INSOLVENCY

When The Tide Goes Out

Get ready for a post-pandemic surge in the UK

Few things go together as naturally as fraud and insolvency. The pattern is now well rehearsed: scams pile up unnoticed while money flows in the good times, but when recession hits, increased scrutiny from lenders, counterparties and the tax man – not to mention insolvency practitioners – means fraud is far more likely to be discovered.

That familiar cyclical trend is likely to be accelerated by the Covid-19 pandemic, with hastily implemented government support measures – designed to provide critical support to business, rather than emphasise rigorous compliance – being obvious targets for abuse.

“There’s clearly been a lot of fraud,” says HFW co-head of fraud and insolvency Rick Brown. “The taxpayer is sincerely hoping that authorities are up to the task of pursuing it.” Quantuma restructuring veteran Andrew Hosking concurs: “The problem is [UK authority] HMRC are under-resourced, so the ability for [state support] to have been accurately tracked is going to be an issue moving forward. Do I think a considerable quantity of fraud occurred? Yes, I do. Do I think employees were being told to work at home while they were being furloughed? Yes, I do.”

The numbers involved are vast. As of February 2021, the UK furlough scheme has paid out £53.8bn to support 11.2 million jobs, after claims by 1.3 million employers. A report from the UK National Audit Office last year concluded that up to 10% of furlough claims involved fraud or sharp practice – most commonly with employees being asked to work while on furlough. HMRC said in January that it has already received more than 21,000 reports of suspected furlough fraud. The agency has previously estimated that between 5% and 10% of claims were the result of fraud or error.

While doubts remain that HMRC has the capacity to tackle the scale of potential abuse, the UK Budget in March 2021 announced the creation of a ‘Taxpayer Protection Taskforce’ – backed by 1,250 tax officials – to investigate fraudulent claims under pandemic schemes. The initiative is underwritten by £100m of public money and more investment has been promised for 2022 to target suspicious activity. HMRC in December 2020 also published the names of more than 740,000 companies that have claimed under the furlough scheme, in a move seen as bolstering transparency and encouraging whistleblowing. Noting that HMRC would need “massive investment” to handle the likely scale of abuse, HFW partner Simon Jerrum says the challenge for the insolvency sector will be that the majority of frauds will be spread over small companies. “It’s unlikely you’ll have many big companies doing this - there will be lots of smaller frauds which cumulatively add up to very large numbers” he says.

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> **Simon Jerrum, Partner, HFW**

There are additional factors at play, with a series of restrictions on formal insolvency procedures during the pandemic – such as the suspension of wrongful trading rules and winding up petitions – curbing many traditional means of exposing wrongdoing. While these restrictions have been extended to 30 June 2021 – quite likely for the last time, given the success of the UK’s vaccination programme – the expectation among advisers is that the UK is gearing up for a very substantial insolvency cycle. The pandemic’s economic shock – pummelling sectors like hospitality and high street retail and triggering the deepest downturn for 300 years – added to the backlog of insolvencies as struggling firms lose state support, mean insolvency professionals predict a busy five years ahead.

Current expectations are that the insolvency cycle will start with a vengeance in late 2021, with frauds unravelling in earnest thereafter as officeholders investigate struggling businesses. HFW’s Jerrum says: “We’ll see an increase in formal insolvencies once the government support ends and then, as insolvency professionals investigate, you’ll see all this fraud coming to light.”

Sectors likely to be impacted by fraud are construction and hospitality, with Quantuma’s Hosking predicting there will be a focus on “fresh air invoicing” when restrictions on insolvency procedures end, referring to firms producing fake invoices to gain trade finance. “At the moment, they’ve been given forbearance where invoices are outstanding, but when we thaw from Covid, you will see corporates will have a run of unpaid invoices which will be under the spotlight from the invoice discounters,” he says. “If there’s been manufacturing of invoices to procure funds, it will be quickly unravelled.”

The sooner the better

While the expectation is that the vast majority of fraudulent activity will have occurred at small firms, presenting a long tail of corporate theft, the sheer scale of the issue means it is set to present complications in many business failures and restructurings. Notably, advisers warn that directors can face substantial liability if any evidence emerges that the business wrongly took furlough money or loans, whether they personally gained or not. If HMRC deems a company that wrongly took furlough grants is insolvent or at risk of insolvency, individuals with management responsibly will be jointly and severally liable to repay the funds. Such liability includes management and directors, and can cover those with indirect involvement with management. The liability will be triggered if individuals were involved in management at the time and knew the firm was not entitled to receive furlough money. Persons involved in furlough fraud also risk criminal sanctions and disqualification as a director. Comments Brown: “The spotlight is very much now on those potentially liable individuals and my sense is that HMRC will want and need to go after some high profile cases in order to make examples of those responsible.”

From 1 December 2020, Crown preference was reintroduced, giving HMRC preferential status for proceedings after that date for amounts owed for certain taxes. Furlough payments will not, however, rank in that preferred status, leaving HMRC as an unsecured creditor to recover such grants. Some advisers argue the difficulty of recovering furlough money from an insolvent business will make it more likely that directors will be pursued personally for repayment.

> ““There’s clearly been a lot of fraud – the question is are the authorities up to the task of pursuing it?”
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> **Rick Brown, Partner, HFW**

Aside from the taxman, insolvency practitioners have numerous avenues of investigation and asset seizure when uncovering suspected fraud under the 1986 UK Insolvency Act. Unlike wrongful trading rules, fraudulent trading provisions have been unaffected by the suspension of insolvency measures through the pandemic. Fraudulent trading can also trigger liability for outside parties with knowledge of the activity – including those based overseas.

What all this adds up to is a complex situation for creditors and directors who see signs of potential sharp practice. “If you’re a creditor, the key is to take steps early so that are at the front of the queue to recover debts,” Brown says. “Keep a watchful eye on your counterparties and be prepared to act early.” For directors who suspect that wrongdoing may have occurred, the balance usually shifts to quickly reporting suspected fraud. Comments Jerrum: “The sooner you liaise with the regulator, the better. The Serious Fraud Office will expect you to co-operate and to report suspicions promptly.”

By a similar token, HMRC has unveiled a grace period to report excessive claims for furlough funds, providing employers notify the agency within 90 days of receiving grants they were not entitled to, or within 90 days of a period in which changed circumstance made the claim invalid. Failure to report means HMRC would treat such behaviour as deliberate and can charge a penalty of up to 100% of the grant’s value. Self-reporting after these grace periods incurs penalties, but likely at discounted levels.

While this may sound somewhat theoretical, it is worth remembering that if conditions over the last 18 months have been tailor-made to stoke fraud, insolvency veterans likewise see the wave of insolvencies set to hit the economy as similarly well evolved to now expose it. It’s going to be a bumpy 2022.

The Takeaway

1. The Covid-19 pandemic has created ideal conditions for widespread fraud, which looks certain to come to light when the insolvency cycle restarts in late 2021.
2. Directors face potential liability for fraudulent trading or even criminal sanctions, should fraud emerge.
3. Creditors need to be prepared to act quickly.

About HFW

HFW is a leading global law firm in the aerospace, commodities, construction, energy and resources, insurance, and shipping sectors. It has more than 600 lawyers, including 185 partners, based in offices across the Americas, Europe, the Middle East and Asia-Pacific.

The firm's fraud and insolvency group are experienced commercial litigators with a particular focus on dealing with high value, cross border matters where there is an overlap between fraud and insolvency. The team's expertise spans a wide range of sectors and industries, as well as knowledge of global jurisdictions and how to ensure the best possible result for clients.

HFW prides itself on its deep industry expertise and its entrepreneurial, creative and collaborative culture.

Contact Us

To discuss any of the issues raised in this article in more detail, please contact:

RICK BROWN
Partner, London
T +44 (0)20 7264 8461
M +44 (0)7855 766885
E rick.brown@hfw.com

SIMON JERRUM
Partner, London
T +44 (0)20 7264 8049
M +44 (0)7917 891062
E simon.jerrum@hfw.com

Find us on LinkedIn at www.linkedin.com/company/hfw

www.hfw.com/Fraud-and-Insolvency

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