SIP 16 – does it do what it says on the tin or is it a can of worms?

Robert Smailes recounts the sorry tale of a pit into which he fell.

Much has been written about pre-pack sales of businesses out of an administration process to both connected and non-connected parties and the use and sometimes abuse of SIP 16. Now nearly a year after SIP 16 was introduced what practical implications are there for practitioner and the rescue culture in general?

Clydesdale v. *Smailes*

A lot of recent industry comments centre around the recently reported case of *Clydesdale* v. *Smailes*. As the insolvency practitioner involved I am very much aware that in this case, like many others, some of the salient points raised have either been taken out of context or indeed have been badly reported. However, there are real implications and indeed might make even the most thick skinned practitioner think twice before undertaking the next pre-pack.

Clydesdale v. *Smailes* centred around Alexander Samuel LLP (LLP), a firm of solicitors. My advice was sought and, at the first meeting, I was informed that the LLP was a firm of solicitors who were in extreme financial difficulties and could not continue to trade. The nature of their business was explained to me and, in particular, that the LLP practised exclusively in the field of personal injury work undertaking a significant volume of cases all of which were conducted under conditional fee agreements. I was also advised that the overwhelming bulk of the work related to road traffic accident cases. The value of any particular file was relatively small, if indeed it held any value at all.

I was also made aware, at the outset, that the LLP had very substantial borrowings and that relationships with its funders were poor. I was informed that there was a real risk of one or more funder taking hostile steps in the immediate future and the position looked bleak.

From the information provided to me by the LLP it seemed clear that the business was not solvent and could therefore not continue trading. An additional complication was that once the principals of the LLP formed the view that they could no longer legitimately trade I was informed that they would have a professional obligation to inform the Solicitors Regulation Authority of this fact and there was a significant risk that this would trigger an intervention into the practice that was likely to have disastrous consequences, not least for creditors.

What were the options?

Time was of the essence and there appeared to be very limited options. Trading out in administration did not seem to me to be a viable option. To run the LLP would mean continuing to employ a large number of staff (the firm was operating on something like 100 or more fee earners) and there would be substantial cash flow requirements in view of the firm's overheads. Funding was unlikely to be available and retaining staff in what would be no more than a run-off process would have been very difficult.

I did not consider that an open market sale was possible for a practice of this nature. Even if there were a relevant market for such businesses it was very unlikely that any purchaser could be found who would be prepared to purchase the business in a short timescale, and there was a real risk that in seeking to market the business news of the situation would leak out with likely adverse consequences in the loss of clients and staff and possible pre-emptive action by one of the creditors as well as possible regulatory issues. It seemed to me unlikely that there would be a ready market for such a large niche firm in any event.

The LLP advised me that they had been in contact with a third party who was interested in buying the business as a going concern and was willing to do so in a short time span. In all the circumstances, this seemed to me to offer the best solution provided that the sale was at an appropriate price and it was therefore agreed to proceed by means of a pre-pack sale to that purchaser subject to reaching agreement on price.

To ensure that a proper price was to be paid for the business a wholly independent large firm of accountants was instructed to carry out a valuation of the business.

In accordance with the stance taken in both the *Transbus* and *Kayley Vending* cases where creditors had been deprived of the opportunity to influence a sale, I invited an offer from the only known interested party and a sale figure was negotiated and agreed; this figure being substantially higher than the expert valuation that I had obtained.

That a pre-pack sale of a firm of solicitors was undertaken in itself was not worthy of any particular mention or debate. In the current climate a number of professional practices had gone into administration and indeed in the majority, if not all of these cases, a pre-pack was not only the route utilised but indeed, the sale to the current management.

Why the concern?

So why did this particular LLP sale cause so much concern? Well firstly, in over 30 years

in the profession I have seldom seen the level of anger shown by the larger creditors. What was clear very early on was that trust had broken down and a variety of serious, and in my view, totally improper allegations were made by the creditors not least of all against me personally. Injunctive proceedings were commenced by two funders and an insurer (who among other things, had provided credit insurance). These proceedings initially sought to effectively unwind the sale although, subsequently, the claimants recognised that that was not practically possible.

The claimants' allegations were continued into their proceedings (somewhat surprisingly given that, by then, they had had the opportunity to reflect on matters) and ultimately a lengthy hearing took place over several days in the Chancery Division before Mr Justice Richards. At that hearing, Mr Justice Richards made it clear that he rejected all allegations of deliberate wrongdoing that were made.

Perhaps the main reason why the case has received such publicity is that it is an unusual situation where the court ordered the removal of myself and my partner as administrators and appointed a replacement administrator.

A significant feature in the case was the complaint by the claimants that I had not complied with SIP 16, though the real industry issue is what precisely does SIP 16 require an insolvency practitioner to do in these circumstances.

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Was it necessary to consult the creditors?

At the time of this transaction, SIP 16 had only just been issued and its practical effect had not been tested. My understanding of the spirit, if not the letter, of SIP 16 was that an administrator dealing with a pre-pack sale should notify creditors of the position at the earliest opportunity but that there was no duty to consult with them to agree any sale figure. As I had been advised that the main creditors were likely to prove hostile (as appears to be borne out by their subsequent actions) I did not feel it was appropriate to notify them at an early stage. I did, however, e-mail the largest creditor immediately prior to the sale proceeding but, admittedly, too late for that creditor to be able to influence the position.

The contention made by the creditors was that I should have consulted with the main creditors before proceeding but in my view, given the circumstances of this particular job, there was simply no room for consultation. I have already explained the risks that were perceived and, at least at that stage, the main creditors were not working as one as became the case in the subsequent proceedings. Mr Justice Richards, in part of his summing up of the case, accepted that, provided an administrator was reasonably confident that the best available deal was done, keeping creditors uninformed for fear that someone might intervene in a way that might ruin the one and only practical opportunity of securing a real value for the creditors as a whole was not a ground for removing an administrator.

Creditors clearly are in a unique position as stakeholders in any insolvent business often having not only provided substantial funding but also time and effort. However, a surprising feature of this case was how the creditors had been persuaded to provide the LLP with vast amounts of funding without ensuring that adequate security was provided and it does call into question what processes they had in place to verify the balance sheet and accounts and any information provided to them by the former members.

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The messages for the future

So what are the messages that come out of the case? Is it that administrators need to be more careful when selling businesses as part of a pre-pack scenario. Hopefully not. I think most practitioners value not only their licences but indeed their sanity and would do anything to be beyond criticism and retain both. I can vouch that being threatened with an injunction on a Saturday and spending most of the weekend liaising with your solicitor is no laughing matter. Being accused of collusion is neither good for myself nor the industry.

I have undertaken a number of high profile jobs throughout my career and my first partner, who was a president of R3 in his time, often reminded me when I was taking early steps that getting experienced solicitors and agents was key. My own solicitors were highly experienced and well known in the industry in which the LLP was acting so one box was immediately ticked. The valuation agent employed had real experience of valuing business and was fully independent.

What was clear from Mr Justice Richards' summing up was that due to the high profile of the case and indeed the concerns of the largest creditor some form of independent view was needed. What was not so clear was why that could not have been done by the appointment of a liquidator of the creditor's choice that I agreed to convene at short notice rather than having another administrator appointed. As most, if not all, of the day-to-day matters of dealing with client's funds had been reconciled and dealt with by my office there was little or nothing to 'administer' and any appointed liquidator would have the same powers if not greater in reviewing the sale. Indeed, shortly after his appointment as administrator the LLP was put into liquidation and the administrator became the liquidator.

Vast amounts of time and money have been wasted. The estimate of legal costs just to deal with the interim application was in excess of £1.5 million. The claimants have been ordered to bear the vast majority of this. It is hard to see how this can have been a worthwhile exercise given that all that has been achieved is the replacement of the administrators, which would have happened in any event once the liquidation was proposed.

So what of the future? If the largest creditor in your next job tells you not to sell a business but you believe that you have been offered the best possible price and there is a real risk of losing the sale do you make a decision based on your vast experience and go ahead and risk the knock on the door on Saturday with the injunction, or do you not sell and risk other creditors wondering why you did not 'snap their hands off', preserve jobs, save redundancy costs and yes, pay a dividend to unsecured creditors. I think this course of action used to be called the rescue culture but will any practitioner feel in the future that the costs and the stakes are too high. Only time and possible case law will tell. □

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