serious injustice.

This acts as a warning to all of us involved in professional practice, particularly when dealing with individuals or non-recurring clients. Robust client acceptance and anti-money laundering procedures should ensure that such an unfortunate turn of events can be avoided. Furthermore, beware the following warning signs (highlighted by the Solicitors Regulation Authority in the 2007 Code of Conduct) that might be expected to raise suspicion:

- third-party payments (i.e. the receipt from one individual to meet the fee of, or to fund the acquisition of an asset on behalf of, another);
- payments to unrelated third parties (particularly following a "cancelled" transaction);
- large payments made in cash;
- the movements of funds between accounts, institutions or jurisdictions without good reason; and
- a delay between the receipt of cash and the application of cash on behalf of the new client (for example, a solicitor's client account will ordinarily hold transitory funds, and should not be effectively operated as a bank account for the long-term holding of funds).

Terminate in haste, repent at leisure

by Phil Southall

Last year's general election campaign and the debate over public expenditure led to a new focus on public sector outsourcing. Following the Comprehensive Spending Review last October, senior politicians and civil servants have been feverishly crunching the numbers to assess the full impact of the budget reductions and how to cope with them. Those dealing with the LSC will be aware of one effective approach, simply string out making any payments for as long as possible – at least until after 5 April!

Many authorities and other public sector bodies have been tasked with reducing their operating budgets by around a quarter over the next three years. Short-term savings can often easiest be achieved through reducing contract commitments with the private sector.

The IT sector is expected to be particularly badly affected. One analysis suggests that UK public sector IT service and software contracts might be worth up to £30 billion, of which more than £8 billion are at "high risk" of cancellation or curtailment. The ID card scheme and the NHS National Programme for IT are high-profile examples of cancelled or failed IT projects.

Other sectors at risk include construction (following the curbing of hospital, prison, school and social housing building programmes), facilities management and professional services. With the bulk of the cull still to come, many in the private sector are concerned where the government's axe will fall next.

However, deciding which contracts can most realistically and easily be cut is not always straightforward. Public procurement issues can be sensitive at the best of times, and the cost of cancelling contracts and compensating suppliers can often outweigh the benefits.

A knee-jerk reaction here can be very expensive; such decisions should not be taken lightly, and should always be informed by measured professional advice. On more than one occasion, we have been instructed to quantify the financial losses resulting from the premature cessation of what was expected to be a long-term supply arrangement – whether relating to distribution services or infrastructure development - and so have seen the potential risks first-hand.

Of course, some contracts include break clauses and can be ended quite reasonably within their normal terms. On other occasions, monitoring performance under the contract might highlight a breach that provides an entitlement to early termination. Otherwise, when contracts are cancelled prematurely, providers expect (and are generally contractually entitled to) compensation.

Often, the terms and condition of the contract will specify the penalties payable on early termination. Some contracts include a "liquidated damages" clause – setting forth a fixed amount of money payable or a formula for determining that sum.

Where the termination penalty is not so clearly set out in the contract, compensatory damages may become payable. There are three general categories of such damages, which are not necessarily mutually exclusive:

- **expectation damages**: these reflect the benefit the provider would have received under the contract had the contract been performed;
- **reliance damages**: these compensate the provider for any costs it has incurred relying on the performance of the contract (typically, this will be a re-imbursement of any items of expenditure incurred by the provider); and
- **consequential damages**: these arise from the knock-on effect of the early termination of the contract, and may include a claim for loss of prospective profits.

Generally, these losses will be assessed by reference to the parties' minimum legal obligations under the contract.

As accountants, we are most often asked to review claims for consequential damages following contract breaches. Compensatory damages can be sizeable, and represent a hefty financial penalty for the cancellation of a contract.

Accordingly, renegotiation is often a preferable alternative. Clearly, however, providers will not agree to price reductions without some form of quid pro quo arrangement. Companies owe a duty of care to their shareholders and employees, and in our experience will not give up something for nothing.

In return for lower prices, the provider might agree to, for example, reduced performance targets, the relaxation of contractual financial penalty regimes, or perhaps an extension to the length or scope of the contract.

In summary, then, you may have clients that are seeking to make savings. Whilst terminating contracts might appear to be a quick win, taking that decision lightly and without proper advice can be a very expensive mistake.

Crunch time for football finance

by Simon Paley

Arsenal might not have enjoyed the greatest of starts to this season's Premier League campaign on the field, but Arsene Wenger is consistently held out as a beacon of sound financial stewardship in modern football. Many other leading English clubs have reported repeated, and worsening, financial losses and increased levels of debt. For example, on the day the signing of Fernando Torres was concluded for a record fee of £50 million, Chelsea announced operating losses of almost £70 million for 2009/2010. Even that figure fell way below Manchester City's reported losses of £121 million over the same period.

Fans of Arsenal are hoping that the club's belt-tightening over recent years, enforced in part by the move to the new Emirates stadium, will reap dividends in the long-term as others become hamstrung by UEFA's Financial Fair Play Regulations ("FFPR") thereby enabling it to become more competitive once again.

These regulations, championed for some time by Michel Platini, were approved by UEFA's Executive Committee in May 2010. The main cornerstone of the regulations is the objective that, over a phased implementation period, all clubs should break-even.

Initially, in respect of the 2011/12 season, clubs will be entitled to overspend by €45 million (around £40 million), so long as that deficit can be met by a cash injection from a rich benefactor. Unfortunately, unless the club has a wealthy sugar-daddy, a lesser loss figure will be tolerated. That allowable loss figure will then reduce gradually over the following six seasons, by which time the club will be expected to trade profitably.

For the purposes of FFPR, income includes revenue from TV rights, gate receipts, competition prize money and sponsorship. Non-football revenue (such as the income Arsenal receives from the sale of flats at its former Highbury home) is excluded.

Expenditure will principally relate to player costs, and include wages and amortised transfer fees. It is customary to spread the cost of a transfer over the term of a player's contract. The effective cost of Fernando Torres, signed on a five-year deal, to Chelsea will therefore be £10 million per annum (amortised transfer fee) plus the cost of his wages (estimated at around £175,000 per week, or around £9 million per season).

In order to encourage youth team and infrastructure, the costs of youth and stadium development are to be excluded from the assessment of expenditure. This will mean that any interest paid by Arsenal in financing the Emirates stadium does not count, nor does any depreciation charge relating to the stadium.

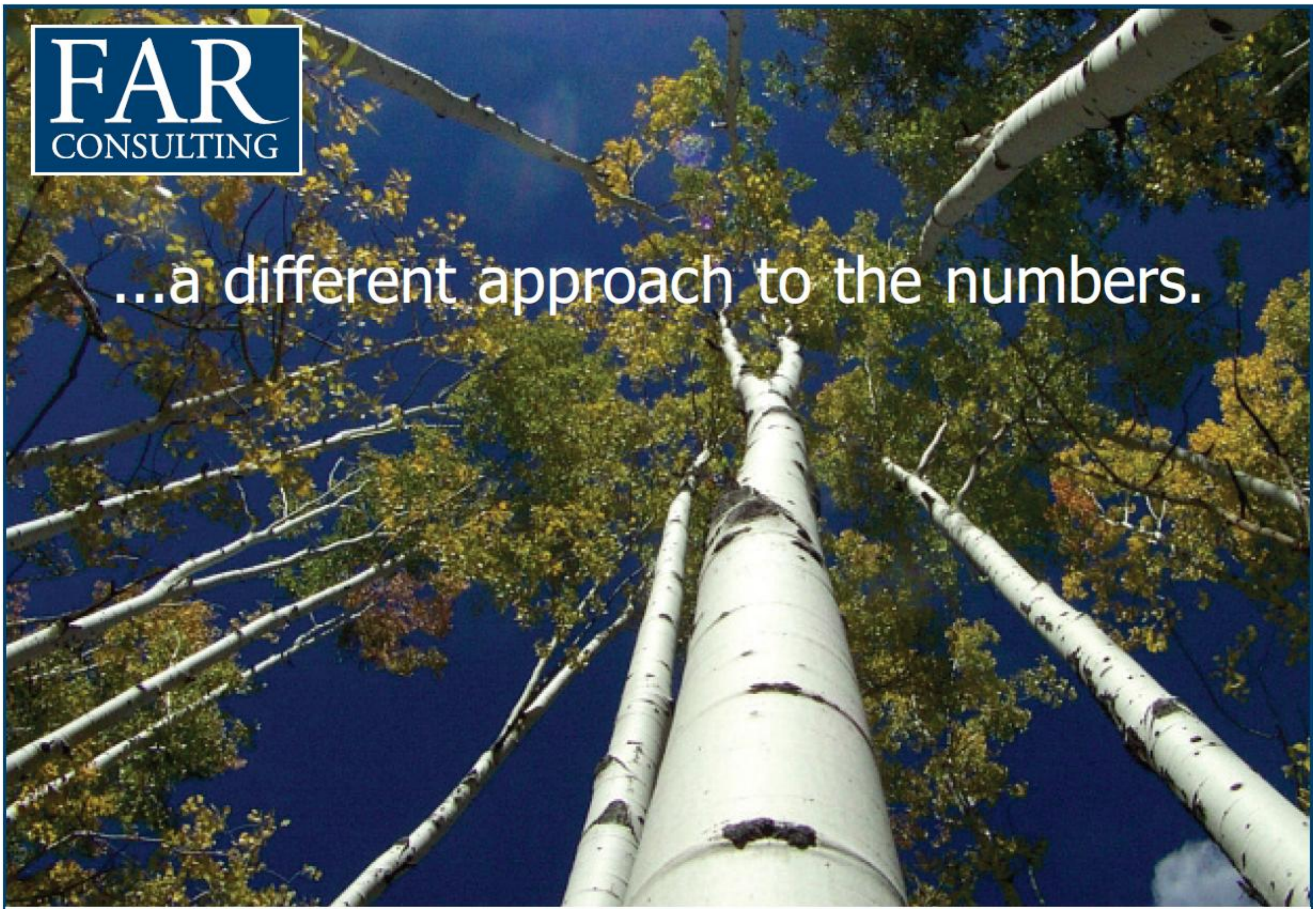
Last year, Karl-Heinz Rummenigge (the CEO of Bayern Munich as well as acting chairman of the European Club Association) observed that he could not see how Manchester City would be able to comply with the impending UEFA rules, unless it had a "trick up its sleeves".

That trick might now have been revealed. In July, City announced a sponsorship arrangement with Etihad Airways, worth £400 million over 10 years. The deal covers naming rights to the stadium (a stadium that, rather remarkably, the club do not own – and so around £2 million per annum will be passed on to gratify Manchester City Council) as well as kit sponsorship and the financial support for the club's new development facility.

Both Liverpool and Arsenal have already voiced their concerns that this deal should fall foul of UEFA's anti-evasion rules. Regulations covering related-party transactions are intended to ensure that the sponsorship reflects a fair price. So is the deal fair? Etihad famously has only the same number of aircraft as Flybe and has never reported a profit, but there is limited capacity to benchmark whether the price agreed represents "arm's length" terms. Arsenal's Emirates deal, negotiated in 2004, was worth £90 million over 15 years of which £48 million related to shirt sponsorship and the balance of around £2.8 million per annum relating to stadium naming rights. However, football finances have significantly moved on in the intervening years – what appeared to be a very lucrative deal for Arsenal in 2004 no longer seems such a wise long-term decision. Manchester United now receives more each year from DHL for the sponsorship of its training kit than Arsenal receives in total from Emirates.

Presuming that UEFA does not successfully challenge Manchester City, the Etihad sponsorship reflects reckonable income and will help the club bridge the hole in its profits. However, even if not, the sanctions of a breach are not clear. Each failure will be assessed by a UEFA panel on a case by case basis. Some leniency is expected to be shown where a club is heading in the right direction, or where losses are attributable to any contracts entered into prior to June 2010. The ultimate sanction might be a ban from European competition. Notably, the regulations don't apply to domestic club competitions. Consequently, if Arsenal's on the field downward spiral continues, compliance or otherwise with the FFPR may become irrelevant.

Whether the regulations will create a more even playing surface is a matter of contention. The elite clubs by nature generate the highest income levels – notably from the revenue received following participation in the Champions League – and so will be entitled to incur the highest costs. Whilst the FFPR should discourage clubs in the lower echelons from gambling their financial future trying to catch up, and thereby avoiding a situation similar to Portsmouth's bankruptcy, it might discourage them from attempting to compete completely, and thereby maintain the elite's status quo.



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