The best bits by FAR

July 2012

Dear All

Not much of a summer so far is it? Here's something to brighten the day.

In this newsletter we look at a few current matters that we consider of increasing relevance in our working:

- tax planning schemes, and in particular directors' loans, which seem to have cropped up rather frequently of late in a number of different contexts;
- the role of litigation funding - it now seems the bar is about to be set much lower than previously with regard to necessary quantum;
- the role of the in-house forensic accountant – as more and more firms look at the option of an in-house resource.

Our "numbers in the news" feature looks at mis-selling of interest rate swap deals.

Hope there is something here that is relevant to you. Of course, if you have any queries on any matters, please do give us a call.

Best wishes,

Greg Lacey, Managing Director

Numbers in the news... interest rate swap deals

In the past several weeks a number of people have mentioned to me clients with potential interest rate swap deal claims.

The gist of these claims appears to be that a number of businesses were sold, around early 2007, interest rate swaps as a hedging vehicle against further increases in interest rates. As I understand it, if rates exceeded a certain threshold figure (typically 3%) the business's effective interest rate would be lower than that under a "normal" deal (i.e. x% above base rate), but if rates were below the threshold the business would pay more than under a "normal" deal.

The expectation at that point with base rates typically around 5.5% was that the business would save on its borrowing costs by around 0.5%. The business would then plan ahead with this expectation in mind. Unfortunately though within 12 months base rates were down to 0.5% leaving the business paying more than it would under a "normal" base rate deal.

As a consequence, businesses were paying significantly more interest than they had expected. I know of one property company with a facility of £110 million paying around 1.5% more than it anticipated. Whilst 1.5% might not sound a lot, it is if your entire property portfolio was financed on the assumption of a lower cost of capital as suddenly it becomes no longer profitable. You can potentially withstand that for a while, but with base rates entering their 4th year at this low rate things are beginning to creak.

Where these deals were mis-sold we expect to be calculating interest rate losses, losses from missed business opportunities and loss of profits as businesses subsequently cease trading.

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Carr's taxes and offshore vehicles (and directors' loans)

Simon Paley considers the infamous "K2" scheme and the general rules covering loans by a company to its directors and employees

Jimmy Carr has been the target of a number of adverse headlines recently, after it came to light that he had significantly reduced his tax bill through the use of an offshore trust. It has been reported that he safeguarded as much as £3.3 million each year through the "K2" tax scheme, which enables its members to pay income tax at rates as low as 1%. The tax arrangement has been described as "morally wrong" by David Cameron (and a lot worse by other commentators).

I understand that the scheme would work as follows for a high-earning employee (who, for the sake of argument, we shall call "Mr Barlow"):

- Mr Barlow resigns from his highly-paid employment, and is rehired by an offshore shell company;
- the offshore company then hires out Mr Barlow for productive employment in the UK, and invoices for his services;
- Mr Barlow receives a salary from the offshore company equivalent to the minimum wage, which is subject to income tax and National Insurance contributions (and declared to the Revenue in the normal manner);
- the balance of the money received by the offshore company is then loaned to Mr Barlow;
- as the loan can technically be recalled at any time, it is not subject to tax.

The arrangement has been described as "legal" in the press, although that might be a little premature. Other than through litigation, the Revenue hasn't agreed any avoidance schemes since around 2004. It is probably more correct to say that the K2 arrangement isn't necessarily illegal, although HMRC has already confirmed that it will be investigating.

The crux of the scheme is the use of a loan made between employer and employee. The rules relating to loans made to employees and directors are quite complex, and worth touching upon here.

For directors, there is a general prohibition on loans (subject to certain exceptions detailed later). This rule extends to "shadow" directors and directors of the company's parent. Moreover, a company should not ordinarily guarantee or provide security in respect of a loan provided to one of its directors. For a public limited company, a breach of these rules represents a criminal offence.

This prohibition was relaxed slightly in the Companies Act 2006. From 1 October 2007, loans to directors are permitted if a memorandum setting out the terms and purpose of the loan has been made available to the shareholders, and they have given their approval to the loan.

The restriction on director loans is not absolute, and there are certain exceptions that don't require shareholder approval, including the following:

- any company can make a "small" loan to a director of up to £10,000;
- where the company is in the business of lending, and the loan is made on non-preferential terms (for example, equivalent terms are available to its employees); and
- loans made to fund a director's defence costs for legal proceedings in connection with any alleged negligence, default breach of duty or breach of trust by him in relation to the company (although if the director is later found liable he must repay the loan).

If a company loans money to an employee (and this includes directors) and the loan exceeds £5,000, a "benefit in kind" arises to the extent that the interest rate charged on the loan is less than the "official rate". The official rate is a rate set by the government – the current rate (set in April 2010) is 4%. As an illustration, if an employee is provided with a loan by his employer at a rate of (say) 2.5%, the benefit would be calculated based on the rate differential of 1.5%. Therefore, if the average outstanding loan balance during the year was £30,000, the "benefit in kind" assessable to tax in that year would be £450.

Any loan to an employee or director that doesn't exceed £5,000 is effectively "tax-free". This may be important, as many companies offer employees small loans for reasons completely unrelated to tax planning – for example, in order to purchase a bike or public transport season ticket, and with a view to reducing the carbon footprint of the business.

If a loan is written-off or waived, then that would be treated as earnings in the year the write-off occurs (and hence subject to income tax and National Insurance contributions along with other, more conventional, earnings).

Quite what was anticipated to happen to Jimmy Carr's loan balance in the K2 scheme in the long-term is anyone's guess. Perhaps there was a strategy to offset it against some other arrangement. Alternatively, the loan might be written-off when he is no longer earning (this might be sooner than he had planned, given the public backlash), so as to most efficiently utilise his allowances and attract only low-level income taxes.

Tax avoidance is big business, and the Revenue has estimated that individual tax planning arrangements such as the K2 scheme cost the UK economy around £4.5 billion each year. Danny Alexander, Chief Secretary to the Treasury, described people who use tax avoidance loopholes as no better than benefit cheats.

Yet the line between what is legitimate tax planning and what is artificial avoidance has become increasingly blurred. Not all avoidance schemes are wrong or without purpose. Some arrangements are designed to encourage certain behaviour (for example, Enterprise Management Incentive and film investment schemes), and are specifically allowed by statute.

A tax "loophole" might alternatively be seen as a reflection of failings in our increasing complex fiscal regulations. If it ain't on the list, it's legal!

Nevertheless, the Revenue has long been known to be hostile to the use of trusts in circumstances that enable tax to be avoided or deferred, and positive steps are now being taken. In the June 2010 budget, the government proposed legislation to tackle these arrangements, badged as the "disguised remuneration" rules. More recently, the government announced a consultation document for a general anti-abuse rule, designed to stop artificial schemes.

They say that you can tell a good tax accountant, because they have a loophole named after them. Jimmy Carr's accountants might not agree.

Litigation funding – the way ahead?

Greg Lacey looks at the evolving market for litigation funding and likely developments

I have had a number of conversations with many of you over the past few years about third party litigation funding. This is an area we are very familiar with, having acted on a number of cases that have been funded, as well as assisting a number of third party funders with their underwriting process when looking to establish the genuine value of a claim. I thought it might be worthwhile to write a short piece looking at how things currently stand.

Some history

My first involvement with third party funders was on the *Factortame* case some 15 years ago, in which my role was helping assess the loss of profits suffered by a number of fishing vessels owned by Spanish fisherman who had pursued a class action following the UK's attempt to prevent them from fishing in UK waters despite them having acquired the fishing licences from UK nationals. The fishermen won big time, and were awarded around £180 million.

The next case I was involved in was *Arkin v Borchard*, now the Court of Appeal leading authority on third party funders' exposure to the other side's costs. In that case my role was to assess the loss of profits suffered by Israeli shipping magnate Yeheskel Arkin, who brought a claim against a shipping cartel alleging predatory pricing. The funders lost that one.

Since then there has been a surge in the number of businesses offering litigation funding, albeit there was a slight slowdown in new entrants in 2008 following the chaos that ensued after the collapse of Lehman Brothers. There are also a number of high net worth individuals who back funds on a syndicated basis, but who are keen to avoid the limelight given the target for some of the cases they back.

What do the funders want?

With the increase in the number of funders in the market the criteria for funding has loosened. Back in the early days the funders were not interested in claims below £3 million, and were looking for a return of 30-40% of any damages received, after the deduction of any costs incurred. Whilst that is still broadly the criteria for a number of funders, in my experience others are happy to take a multiple of 4x their outlay, but realistically this still tends to require that claims have a value of above £1 million.

Having discussed in the last six months a particular case with a number of funders, I know that there are many who are open minded about lending specific sums on the basis of a specific percentage return, so not so much funding the claim but covering certain

disbursement costs.

Whilst we have acted on a contentious divorce matter that was funded (at least up to a certain point), matrimonial cases are not popular with funders although, again, I know of a funder that will advance matrimonial loans.

So what cases do funders want? The following in my experience tick the right boxes:

- professional negligence cases – or any claim where there is an insurer standing behind the respondent;
- claims against the UK government – albeit I know of at least one funder (part of a banking group), that will shy away of such cases as they are wary of the potential reputational risk.

Both these type of cases have the advantage of a respondent with the wherewithal to meet a significant damages award.

What do you need to do to get a case funded?

Here's an obvious checklist, but I understand some funders are often surprised that item 1 is often overlooked:

1. The respondent is good for the money – no point pursuing a claim if they can't pay;
2. The claim is significant – assume above £1 million – however see the final paragraph for a new development in this area;
3. The case is a good one – i.e. above 60% chance of success, and you will need Counsel's opinion confirming this; and
4. The claimant team has a good handle on what their expected costs will be.

The legal team will often be required to work under a CFA – not because the funders want them to get a good return, but because they will want them to have some skin in the game. This serves to improve the apparent strength of a claim confronting the other side. If you think about it, the simple fact that lawyers are on a CFA suggests the case is good, a backing from funders further supports this, and an ATE insurer signed up for it provides even more confirmation. Confronting that prospect the respondent needs to be very sure about their position if they intend to fight the case.

Given the number of funders now, there are also brokers in the market who will advise on which funder may be interested in backing your case. We have a relationship with a few of these, and I think it is fair to say that some funders like the role of the broker, although I know of others who prefer for brokers not to be involved. Their price is something like 10% of the return that the funder will make.

The number is robust

This is often where we get involved in the underwriting process. Litigation funders understand the litigation risk (a probability is applied), the costs (you will have told them) and they have a fair idea how long the case will run (in theory anyway). These are essential elements required to make the financial decision whether to back a case or not; the only other unknown being the value of the claim. Where the claim for instance is a loss of profits claim, or there are causation issues, for surprisingly little effort on our part we are able to sense check the amount claimed to see whether in reality it is likely to pass the de minimus threshold set by that particular funder. We expect this service to be needed too when contingent fees become permissible. Often our work on the underwriting side will then evolve into a full quantum assessment but usually only after the funding is in place.

The way ahead?

Given the opportunity for finance directors making use of funding to keep legal costs off their profit and loss accounts, we would in time expect the funding option to become more attractive to more and more businesses as they become aware of this often overlooked benefit.

The demand will also increase given the potential curbing of CFAs.

And there is another development which might just open up a whole new market for funding. We are in close contact with one funder who has in the offing a delegated authority package that it will aim at a number of selected "individual" litigators, with the aim being to fund costs on cases where claims lie between £500,000 and £1 million. This will be a significant differentiator for those with authority and will be a huge career boost for the individuals who are granted these deals as the funder is looking to target litigation "stars". We're happy to discuss this if anyone has any further interest in it.

In-house forensic accountants – the future?

With the arrival of alternative business structures and multi-disciplinary practices, many law firms are investigating the benefits from incorporating other professionals into their business. Whilst offering a one-stop shop may potentially differentiate certain firms within the market, based on our experience of advising as "in-house" forensic accountants, there are perhaps other tactical advantages to be gained from offering such advice.

Phil Southall considers these in more detail below:

A realistic assessment of losses

The key benefit from having an in-house forensic accounting capability is to enable an affordable, reliable assessment of damages at the early case assessment stage.

The advantages of this include the following:

- it ensures you get the right, proportionate strategy in place at the outset. There are numerous horror stories regarding the "disappearing claim", where claims that were anticipated to run to many millions of pounds vanish, or substantially diminish, under scrutiny, as quantum issues were not adequately addressed at the outset. A client's disappointment of a significantly reduced claim can subsequently be compounded if they are then unable to recover costs that are deemed to be disproportionate to the settlement achieved or, worse still, if they have to contribute to the other party's costs if it has failed to beat a Part 36 Offer that was considered derisory compared to initial expectations;
- it ensures your client makes the appropriate financial decisions it has to at an early stage. In particular, is their investment in the litigation process worthwhile? – this will depend on the time, costs, risks and the potential rewards involved; and
- with the arrival of contingency fee arrangements, where the legal team's incentive is a return based on recovered damages, it becomes even more important to understand the full value of any claim and likely recoveries right at the inception – something an in-house capability can obviously assist with.

For example, in a shareholder dispute, it is clearly helpful to have an initial idea as to how much the business is worth. Your client's strategy will vary depending on whether the company might be valued at (say) £500,000 or £5 million. In some cases, there is a debate whether the business is worth anything at all! The owners of a business might have their own thoughts on value, but often these are distorted by their emotional investment. In such circumstances, an early desktop appraisal can be invaluable. We can often arrive at a ball-park figure simply and cheaply, based on even basic historic financial information. Moreover, if this represents a discrepancy with the owner's expectations, then we can investigate that and explain the approach we have taken. It might be that the owner has a mistaken perception of value. Sometimes, however, there are intangible drivers to valuation that are not easily identifiable and quantifiable through the normal valuation process. If so, then it is may be necessary to draw these out and emphasise them in submissions made to the other party (or perhaps to an independent accountant that is performing a formal valuation).

Costs v cash flow

As the duty of an "expert" is to the Court, their fees cannot be linked to the success of the matter at hand. Consequently, experts cannot participate in conditional fee arrangements. Nevertheless, the same constraints do not necessarily apply to in-house forensic accounting expertise. Where we are asked to perform a support role, advising on quantum-related issues as they arise, then it is possible to include in-house forensic accounting assistance within the framework of the CFA.

Consequently, all of the tactical and practical advantages of CFAs and third party funding arrangements can include accounting input and presentation of the case on quantum.

Cash flow benefits aside, the other side may not be aware of any behind-the-scenes specialist involvement, as there is no need to ask permission of the court for advice of this nature. This can provide a tactical advantage in its own right, particularly if the other party does not have access to the same specialist advice.

In the same vein, in-house experts are not hampered by a conflict of duality of role. An in-house forensic accountant is part of your team, and the advice is provided to optimise your client's position.

The advice is not hampered by an expectation of later acting as expert should the matter not settle. Of course, giving an honest appraisal is necessary in order to realistically manage client's expectations, but that may not always be the position that is advanced to the other side! We are often asked to perform a number of alternative calculations; best case, worst case, and most reasonable estimate.

Whilst an in-house specialist could not act as an independent expert, with so few cases going to trial, the question is whether an independent expert is actually needed to achieve a negotiated or even mediated settlement? In our experience, mediations and without prejudice settlements are now far more commonplace, and at that stage there is often no requirement for accounting advice to necessarily be independent.

Should the matter not settle and proceed to trial, an independent expert might later be required. Here, the engagement of an in-house advisor can identify areas of potential weaknesses in the case and supporting documentation. The advisor can hence assist in framing the subsequent instructions to the independent expert so that they are deliberately and narrowly scoped, thus avoiding areas that may be unhelpful to a client's case.

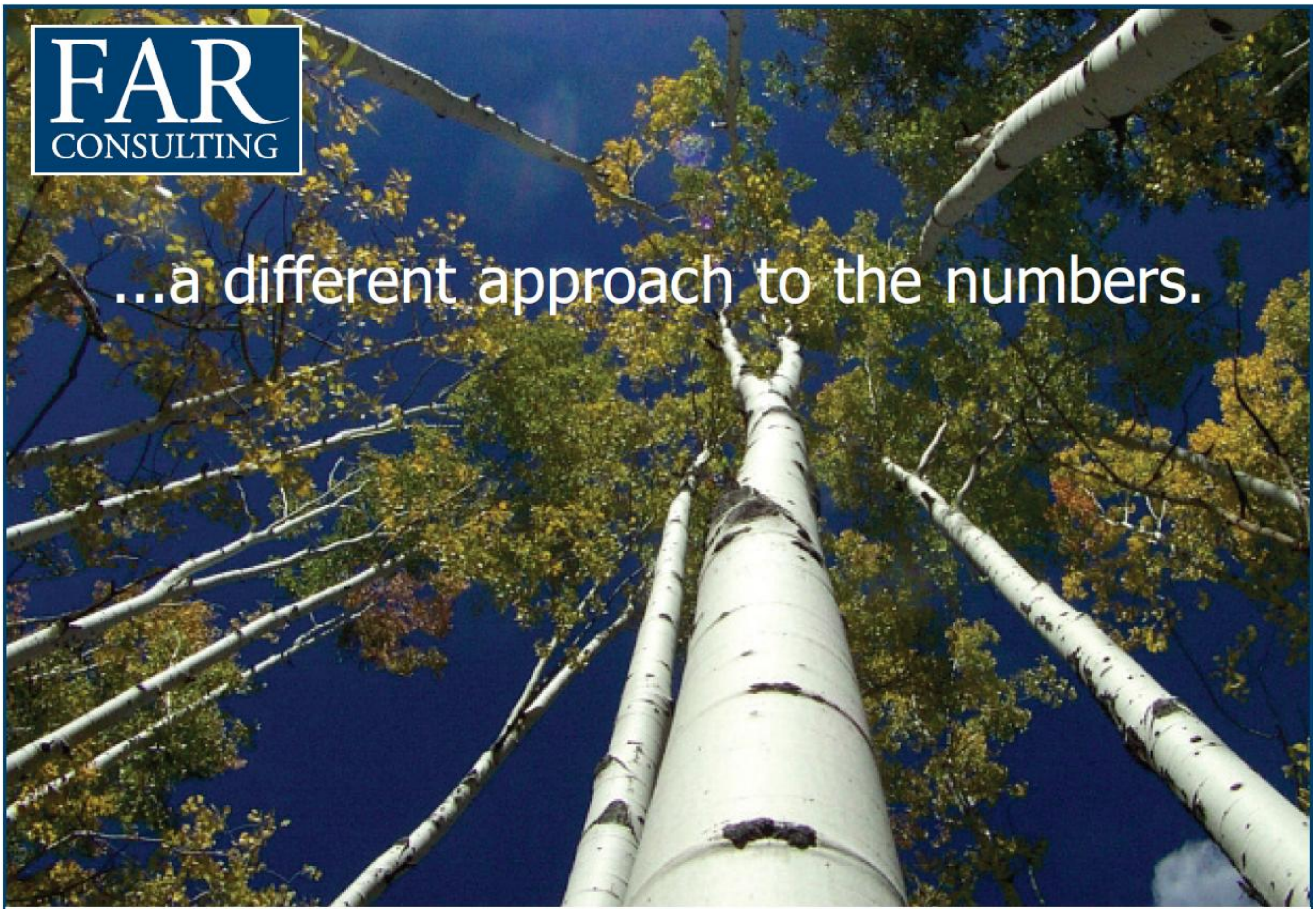
Summary

Whilst it may suit some firms to have a dedicated internal resource, for others, drawing on accounting expertise on a consultancy basis will be preferable.

Effectively acting in an in-house consultancy role we regularly provide up-front valuations and advice on losses in respect of shareholder disputes, contractual disputes and matrimonial matters, enabling solicitors and third party funders to make informed decisions regarding accepting and funding certain cases, and the strategy that should be adopted.

Additionally, we have also acted "behind the scenes" on a number of cases on a CFA basis, with our instructions and success criteria mirroring those of our instructing solicitors. This enables the team to advance cases and make informed decisions regarding quantum, whilst assisting the client's cash flow throughout these current uncertain times.

If you would like to discuss any aspects of an in-house arrangement with us, please don't hesitate to get in touch.



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FAR Consulting - Key contacts

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Greg, a Chartered Accountant, has specialised in forensic accounting for over ten years. Greg has represented many of his clients at mediations and as an expert witness. He has prepared reports as an expert, a single joint expert or court appointed expert. He has experience of high profile cases involving contract and pricing disputes, completion accounts disputes, product recalls and royalty disputes, gained whilst acting for a number of high profile clients across a broad spectrum of sectors.

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Phil is a Chartered Accountant with ten years of post qualification forensic experience during which he spent over two years working as an in-house forensic accountant at a national law firm. His almost unique experience in this role and extensive forensic background make him ideally placed to advise on settlement strategies, using "decision analysis" techniques, which analyse a client's potential costs, risks and rewards of being involved in litigation.

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Simon Paley is notionally based in Birmingham. Before joining FAR Consulting, he worked in Ernst & Young's forensic accounting team. Simon has over ten years' forensic experience, principally in commercial and contractual disputes, with a particular interest in insurance claims. He also has a broad experience advising clients on purchase price adjustment mechanisms, completion accounts, breach of warranty claims and other transaction-related disputes. He has provided advisory and expert witness services to clients involved in disputes across a wide range of industries and has experience of most forms of dispute resolution.

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