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Re SHB Realisation Ltd (formerly BHS Ltd); Wright and another (as joint liquidators of SHB Realisations Ltd (formerly BHS Ltd)) v Prudential Assurance Companies Ltd [2018] EWHC 402 (Ch); [2018] All ER (D) 58 (Mar)

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Synopsis

With high street insolvencies on the rise, CVAs have grown in popularity as a restructuring tool, allowing companies to hold on to leases for the purposes of continued trade at a reduced rent, in the hope that this will facilitate rescue. *Re SHB Realisations Ltd* is a timely decision about the effect of such rent concessions within a company voluntary arrangement. Although elements of the judgment in *Re SHB Realisations Ltd* turn upon the provisions of the specific CVA, the decision also clarifies some important principles relevant to voluntary arrangements and administrations generally.

The facts

SHB Realisations Ltd ('the Company') was the principal trading company in the BHS group, a prominent high street retailer in the UK. In March 2016 the Company made proposals for a company voluntary arrangement (CVA) to afford the Company an opportunity to restructure. The proposals attributed the Company's financial difficulties in part to its excessive rent commitments and contained provisions which would allow for the Company to pay a reduced rent on certain stores while the CVA was in force. Clause 25.9 of the proposals provided that, in the event the CVA terminated, this rent concession would be deemed never to have happened and the landlords would be able to claim the full amount of rent as if the proposal had never been approved.

The proposals were approved by members and creditors on 23 March 2016 but by April 2016 it had become apparent that the Company lacked funds to continue to trade in the CVA and the Company went into administration on 25 April 2016. The CVA did not terminate as a consequence of the appointment of administrators but ran alongside the administration. For a while, the administrators continued to trade while paying the reduced rent under the terms of the CVA. The Company eventually went into voluntary liquidation in November 2016. Following the Company's failure to comply with a notice served by one of its landlords, the CVA was formally terminated for default in December 2016.

Upon termination Prudential Assurance Companies Ltd ('Prudential'), the landlord of the Company's stores in Chester and Southend made a rent demand on the liquidators. Prudential argued that:

(i) Pursuant to clause 25.9 the rental concession had been revoked as a consequence of the termination of the CVA. Prudential was therefore entitled to receive the full amount of rent due for the duration of the CVA less the sum actually paid under the rental concession.

(ii) Part of the outstanding balance, which comprised the rent relating to the period during which the administrators were trading from the premises, was an administration expense payable in priority to other claims.

The liquidators of the Company made an application under s.112 Insolvency Act 1986 ('IA 1986') asking the court to resolve to the following questions:

(i) Whether, as a matter of contract law, clause 25.9 was an unenforceable penalty;

(ii) Whether the clause 25.9 infringed the pari passu principle; and

(iii) Whether any part of the rent would be payable as an administration expense in circumstances where it accrued after the administration.

Summary of the court's conclusions

The court's conclusions on these points were as follows:

(i) Clause 25.9 was not an unenforceable penalty clause. The contractual law of penalties could not be applied to voluntary arrangements and even if it was so applied clause 25.9, properly construed, was not a penalty clause.

(ii) Clause 25.9 did not infringe the pari passu principle.

(iii) The rent which accrued during the period the administrators were using the premises was payable as an administration expense, at the full rate.

Voluntary arrangements are not subject to every principle of contract law

The idea that a voluntary arrangement operates as contract dates back to the Court of Appeal decision in *Johnson v Davies*.[1] In that case the court considered the effect of the following words of s.260 IA 1986:[2]

> 'The approved arrangement (a) takes effect as if made by the debtor at the meeting and (b) binds every person who in accordance with the rules had notice of, and was entitled to vote at, the meeting (whether or not he was present or represented at it) as if he were a party to the arrangement.'

Chadwick LJ noted this provision did not directly impose the arrangement on a dissenting creditor, but created a 'statutory hypothesis' whereby the creditor was required to be treated 'as if he had consented'. Subsequent authorities have referred to voluntary arrangements being a 'species of contract'[3] taking 'effect as a contract'[4] or being 'contractually based'.[5]

In *Re SHB Realisations Ltd* the judge noted that it has been established that a CVA has contractual effect, and that the court is therefore compelled to apply a contractual analysis to issues such as the true construction of the CVA[6] or its effect on co-debtors and sureties.[7] However, the judge held that it does not follow that a CVA would have every attribute of a contract or that every principle of contractual law should apply to it.[8] The clearest example of this, is that the usual principles of contractual formation do not apply to CVAs because they are ousted by s.5 IA 1986 which provides that the CVA binds everyone entitled to vote, including those who did not receive notice of the CVA or voted against it.

The law of penalties cannot be applied to CVAs

In the writer's view, the most controversial part of the decision was the court's finding that is it impossible to apply the law of penalties to hypothetical contracts of this kind. The judge, Christopher Pymont QC, reached this conclusion for two reasons.

First, the judge observed that when applying the law on penalties it is necessary to consider whether there has been oppression, as judged by reference to the circumstances at the time of contracting, including the parties' respective bargaining power and legitimate commercial interest. He held it was 'impossible to see how such principles can be applied to a situation where there has been no negotiation ... but where an arrangement has been brought about by a statutory procedure and is binding ... by reason of a statutory hypothesis.'[9]

Secondly the judge found it impossible to see how a proposal put forward by the Company in the interests of itself, its members and its creditors using the statutory procedure could somehow be said to have oppressed the Company.

Although this proposition is expressed as a principle of general application it is perhaps the part of the decision most likely to be susceptible to challenge if invoked in future cases.

(i) The existence of oppression is not a pre-requisite to the operation of the rule against penalty clauses – see Cavendish per Lord Hodge JJSC at paras. 256 to 257 and 267.

(ii) Although voluntary arrangements are created via a statutory procedure, it is possible to draw analogies between the statutory procedure and the elements of contractual formation in order to assess whether the clause goes further than needed to protect the legitimate commercial interest of the party.

(iii) If a clause genuinely comprises a penalty, it is unclear why it should be enforceable because it was contained in a voluntary arrangement not a contract. The fact that the arrangement is imposed upon a proportion creditors might be relevant to the degree of oppression which resulted as against creditors who are reluctantly bound by its terms, but it would not be a reason to infer oppression as against creditors who had approved of the proposal, or creditors who had imposed the clause upon a distressed company by way of modification to the proposal.

Notes

1 [1999] Ch 1117.
2 Section 5 IA 1986A contains a corresponding provision applicable to CVAs.
3 *Welsby v Brelec Installations Ltd (in liq)* [2000] 2 BCLC 576 at 579g, [2001] BCC 421, (2000) Times, 18 April, [2001] BPIR 210, [2000] All ER (D) 515.
4 *Lloyds Bank PLC v Ellicott* [2003] BPIR 632 at para. 51 per Chadwick LJ).
5 *Tanner and another v Everitt and another* [2004] EWHC 1130 (Ch) [2004] BPIR 1026 at para. 75 per Mann J.
6 *Welsby v Brelec Installations Ltd, ibid., Sea Voyager Maritime Inc and others v Bielecki* [1999] 1 All E.R. 628 at 645a; [1999] B.C.C. 924; [1999] 1 B.C.L.C. 133; [1998] B.P.I.R. 655; [1999] Lloyd's Rep. I.R. 356; Times, 23 October 1998.
7 *Johnson v Davies* [1999] Ch 1117.
8 At [28].
9 At [29].

It is submitted that the application of the statutory procedure and the statutory hypothesis would be a factor to be taken into account when assessing bargaining power and oppression but does not justify the exclusion the rule against penalty clauses in all voluntary arrangements.

Properly construed the clause was not a penalty clause

The judge also held that, properly construed, the clause in question would not constitute a penalty in any event, because it provided for the precise commercial outcome promised to the landlords in the introduction to the proposals, namely that they would be in no worse position if the arrangement should terminate.

The liquidators argued that court should not have regard to the statements made within the introduction to the agreement in considering whether clause 25.9 was a penalty. They argued that clause 25.9 did not discount an existing liability, but replaced the original liability to pay rent with a new liability to pay rent at a reduced rate. The payment of rent at the reduced rate became the primary obligation under the CVA. By providing that, in the event of the default, the Company would be obliged to pay rent at a higher rate, Clause 25.9 created a new liability where none had existed before. This secondary obligation, triggered upon breach, was said to be a penalty.

The judge rejected these submissions.

First, the liquidators' construction failed to have regard to the fact that the Company only obtained the benefit of the reduced rent because clause 25.9 provided that this concession would be unwound if the CVA failed. The two clauses were inextricably linked and had to be viewed together.

Secondly, clause 25.9 was not exorbitant, extravagant or oppressive but reflected the landlords' legitimate commercial interests, and there was no evidence that the Company's negotiating position was any weaker than that of the landlords.

Finally, the argument that the CVA provisions containing the concession effected a variation of the relevant Leases was not supported by the facts. The language of the provision could not support that interpretation and more importantly, as the leases were granted by deed, they could only be varied by deed.

Properly construed, clause 25.9 did not create a new liability which was unenforceable as a penalty. Instead it was a provision which brought to an end a rent concession period and restored the landlords' original claims which would have existed prior the compromise contained within the CVA.

Infringement of the *pari passu* principle

The *pari passu* principle is the rule that 'statutory provisions for pro rata distribution may not be excluded by a contract which gives one creditor more than its proper share'.[10] The liquidators argued that clause 25.9 offended this rule by providing for a substantial increase in the landlords' claims in the event the Company's insolvent collapse prevented the rescue under the terms of its CVA. This argument was dependent on the same construction of the CVA that the liquidators had advanced to support the penalty clause argument. The *pari passu* argument was therefore also rejected on the basis that, properly construed, the terms of the CVA did not provide for the Landlord's claims to increase upon termination.

Contingent obligations as administration expenses

For some of the period in which the rent concession was in place the administrators were in possession of the premises for the benefit of the administration. During that period the rents became payable as an administration expense, applying the *Lundy Granite* principle,[11] as summarised in *Jervis v Pillar Denton Ltd.*[12] The issue was whether the sum so payable was the reduced concessionary rate which was due during the relevant period and under the terms of the CVA or whether, upon the CVA terminating and the concession being unwound, the full amount of the rent.

The liquidators argued that following *Jervis v Pillar Denton*, the rent which was payable as an expense was the rent which accrued during the relevant period. In this case, the rent accruing during the relevant period was the reduced amount under the CVA. The full amount only accrued after the CVA was terminated, by which point the administrators had given up possession and were no longer responsible for payment of rent as an administration expense.

The judge rejected this analysis. For the purpose of the *Lundy Granite* principle, rent accruing for the relevant period would include all sums payable for the

Notes

10 *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, [2012] AC 383, [2012] 1 All ER 505, [2011] 3 WLR 521, [2012] 1 BCLC 163, [2011] Bus LR 1266, [2011] BCC 734, (2011) Times, 15 August, [2011] BPIR 1223 per Lord Collins of Mapesbury at para. 1.

11 See *In Re Lundy Ganite Co, ex p Heavan* (1871) LR 6 Ch App 462.

12 [2014] EWCA Civ 180, [2015] Ch 87, [2014] 3 All ER 519, [2014] 3 WLR 901, [2014] 2 All ER (Comm) 826, [2014] 2 BCLC 204, [2014] 2 EGLR 9, (2014) Times, 16 April per Lewison LJ at para. 101.

premises during that period, including sums which were only contingent or yet to be ascertained, and even if those sums became payable with retrospective effect.

The significance of the decision

Although the decision to some extent turns on its specific facts, the collapse of BHS is far from an isolated incident. The pressures faced by the retail and casual dining industries have led to a number of high profile insolvencies in recent times. The costs associated with premises is invariably a significant contributing factor to insolvencies in these sectors and it is likely that these issues will continue to surface in the future. The SHB Realisations decision is likely to have widerspread impact on the approach taken by insolvency practitioners and landlords to such insolvencies.

On the one hand, the case serves as a warning that insolvency practitioners must take into account contingent and unascertained liabilities when considering the expenses which may be associated with a particular strategy.

On the other hand, the case reassures landlords that concessions which are applied in the hope of facilitating a restructuring via CVA are not irrevocable and need not be binding if the arrangement fails. Although popular among insolvent companies, CVAs involving rent concession have attracted criticism from landlords and commercial competitors, who feel the rental concessions give insolvent stores an unfair trading advantage. If the decision in SHB Realisations Ltd had been unfavourable to the landlords it is likely that opposition to such arrangements would only have increased.

Although the decision potentially has wider relevance as authority that the rule against penalty clauses does not apply to voluntary arrangements there is some scope to challenge this proposition in the future. The decision does not exclude the possibility that other principles of contract law could apply to voluntary arrangements.

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