Rollits LLP

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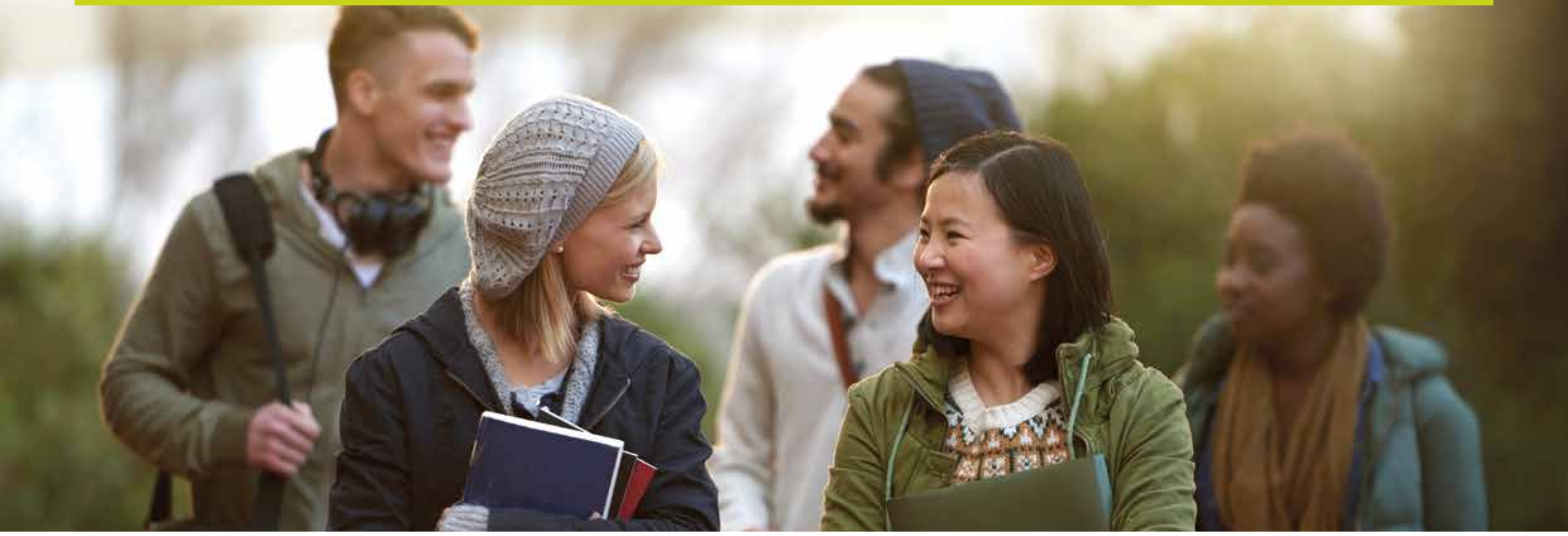
Spring 2016

Education Focus



Area Based Reviews Update

We pushed back the release date of the Spring edition of Education Focus in the hope that the updated guidance on Area Based Reviews would have been released as promised in February. With time ticking on we were ready to press ahead without it, but just as we were about to go to print the guidance landed, on 1 March 2016. Turn to the next page if you would like to read an interview with Tom Morrison, the Head of Rollits' Education Team, in which he gives his initial reaction to the guidance.

So why is the guidance late? For one thing, the Wave 1 Reviews have not gone totally to plan, and Wave 1 was intended to inform the guidance by sharing lessons learned from what is clearly an evolving process. And what of the process so far? Full participation was, by design, not an option. Most notably, school sixth forms are not directly involved albeit the Regional Schools Commissioner plays a role. Even amongst those who participate, there have been rough patches with some feeling they are not being heard, some effectively putting their involvement on hold.

Timetables have been slipping and the Government clearly wants to try to set some precedents early on. A Wave 1 Area Review was inevitably going to result in several proposals for mergers, perhaps disproportionately so for that reason. The Minister makes clear his position in that he wants to see fewer colleges as a product of this process and Area Review Teams are trying to shepherd participants in that direction. Perhaps shepherding is not a strong enough word. Perhaps if there was a little less shepherding those mergers which make good sense with the needs of the learner at the centre may come with less of a feeling of having been pushed into it; the Government's fear is seemingly that less intervention will result in fewer mergers than it feels are needed.

Some mergers may have happened without this process at all, some may have happened with the threat of the process looming on the horizon and indeed we are seeing this prospect start to materialise with colleges scheduled for participation in later Waves. Forms of collaboration other than full scale merger seem to be at the margins at the moment, but as colleges in later Waves prepare and position themselves, taking control of their own destinies both individually and collectively, we expect to see a much richer range of solutions emerging in response to learners' needs.

Policy seems to be developing by evolution – or some might say by reaction. The call for grants to support potential mergers seems to have been met with a limited half billion pound restructuring facility (largely in the form of loans) which can be accessed only once other options have been exhausted. Not a lot of money for the potential number and size of calls which may be placed upon it, not least by virtue of bank refinancing costs and pension issues. Throw in the proposed bringing forward of an insolvency regime for colleges and the picture gets ever more interesting. There are also increasing calls to consider paying Corporation Chairs for their work, recognising the very significant demands the Area Based Review process – and potentially implementing recommendations – will place upon them. There are charity law issues to address, but a number of colleges are already taking steps to move this forward urgently.

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Also in this issue

Q&A

Area Based Review Guidance

In this latest in a series of interviews we talk to Tom Morrison, the Head of Rollits' Education Team, about the Government's updated guidance on Area Based Reviews.

The updated Area Based Review Guidance has just landed. What is your initial reaction to it?

I think that there are plenty of questions which remain unanswered, but honestly there is a little more substance in there than perhaps was expected. There has been a fair degree of lobbying taking place, which may in part account for the delay in the guidance being published, but at least some of that lobbying appears to be having an impact.

What are you thinking of in particular?

Towards the top of my list would be the fact that it is now formally being acknowledged that colleges are going to need financial support in connection with this process. The guidance talks about a restructuring facility (earlier terminology referring to a "fund"). To most of us, a facility is not a grant, rather it is a loan of some description. The Government is clearly wary of setting precedents in offering financial support in connection with implementing recommendations arising out of Area Based Reviews, but there is finally a realisation centrally that there will be some mergers, for example, which might make good sense but which will be dead in the water without some form of financial accommodation. The guidance sets out criteria with which colleges are required to adhere to to be eligible for consideration for access to the restructuring facility. Even then the decision will be taken by the Treasury in conjunction with Ministers, with the very clear ambition of parting with as little taxpayer money as possible.

So good news then?

Not completely. The Government continues to be trying to play hard ball with colleges, but there is some softening. The total size of the facility is not huge – around half a billion pounds in total, which could be swallowed up quite easily given the potential number and scale of calls which may be placed upon it. But the fact that the facility exists is a start. How the Transaction Unit (whose role it is to coordinate all of this) administer all of this in practice could be crucial and remains a big unknown at this stage.

So no grants then?

Actually there have been two positive signs on this front. Firstly, the guidance acknowledges that there may be some situations where a loan is just not going to work because the repayments will simply not be affordable to the ongoing provider in a given scenario. The guidance goes to some lengths to make clear that this will be highly exceptional and will require top level sanction from Government. Any recommendation arising out of an Area Based Review which is unaffordable without a grant being made will have to be very well reasoned, with clearly defined benefits which outweigh the strong presumption against a grant being made.

Separately, it seems that there is also a dawning realisation that irrespective of whether or not there are liabilities to be dealt with arising out of, say, a merger, there is an inherent cost in even the most straightforward of recommended mergers and that if the Government is going to encourage colleges to pursue positively those recommendations then it is going to have to support that process financially. It seems that there will be grants of up to £100,000 available and no doubt there will have to be a sound case made for access to these. This is positive movement though; in some earlier phases there has been quite a bullish stance that the continuing colleges are those which are going to reap the benefits so, it was said, they should fully fund any process themselves.

What would be your single biggest concern in connection with the criteria for accessing the restructuring facility and grants?

In its desire to minimise demand for access to the central pot, the Government is effectively saying that a college will have had to pare itself back to the bone before asking for financial support. If one of the aims of the Area Based Review process is to create more resilient providers then on what basis does it make sense to require a college to weaken itself, to sell off assets, to use up hard won reserves and to maximise borrowings before seeking financial support from the Government? Could that not have the opposite effect, weakening the sector and ultimately increasing demand for Government support? The real test will be how the Government operates this process in practice. If they overcook it then it could seriously backfire.

There is much talk of the role of banks. What is your take on this?

I think there are several parts of the guidance which will only support banks in hardening their view of the sector. There is no doubt that some banks feel they have more exposure to the sector than they are comfortable with and that they see the Area Based Review process as an opportunity to review their relationship with the sector. It is highly likely that any college which is looking to join with another college will be in some way impacted by the position of one or more banks – most likely because there will be a change of control, a change of entity and a likely breach of covenant.

Many sizeable banking arrangements were hedged by the bank and any break of these hedges results in costs which will be passed down the line to the affected colleges. It only takes one of the colleges in a merger to have a banking issue for the whole merger to be affected. And by affected I mean killed dead unless funds can be found to make the deal stack up financially for everyone. Of course that money could potentially come from refinancing with the same or another bank, but there will inevitably be an increased cost of borrowing for a sector the Government is saying it wishes to help make more resilient. For that reason I think there must be some potential mergers which basically involve money leaving Government coffers and ending up with a bank, directly or indirectly.

The guidance suggests that some mergers may be affected by this type issue – I would instead suggest that most will be. The fact that this issue, together with the other big pension-shaped elephant in the room, gets little more than half a page of coverage in a sixty page document is bizarre, and is perhaps reflective of the fact that there are no easy answers to this.

Are there any other issues likely to make banks concerned?

Yes – insolvency is never something which makes a current, or potential, provider of finance feel comfortable. The guidance makes clear that the Government intends to introduce an insolvency regime for colleges by 2019. Add to this the comments that Exceptional Financial Support is to be abolished and that the Area Based Review process is a one-time-only process and, looking at it objectively, you can see why banks would feel that the sector as a whole represents a greater credit risk than perhaps it once did. Having said that, I cannot see why that risk should necessarily be seen as greater than very many other sectors.

What do you think could be improved about the process?

The list is long, so I will stick just to a few key points. I do not think that anyone is asserting that there will be zero positive outcomes from the Area Based Review process. Mergers will take place which make great sense and which perhaps could have happened earlier but for whatever reason did not. Conversations will have taken place which would not otherwise have done so and when people speak good things can happen – certainly it is much harder for good things to happen when people do not speak. Having said that, a great many people – me included – feel that some opportunities are so far not being realised out of a process which has some fundamental flaws.

This is not a post-16 provision review, it is a review of colleges. If in any good structure chart the learner is at the centre, then how can it make sense to only be focussing on a sub-set of providers who serve those learners: how can joined up solutions be achieved when not everyone is at the table? There is also an irony that Sixth Form Colleges are being offered an opportunity to become academies – a part of the sector which is not directly engaged in this process. That is a topic in itself, but for me the headline points on conversion are that the opportunity opens up some interesting possibilities for Sixth Form Colleges which should be educationally driven. Conversion is in practice only going to be available (at least in the first instance) on the back of a recommendation arising out of an Area Based Review, and whilst conversion to a single academy trust is a legal possibility the political weight is behind conversion to a multi academy trust ("MAT"). MATs open up a whole range of possibilities for collaboration, including with other colleges, so there is much which could happen around this. There is also no doubt in my mind that linking the availability of conversion to the Area Based Reviews is a Governmental tool to encourage Sixth Form Colleges to participate fully in the process.

The concept of an "area" is itself inherently flawed. The Government says it wants fewer, larger providers. A very great many larger providers (and some smaller ones) serve learners in multiple areas, so how does a review focussing on one area – or more accurately the providers in one area – result in recommendations which include cross-area solutions to cross-area problems? How do we even identify cross-area problems in this process?

The focus is on mergers. Indeed the latest guidance makes more frequent use of the word "takeover" than I have seen before. Whilst there will be scenarios where mergers make very good sense there seems to be much less focus on true collaboration than I would have liked to have seen. The initial guidance at least paid lip service to collaboration. The updated guidance does less than this, only citing one solid example of setting up a joint apprenticeship company, and a couple of vague mentions of shared services and "back office" functions. I think the narrow focus on the last point overlooks the complexity of the sector and the skill of those who work within it. As for collaboration generally I think there could be some very positive forms of collaboration which are in danger of being pushed to the side.

What would be your top piece of advice right now?

Embrace the process, not because it is perfect – it is patently not – but because it is happening come what may and colleges are always at their best when they take control and shape their own destinies. If you are in an early Wave, take advantage of the fact that the Government wants to see certain outcomes and if a recommendation coincides with your college's own preferences then make the most of that opportunity when it comes to negotiating for financial and other support. If you are in a later Wave, take advantage of being able to consider any lessons from earlier Waves and use the time to find solutions which you prefer – in short get your own unofficial Area Based Review recommendation in place before someone else makes it.

Accidents in schools and colleges

The issue of accidents has hit the headlines again in recent weeks, following Press coverage of a Road Safety Scheme launched by a primary school in Cardiff. The Scheme will allow teachers to meet with their pupils in a car park near to the School premises and to walk them safely to School, following an accident earlier this year in which one pupil was hit by a car during the School Run.

It is worth reminding ourselves of the legal position in relation to accidents involving under 18s, and in particular the extent to which supervision will impact upon the general duty of care owed by an education provider to its students. If you would like to read our analysis of some of the key issues to consider when it comes to keeping children safe, illustrated with real life examples, please visit the News section of our website and look out for the article *Accidents at school* by Rebecca Latus.

Training provider purchases
Incentivising sellers using earn-outs

In this latest in the series of articles on sector mergers and acquisitions we look at the concept of "earn-outs" and incentivising sellers to ensure that, say, the training provider they are selling continues to grow once it has been acquired by another provider. An earn-out is a mechanism used on the sale of a company where at least part of the price is calculated over a period of time after the acquisition has taken place.

Earn-outs should be distinguished from deferred price. Deferred consideration is simply part of the agreed price which, although known, is not paid until a date after completion. This mechanism could be used for a variety of reasons which include an inability to fund the entire price at completion. In essence, the Seller is partially funding the cash flow for a sale.

An earn-out, on the other hand, is usually linked to profits for two or three financial periods after completion. For the Seller there is more chance to receive the full benefit of selling the business; for the Buyer the price is directly linked to performance and it could help cash flow. In addition where the Sellers themselves are important – perhaps they have close contact with key customers – it could encourage loyalty.

At a basic level both the Buyer and Seller have an interest in maximising profits but:

- the Buyer may want to invest looking beyond the earn-out period;
- the Seller will be exposed to external factors – the general economic climate may directly affect financial performance; and
- tax treatment is not straightforward. There are difficult issues whether the Seller is a company or an individual.

If profits are used to calculate the earn out it can be difficult and so in some cases the earn-out is calculated as a proportion of turnover – but again there are issues for both the Buyer and Seller.

Typical issues for Sellers

The Buyer may for legitimate business reasons want to make management charges or take other action which may reduce the level of profitability in the target. The usual areas for negotiation are:

- Buyer will not do anything to reduce or discount the earn-out
- Buyer will not direct business through other group companies
- Restriction on the level of management fees
- Remuneration levels
- Future investment and the effect on profits
- Funding and borrowing limits
- The payment of dividends
- Senior appointments and removals

Typical issues for Buyers

- What happens on the death, incapacity, dismissal of a Seller?
- What happens if the Seller leaves during the earn-out period? If the Seller is what is called a 'good leaver' it may be appropriate to accelerate the payment.
- Who controls the business in the earn-out period? It may be possible to agree decisions that require the consent of both parties.

Security

The Seller may want some comfort that the earn-out consideration is paid when it is due. This will depend on the nature of the transaction but it is more common in the case of deferred consideration. The most common forms of security are cash escrow account, bank guarantee (but there are associated costs), parent guarantee or charge over assets (but this may affect the Buyer's banking arrangements and if the Buyer's bank has security over some of the business' assets already, arrangements might be needed to regulate priority).

Earn-out arrangements can work well for both parties, reducing the risk of a Buyer of overpaying for a business and increasing opportunity to maximise value for a Seller, but the practical impact of such an arrangement needs careful thought.

Richard Field and John Flanagan

Pension reform and increased costs

A number of recent changes to pensions legislation will not only increase the pension costs of education providers, but could also reduce the take home pay of their employees and may affect decisions about joining or remaining a member of the relevant pension schemes offered by education providers.

A single tier state pension was introduced in the Pensions Act 2014, and will take effect from April 2016. This has led to the abolition of contracting-out for defined benefit schemes, which includes both the Local Government Pension Scheme (LGPS) and the Teachers' Pension Scheme (TPS).

Under contracting-out, both employers and employees paid reduced National Insurance Contributions (NICs), and its abolition will mean that payroll costs for employers will be increased by the amount of the reduction in respect of employer contributions (3.4%), and employees' net pay will reduce by 1.4% of relevant earnings. For private schemes, the legislation allows employers to reduce benefits or increase employee contributions to offset the extra cost payable by the employer for NICs, but the government promised to make no changes to public sector pensions for the next 25 years, and therefore there is no ability to pass on these increased costs to members.

This is likely to lead to more employees opting out of the relevant pension scheme, or, in the case of the LGPS, choosing to take up the 50/50 option in that scheme, whereby an employee pays half of the contributions and receive half of the benefits. This would benefit employers, as it would reduce pension costs.

A second reform, introduced in the 2015 Summer Budget, relates to the taxation of pensions saving. The Chancellor has introduced a tapered reduction in the Annual Allowance (currently at £40,000 per year) for high earners. A new definition of income was introduced, which includes income from investments and property and includes the value of pension contributions (including employer contributions). This, together with the reduction in lifetime allowance to £1 million from April 2016 which had previously been introduced, is likely to lead to higher earners employed by education providers considering their options, as the lower tax relief makes continued participation in the pension scheme unattractive, and may lead to requests to have extra pay or other compensation in lieu of pension.

Together with the flexibilities in accessing defined contribution pension benefits that came into effect last year and the recent introduction of the new LGPS and TPS schemes, with career average pensions with higher accrual rates, this all means much more for employers and employees alike to consider in terms of pensions.

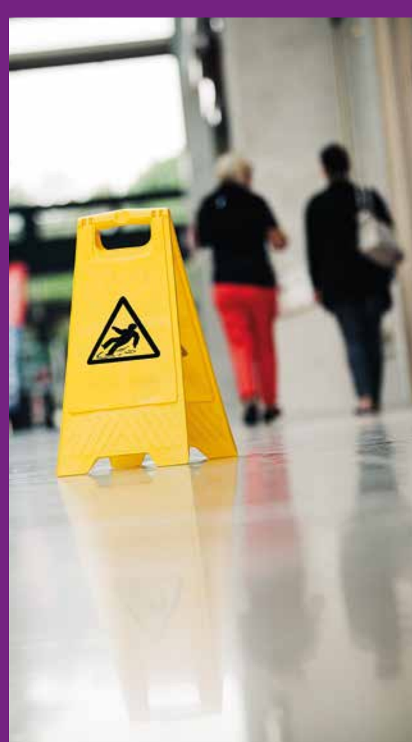
Craig Engleman

Health and safety fines hiked up

1 February 2016 marked the day on which new guidelines indicated that the financial penalties for health and safety offences would rise to an unprecedented level. The guidelines apply to all organisations, including education providers, as well as individuals responsible for health and safety, which can include the Governors and members of the Senior Management Team.

In appropriate cases the Court will now impose a financial penalty even where it is known in that it could lead to the financial collapse of the organisation upon which the fine is to be imposed. Fines are now to be calculated proportionately based on the organisation's turnover. As an example, if serious injury occurs at a "medium" sized organisation (categorised as having a turnover of between £10 million and £50 million) the Court will (depending on the circumstances of the case) now consider a fine of between £220,000 to £1,200,000.

This change forms part of the Government's drive to ensure that it is not cheaper for an organisation to ignore its responsibilities in relation to health and safety and just pay a fine if it is prosecuted, than it is to properly comply with its duties. The impact has already been felt: cases which would previously have resulted in a fine of less than £20,000 have seen fines of more than £250,000 imposed.



Jennifer Sewell

LSBF Tier 4 Highly Trusted Sponsor licence revoked

The London School of Business and Finance (LSBF), a provider which forms part of the for-profit education group Global University Systems, has had its Tier 4 Highly Trusted Sponsor Licence revoked. The revocation followed a "technical discussion" regarding the number of non-EU students being accepted by LSBF, whose visa applications had then been refused. It is a strict requirement that to qualify for a Highly Trusted Sponsor Licence, a refusal rate of 10% must not be exceeded in any 12 month period.

The revocation of LSBF's Licence has resulted in excess of 350 international students receiving a "notice of curtailment" from the Government, the outcome of which being those students having to return their residence permits and having no permission to work in the UK. LSBF has advised that the affected students will hopefully complete their studies by way of accelerated teaching. However, the remaining students who are not able to conclude their studies are expected to be transferred to one of LSBF's fellow institutions in either France or Italy. LSBF was one of the institutions included in the mass suspensions last year; its Licence being reinstated prior to this further revocation.

The case of LSBF is just another example of the Government's no-nonsense approach to compliance with their requirements and also, the importance of consistent and ongoing internal monitoring at all sponsoring institutions.

Christina Sledmore

National recognition by independent directory

Independent legal directory Chambers and Partners has again noted Rollits' Education Team as "active and accomplished" nationwide in further education and higher education. Chambers conducts its own independent research, asking clients and other sector representatives about our work in the sector. We are immensely grateful for the support of our clients and look forward to contributing to an exciting year ahead in what remain unprecedented times.

CHAMBERS AND PARTNERS

Area Based Reviews Update

Continued from cover…

Sixth form colleges are being encouraged to consider converting into academies and moving into multi academy trusts. Whilst there are potential advantages, including in relation to VAT, the Government is clearly making these opportunities available in the first instance only to those who have secured a recommendation for a MAT arising out of an Area Based Review. Perhaps a tool to encourage greater engagement in the process as a whole. Whilst recent guidance on the topic does not rule out the creation of a single academy trust to house a sixth form college, the direction of travel remains clear.

All of these issues raise interesting questions in relation to the independence of providers which are charitable at law. The Government has been somewhat unsubtle in its assertions that it will only fund efficient providers, with perhaps the faintest suggestion that only organisations which survive or are born out of Area Based Reviews are guaranteed to make the grade. Governors, not least in their roles as charity trustees, together with their Executive Teams have some interesting times ahead.

Information

If you have any queries on any issues raised in this newsletter, or any education matters in general please contact Tom Morrison on 01482 337310.

This newsletter is for the use of clients and will be supplied to others on request. It is for general guidance only. It provides useful information in a concise form. Action should not be taken without obtaining specific advice.

We hope you have found this newsletter useful. If, however, you do not wish to receive further mailings from us, please write to Pat Coyle, Rollits, Citadel House, 58 High Street, Hull HU1 1QE.

The law is stated as at 15 March 2016.

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