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Thistle Hotels Ltd v Orb Estates plc and others

[2004] EWHC 322 (Ch)

CHANCERY DIVISION

SONIA PROUDMAN QC (SITTING AS A DEPUTY JUDGE OF THE HIGH COURT)

17 DECEMBER 2003, 3 FEBRUARY 2004

Costs - Security for costs - Counterclaim - Counterclaims arising from same transaction as claims and reflecting substantive defence to claims - Application for security made on basis that there was reason to believe that defendants would be unable to meet an adverse order for costs of relevant counterclaims and were also companies resident outside jurisdiction - Whether appropriate for court to exercise discretion to order security - CPR 25.12, 25.13.

The claimant entered into a transaction with certain of the defendant companies in a group to transfer hotels belonging to companies which it owned to the group. The transaction was effected by a sale of shares to a member of the group (Gamma), a Jersey company, whose liabilities two other members of the group (Orb and Euro) guaranteed under the share sale agreement. Immediately after the acquisition Gamma sold on its interests within the group so that the hotels became vested in HPUK (a UK company), a subsidiary of Euro, and the claimant continued to manage the hotels pursuant to operating and relationship agreements. Both Gamma and Euro were non-trading holding companies resident outside the jurisdiction. Euro was the beneficial owner of the shares in Gamma, Sceptre (another UK company) and HP Jersey (another Jersey company which held the shares of HPUK). Euro's principal asset was its shareholding in HP Jersey which was subject to two charges securing very substantial liabilities. Disputes arose over aspects of the share sale agreement and proceedings were instituted by the claimant against inter alia Gamma and Euro who counterclaimed for damages for misrepresentation and rectification of the agreement alleging breach of warranty and claiming entitlement to an equitable set-off. The claimant applied under CPR 25.12 for security for costs of the counterclaims on the basis that there was reason to believe that Gamma and Euro would be unable to pay the claimant's costs of the counterclaims if ordered to do so and that both companies were resident outside the jurisdiction (CPR 25.13(2)). Gamma and Euro contended inter alia that in any event an order for security was inappropriate because all the counterclaims arose out of the same transaction as the claim and reflected their substantive defence to the claim.

Held - The application would be granted for the following reasons--(1) A net asset balance was not determinative of the question whether a company

could pay a costs liability when it fell due. That issue involved consideration of the nature and liquidity of the assets. On a balance of probabilities neither Gamma nor Euro had readily available assets of their own from which they could meet an award of costs. Euro could not raid the assets of its subsidiaries at will to pay those costs since despite the substantial hotels owned by its UK subsidiaries, HPUK and Sceptre, the enforcement of a costs order against Euro would not give the claimant access to the property and cash of those subsidiaries because those assets were either unrealisable or not readily available (see [11], [12] below); *Re Unisoft Group Ltd* (*No 2*) [1993] BCLC 532 considered.

(2) An order made on the ground of non-residence could only be justified on objectively justified grounds relating to obstacles to or the burden of enforcement. In considering whether such obstacles or difficulty existed formal evidence did not have to be adduced in every case but the court should take note of the obvious realities without formal evidence. Although the mere fact that Gamma and Euro were non-resident was an insufficient basis to order security for costs, an order for security was justified in the present case because in order to gain access to the assets of Euro's subsidiaries within the jurisdiction the claimant would inevitably face extra costs and delays attendant upon difficulties in enforcing its award. The court therefore had jurisdiction to make an order for security for costs (see at [14], [15] below); *Nasser v United Bank of Kuwait* [2001] EWCA Civ 556, [2002] 1 All ER 401 considered.

(3) When considering whether a counterclaim merely operated as a defence the substance of each claim had to be considered and whether, and if so how far, the counterclaim enlarged the ambit of the action in terms of issues, time and costs. In the present case the counterclaims raised substantial issues which were not mere defences but had an independent vitality of their own. They involved detailed investigations into, and decisions on, law and fact which ought not to be decided on an interim application. In all the circumstances it was just for an order for security for costs of the counterclaims to be made to protect the claimant against irrecoverable costs of litigating the substantial issues raised by the relevant counterclaims (see at [36]-[38], [40]-[42], [46], [47] below); *Hutchison Telephone* (*UK*) *Ltd v Ultimate Response Ltd* [1993] BCLC 307 considered.

Cases referred to in judgment

Ashworth v Berkeley-Walbrook [1989] CA Transcript 896.

Bowring (C T) & Co (Insurance) Ltd v Corsi & Partners Ltd [1995] 1 BCLC 148, CA.

Cohl (Samuel J) Co v Eastern Mediterranean Maritime Ltd, *The Silver Fir* [1980] 1 Lloyd's Rep 371, CA.

Grimstead (*E A*) *& Son Ltd v McGarrigan* [1999] CA Transcript 1733.

Hutchison Telephone (*UK*) *Ltd v Ultimate Response Ltd* [1993] BCLC 307, CA.

Keary Developments Ltd v Tarmac Construction Ltd [1995] 2 BCLC 395, [1995] 3 All ER 534, CA.

Mapleson v Masini (1879) 5 QBD 144, QBD DC.

Nasser v United Bank of Kuwait [2001] EWCA Civ 556, [2002] 1 All ER 401, [2002] 1 WLR 1868, CA.

Neck v Taylor [1893] 1 QB 560, CA.

Parkinson (*Sir Lindsay*) *& Co Ltd v Triplan Ltd* [1973] 2 All ER 273, [1973] QB 609, [1973] 2 WLR 632, QBD and CA.

Petromin SA v Secnav Marine Ltd [1995] 1 Lloyd's Rep 603.

Somatra Ltd v Sinclair Roche & Temperley (a firm) [2000] 1 WLR 2453, CA.

Unisoft Group Ltd (*No 2*), *Re* [1993] BCLC 532.

Application

The claimant, Thistle Hotels Ltd, applied for security for costs of counterclaims made by two of the defendants, Gamma Four Ltd and Euro and UK Property Ltd, in proceedings arising out of a share sale agreement. The facts are set out in the judgment.

David Blayney (instructed by *Clifford Chance LLP*) for the claimant.

Paul Downes and *Charles Dougherty* (instructed by *Memery Crystal*) for the defendants.

Cur adv vult

3 February 2004. The following judgment was delivered.

SONIA PROUDMAN QC.

[1] This is an application by the claimant, Thistle Hotels Ltd (Thistle), for security for the costs of counterclaims made by two of the defendants, Gamma Four Ltd (Gamma) and Euro and UK Property Ltd (Euro). The application regarding the position of another defendant, Orb Estates plc (Orb), a company in administration, has been dealt with already by a consent order.

[2] The court may only order security for costs under CPR 25.12 if (i) it is satisfied, having regard to all the circumstances of the case, that it is just to do so, and (ii) one or more of the conditions specified in CPR 25.13(2) is or are met or an enactment permits the court to require security. In this application the jurisdiction is invoked primarily under CPR 25.13(2)(c) on the basis (which is disputed) that there is reason to believe that Gamma and Euro will be unable to pay Thistle's costs of the relevant counterclaims if ordered to do so, and also under CPR 25.13(2)(a) on the basis that (as is common ground) both Gamma and Euro are companies resident outside the jurisdiction, and not resident in a Brussels contracting state, a Lugano contracting state or a regulation state. Gamma and Euro submit that an order is inappropriate in any event, because the counterclaim arises out of the same transaction as, and reflects their substantive defence to, Thistle's claims. Gamma and Euro also submit for other reasons that the discretion to order security ought not to be exercised in this case and that delay in making the application constitutes an abuse of process.

[3] The action concerns a transaction whereby 37 of the 55 hotels belonging to the 4th to 17th defendants (the Hotel Group), companies owned by Thistle, were transferred to a group of companies (the Orb Group), of which Gamma, Orb, Euro, the 18th defendant Hotel Portfolio II UK Ltd (HPUK) and Sceptre Hotels UK Ltd (Sceptre), are members. The transfer was effected by a sale to Gamma of the shares in the 4th to 6th defendants, of which the 7th to 17th defendants are subsidiaries. Orb and

Euro guaranteed Gamma's liabilities under the share sale agreement (SSA). Prior to the sale Thistle effected an internal reorganisation by which the 18 hotels that were not to be included in the sale were removed from the Hotel Group's ownership. As a result of that reorganisation, the Hotel Group incurred substantial liabilities (the intra-group indebtedness) to Thistle. Immediately after the acquisition Gamma sold on its interests within the Orb Group (I was not taken to the details) so that the hotels became vested in HPUK. Thistle continues to manage the hotels pursuant to operating and relationship agreements.

Ability to meet an award of costs

[4] Gamma is a non-trading holding company incorporated in accordance with the laws of Jersey. Euro is a company incorporated in accordance with the laws of the British Virgin Islands and is also a non-trading

holding company. Euro is the beneficial owner of the shares in Gamma, Sceptre and another Jersey company, Hotel Portfolio II (Jersey) Ltd (HP Jersey). HP Jersey holds the shares of HPUK. HPUK and Sceptre (both of which are UK companies) respectively own 32 and 5 of the hotels (all of which are in the UK) although Thistle queries the regularity of Sceptre's acquisition.

[5] Mr Downes, counsel representing Gamma and Euro, submitted that Thistle has not established that Gamma and Euro would be unable to meet an adverse costs order. He relies on the summarised draft pro forma balance sheets of Gamma, Euro, HPUK and Sceptre.

[6] Gamma's pro forma balance sheet purports to show (as at 31 March 2003) net assets of over £11m. Witness statements from Mr Kosky of Clifford Chance LLP, Thistle's solicitors, supported by Mr Stephen Lewis FCA, head of Clifford Chance's forensic accounting department, explain in detail Thistle's reasoning for its contention that (a) the balance sheet includes double counting of certain assets and (b) in any event the investments shown on the balance sheet must be inferred to be illiquid. In either case there would be, it is said, an insufficiency of current assets to meet Gamma's current liabilities.

[7] Euro's pro forma balance sheet purports to show net assets of some £3.77m as at 30 June 2003. Euro's assets are entirely composed of investments in subsidiary companies. Again, Mr Kosky's witness statement explains in detail Thistle's reasons for believing that Euro has substantial liabilities and no currently realisable assets.

[8] Mr Downes's submissions on the question of ability to pay concentrated primarily on the asset position of Euro's subsidiaries, HPUK and Sceptre, which had, according to the balance sheets of those companies (purporting to show the asset position in July 2003--there is a query about the date), £20m in cash between them as well as the hotels. He submits (describing this as an 'unchallenged fact' in his skeleton argument) that the value of those assets could be realised for enforcement purposes.

[9] I do not see that the position of Euro's subsidiaries avails Gamma at all. Even in relation to Euro, the assets of HPUK and Sceptre are not necessarily directly available to their parent company. So far from supporting the submission that Euro could raid the assets of its subsidiaries at will to pay costs of the action, the evidence points in the opposite direction. Euro's shares in HP Jersey are subject to two charges securing very substantial liabilities which would prevent realisation of HP Jersey's

assets. Secondly, while HPUK's pro forma balance sheet shows total net assets of nearly £51.5m, this depends on the accuracy of the value ascribed to its tangible assets (presumably principally the 32 hotels) of nearly £816m, and the ability to collect its balance sheet debts of £54.1m, some of which must plainly include intra-group lending which is likely to be unrealisable. Thirdly, a caution against dealings has been registered at the Land Registry against the 32 hotels and other real property owned by HPUK, relating to undertakings involving the transfer of £35m of the proceeds of sale of the property to the cautioner. Euro has not answered Thistle's allegation that the balance sheet does not take account of this liability. Fourthly, Thistle maintains that the £18.7 shown as cash in the balance sheet is tied in to the security structure of the acquisition and is already earmarked for capital expenditure pursuant to the relationship agreement with Thistle. Again, there has been no rebuttal of this reasoned allegation. As to Sceptre, while its net assets are shown as £277,000, Thistle contends its net current liabilities exceed its readily realisable assets and Sceptre's assets (including its five hotels) are charged as security for substantial loan facilities. Further, as to the cash balances in both HPUK and Euro, Thistle's evidence as to the business, company structure and borrowing is such that it seems to me unlikely that cash in those companies is available for distribution to parent companies by way of dividend or otherwise.

[10] As Mr Rands, a partner in Memery Crystal, the defendants' solicitors, accepts in his witness statement, his clients originally instructed him, in response to a request from Thistle, to agree to provide a balance sheet for HP Jersey and profit and loss accounts and cash-flow statements for Gamma, Euro, HPUK and Jersey. A timetable was agreed but after the pro forma balance sheets were prepared the defendants declined to furnish further information, saying that sufficient details of available assets were contained in those balance sheets. No response has been given to Thistle's detailed analysis of the figures (on which Mr Blayney relied)

other than that Gamma and Euro do not agree with it. Mr Downes said little more than that the costs of production of further documents would be disproportionate and that there was no basis upon which the court could properly find that the bottom line figures shown in those balance sheets were untrue or incorrect.

[11] Even if I were to accept the net asset position as shown (and leaving aside the fact that the balance sheets were several months old by the date of the hearing), I do not accept that a net asset balance is determinative of the question whether a company can pay a costs liability when it falls due. That issue involves consideration of the nature and liquidity of the assets. In *Re Unisoft Group Ltd* (*No 2*) [1993] BCLC 532, Sir Donald Nicholls V-C considered the test for the purposes of deciding whether a company will be unable to pay the defendant's costs if successful in his defence in the context of an application under s 726 of the Companies Act 1985. Although the present application is not made under that provision it is common ground that the same principles apply. Sir Donald Nicholls V-C said ([1993] BCLC 532 at 534):

> 'Thus the question is, will the company be able to meet the costs order at the time when the order is made and requires to be met? That

> is a question to be judged and answered as matters stand when the application is heard by the court, although the court will take into account and give appropriate weight to evidence about what is expected to happen in the interval before the costs order would fall to be met. The court will draw appropriate inferences and here, as elsewhere, it will not let common sense fly out of the window ... the test is whether the court, on the basis of credible testimony, believes the company will be unable to pay ... If there is conflicting evidence the court must have regard to that also. The court must reach a conclusion on the basis of the totality of the evidence placed before it, giving such weight to the various matters deposed to as is appropriate in the circumstances. The matter on which, in the end, the court is required to reach a conclusion is whether the company will be unable to pay.'

In the *Unisoft* case, the evidence as to the solvency of the company, SHL, consisted of accounts audited to a date some two years before the hearing. SHL's principal asset was shares in a subsidiary company. The fixed assets included substantial properties held for investment and development. Although there was a net asset surplus of some £669,000, the Vice-Chancellor held that SHL would not be able to satisfy an award of costs. He said ([1993] BCLC 532 at 535):

> '... in my view if the petition fails SHL will be unable to pay a substantial costs bill as it falls due. SHL has no cash, and substantially its only current asset is not readily realisable.'

[12] It seems to me that the court can properly draw inferences from the fact that Gamma and Euro have neither directly answered Thistle's analysis of the balance sheets, nor have they produced information from which such an answer could be derived. In short, I am satisfied on the balance of probabilities that neither Gamma nor Euro have readily available assets of their own from which they could meet an award of costs. Further, despite the substantial hotels owned by HPUK and Sceptre, I do not accept, in the circumstances deposed to by Mr Kosky, Mr Downes's submission that enforcement of a costs order against Euro would give Thistle access to the property and cash vested in HPUK or Sceptre.

[13] Mr Downes also relied on a statement in the evidence of Mr Rands that HPUK and Sceptre have the support of their bankers, mortgagees and their parent company Atlantic Hotels (UK) Ltd (Atlantic):

> 'Their bankers and parent company self evidently would not wish to risk liquidation or any other form of insolvency procedure which would undermine the inherent value of the Hotels business in circumstances in which a forced sale would become necessary.'

However, it is not at all self-evident that bankers or parent would support Gamma, which is the sole counterclaimant for breach of warranty. Indeed, it does not seem to me that support would necessarily be given to Euro. There is no direct evidence that such support would in fact be forthcoming in either case. The position is similar to that in *Re Unisoft Group Ltd* (*No 2*), in which Sir Donald Nicholls V-C said ([1993] BCLC 532 at 535):

> '... SHL would have to obtain a loan. It is possible that its bank would be prepared to make an advance for this purpose. That is
>
> *[2004] 2 BCLC 174 at 180*
>
> possible. It is also possible that money might be coming from another source, for example its controlling shareholder. However, there is no evidence before me on these points. There is no letter from the bank. Nor, on the figures I have summarised, is it at all obvious that a loan of a six-figure sum would be forthcoming when sought.'

[14] I now turn to the application under CPR 25.13(2)(a). It is common ground that the mere fact that Gamma and Euro are non-resident is an insufficient basis to order security for costs. An order made on the ground of non-residence can only be justified on objective grounds relating to obstacles to or the burden of enforcement (for example in terms of costs or delay) in the context of the particular foreign claimant or country concerned: see *Nasser v United Bank of Kuwait* [2001] EWCA Civ 556, [2002] 1 All ER 401 at 419, [2002] 1 WLR 1868 at 1885 per Mance LJ. Mr Downes submitted, citing that case as authority, that this application is bound to fail as evidence of such obstacles or burden is required and none has been adduced. I do not agree that *Nasser*'s case is authority for the proposition that formal evidence has to be adduced in every case. While it cannot be assumed that there will be obstacles to or difficulty attendant on enforcement, and there must be a proper basis for considering that such obstacles or difficulty exist, the court may and should, as Mance LJ said in *Nasser*'s case ([2002] 1 All ER 401 at 419-420, [2002] 1 WLR 1868 at 1885-1886), take note of obvious realities without formal evidence. Euro is resident in the British Virgin Islands and its principal relevant asset is its shareholding in HP Jersey. It is common sense that, in order to gain access to the assets of HPUK and Sceptre within the jurisdiction, Thistle would inevitably face extra costs and delays in enforcing its award. It seems to me that the jurisdiction is correctly invoked under this head as well, at any rate as far as security for the extra costs attendant upon such difficulties is concerned.

[15] In my judgment therefore, the court has jurisdiction to make an order for security for costs and I turn to the issue of whether it is just to do so.

The claims, defences and counterclaims

[16] In the present case the proceedings comprise disputes over the SSA which was entered into on 12 March 2002. Completion of the SSA, that is to say the transfer of the shares to Gamma, the release from escrow of related agreements and a transfer of just over £600m, took place on 4 April 2002. The sum of £600m was set by reference to the book value of the hotel properties and working capital as at 1 December 2001 and comprised (i) a cash sum (the cash sum) of £555,424,200 transferred by the Hotel Group to Thistle by way of repayment of the intra-group lending and (ii) a loan note for £45m from the seventh defendant, guaranteed by Gamma, Orb and Euro.

[17] The consideration for the sale of the shares was prescribed by cl 4 of the SSA, as follows:

> 'the total price payable by the buyer to the Seller for the sale and purchase of the Shares is £1 in cash payable on Completion, subject to an adjustment for Net Asset Value to be calculated in accordance with Schedule 7, provided that in no case will the purchase price attributable to the Shares be less than £1.'
>
> *[2004] 2 BCLC 174 at 181*

Schedule 7 of the SSA provided for the adjustment to be made through a completion accounts mechanism, the reference date for these accounts (the completion accounts) being 24 March 2002 (the period end date). In effect, there was to be a balancing payment to take account of the impact on the Hotel Group's net asset value (NAV) of ordinary trading and fluctuations in the intra-group indebtedness up to the period end date. If the intra-group indebtedness at the period end date as shown in the completion accounts was less than the cash sum, Thistle was to pay the difference to the Hotel Group, and vice versa. The difference is referred to as 'the RIGD', the residual intra-group debt. However, the entitlement to be paid, or the liability to pay, would appear in the completion accounts as an asset or a liability, as the case might be, and thus be reflected in the NAV of the Hotel Group.

[18] Thistle's claims in the action are, in essence, as follows. (i) For judgment against Gamma as principal debtor and Euro as guarantor for the balance payable pursuant to the completion accounts, which Thistle says is some £24.853m. (ii) For judgment against the Hotel Group, alternatively Euro, for £10m paid by Thistle into the bank accounts of Orb and HPUK following completion. Several bases for return of this money as a matter of law are pleaded in the alternative. (iii) For judgment against Gamma as principal debtor and Euro as guarantor for more than £6m (plus interest) due under a tax covenant (the buyer's tax covenant). (iv) For a declaration that the RIGD payable by Thistle amounted to some £26.3m (thus leaving a balance in favour of Thistle of some £14.65m leaving aside interest).

[19] The case of Gamma and Euro by way of defence is, in summary. (i) That completion accounts were not validly served in accordance with the formal requirements of cl 18 of the SSA as to service in that the completion accounts relied on by Thistle were served by e-mail and out of time. The price adjustment mechanism therefore never came into operation and there was no adjustment from the original price of £1. The RIGD is due and owing as a debt from Thistle to the Hotel Group. (Thistle accepts that cl 18 was not complied with but alleges that time was not of the essence of the service provisions, and in any event there was an agreement, shared assumption, or estoppel by representation or convention that service by e-mail would constitute valid delivery.) (ii) In the alternative that Thistle was bound by completion accounts showing an erroneous figure for RIGD. (iii) That the correct NAV of the Group Companies was a negative of over £30m, owing to a deferred tax liability which had wrongly been excluded from the statutory accounts of the Hotel Group to 31 December 2001 (the principal accounts). Whether or not this should have been brought into account in assessing the NAV is pleaded as a matter of construction of the SSA. (iv) That there is no basis in law for recovery of the £10m. (v) That although the liability to reimburse £6m VAT is admitted, the overall liability of Thistle to Gamma on the account between the parties is in the defendants' favour. (I observe that no answer has been suggested to Thistle's reliance on cl 6.1 of the buyer's tax covenant which requires that sum to be paid without set-off or deduction.)

[20] The counterclaims in respect of which security is sought are, in summary, as follows. (i) A claim by Gamma for breach of warranty by Thistle under the SSA as to whether the principal accounts gave a true and fair view of the deferred tax position in compliance with Statements of

Standard Accounting Practice. The amount claimed would result in a substantial net balance between Thistle and Gamma in Gamma's favour. (ii)+(iii) Claims by Gamma and Euro arising out of an alleged misrepresentation based on an alleged acceptance and endorsement by James Clark, Thistle's finance manager, of a mistaken statement allegedly made by Steve Johnstone, acting on behalf of Gamma and Euro, to the effect that deferred tax has no effect on the asset value of a company. It is said that it was only in reliance on Mr Clark's alleged misrepresentation that Mr Johnstone agreed (by SSA, Sch 7, para 11.7) that deferred tax would be excluded from the completion accounts. The claims are for damages for misrepresentation and rectification of SSA to excise Sch 7, para 11.7.

Deferred tax

[21] The timing differences between the recognition of profits in financial statements and their recognition in a tax computation results in so-called deferred tax, that is, the corporation tax on profits shown in financial statements for one period but assessed for tax in another. FRS 19 'Deferred Tax' issued on 7 December 2000 superseded SSAP 15 'Accounting for deferred tax', as from years ending on or after 23 January 2002. Whereas under SSAP 15: 'Tax deferred ... by the effect of timing differences should be accounted for to the extent that it is probable that a liability or asset will crystallise,' under FRS 19 full provision is required to be made for deferred tax liabilities related to timing differences, regardless of whether those timing differences are expected to reverse and whether or not it is probable that the liabilities will crystallise.

[22] The accounting treatment of such deferred tax is at the heart of the counterclaims. Gamma and Euro maintain that the principal accounts ought to have made, but did not make, provision in accordance with SSAP 15 for deferred tax likely to crystallise. Gamma and Euro therefore counterclaim for breach of warranty under the SSA. Although this is a separate head of counterclaim, and not a defence as such, Mr Downes submits that it raises most of the same issues of fact as are involved in the defence of Gamma and Euro to

the claim for payment under the completion accounts. He says that the same evidence will be deployed in the defence as on the counterclaim, and so the court's discretion ought not to be exercised to order security.

[23] Schedule 7 to the SSA deals with the completion accounts, and it begins (para 1) with the statement that: 'The sole purpose of the Completion Accounts is to determine the [NAV].' By para 9 (comprised in Pt 2 of SSA, Sch 7) the completion accounts were to be prepared (if a matter was not specified in Pt 2) in accordance with the accounting policies and practices used in the vendor's audited accounts except where new accounting reporting standards had been issued. Nevertheless in Pt 3, para 11 provides as follows: 'The following shall be excluded from the Completion Accounts ... 11.4 deferred taxation arising in accordance with FRS 19.'

[24] Mr Blayney submits that this provision plainly and unequivocally excluded all deferred tax, that is to say, regardless of whether or not the liability was likely to crystallise, in accordance with the terms of FRS 19. Mr Downes submits however that, construed against the factual

background, para 11.4 did not exclude a liability which was likely to crystallise.

[25] The defendants' construction argument is as follows. All parties knew that there was a deferred tax liability of £54m: indeed it was referred to in the notes to the principal accounts and in a disclosure letter. However the principal accounts included no deferred tax liability pursuant to SSAP 15. It was therefore to be inferred that this liability was unlikely to crystallise. However, those preparing the completion accounts would have had to include it under FRS 19 and the exclusion in the SSA was made to exclude a non-crystallising liability from affecting the NAV. Given the effect on the NAV of a liability which was likely to crystallise, it could not have been the intention of the parties to exclude deferred tax which ought to have been, but was not, included in the principal accounts. Accordingly, the argument runs, the reference to 'deferred tax arising in accordance with FRS 19' means only the tax which would not have had to be accounted for under SSAP 15. The substance of the claim is (a) that the principal accounts were wrong and (b) that it was only on the basis that the principal accounts were correct that the impact of deferred tax on NAV could safely be excluded.

[26] The breach of warranty counterclaim, submitted Mr Downes, is a reflection of the construction argument. If Gamma and Euro win the construction argument, the court will need to make a finding as to whether there was any deferred tax liable to crystallise, an issue which will raise the same issues as the breach of warranty claim. If they lose the argument, it is said that it would still be unconscionable for Thistle to take advantage of its mistake in the principal accounts to claim the full amount said to be due under the completion accounts. Moreover, he submitted, in considering the estoppel by convention asserted by the claimant in relation to mode of service of the completion accounts, Thistle's conduct in relying on the strict terms of Sch 7, para 11.4 is relevant. In any event, it is further submitted, there would be an equitable set-off in relation to the breach of warranty claim that is so closely connected to Thistle's own claims that Gamma and Euro should not be prevented from relying on it. It is a question of net entitlement.

[27] Turning to the misrepresentation and rectification claims, it is said that Thistle was aware that Gamma and Euro were operating under a mistake as to the effect of the exclusion of deferred tax and this alone would be sufficient to support an estoppel to Thistle's reliance on the strict terms of Sch 7, para 11.4. The claims for misrepresentation and rectification are merely a positive reflection of a defence to Thistle's claim for payment pursuant to the completion accounts. Again, as to damages for misrepresentation, there is an equitable set-off so closely connected to Thistle's claims that Gamma and Euro should not be prevented from relying on it.

The discretion to order security

The analysis of a counterclaim

[28] The policy behind the jurisdiction to order security for costs is to counter the prejudice suffered by a defendant who is unsuccessfully pursued by a claimant unable to meet an order for costs. It is not intended

to counter prejudice to a claimant in meeting a defence that proves

unsuccessful. It is the claimant's business if he chooses to sue a defendant who is not good for costs. An impecunious defendant is not to be prejudiced in defending the main claim by an order for security on the counterclaim. In *C T Bowring & Co (Insurance) Ltd v Corsi & Partners Ltd* [1995] 1 BCLC 148 at 153 Dillon LJ said that there was--

> '... a strongly established rule of practice that a person who is in the position of a defendant is to be at liberty to defend himself and is not to be called on to give security ... I regard this as a rule of practice, and not a mere matter of discretion to be determined on the facts of each individual case--although of course any decision even to order a plaintiff to give security is a matter for the court's discretion ... I regard this rule of practice as of the same class as the rule of practice under which any litigant, other than the Crown or a public authority as law enforcer, who obtains an interlocutory injunction is required to give a cross-undertaking in damages. That is not a matter for discretion in the individual case ... it is clear that an impecunious company which makes a counterclaim which is more than a mere formulation of its defence can be ordered to give security for the plaintiff's costs of the counterclaim.'

[29] Mr Downes submitted that as all the counterclaims of Gamma and Euro arise out of the same transaction as Thistle's claims and are closely connected, those defendants are entitled to an equitable set-off. His first line of argument was that as such a set-off operates as a defence, the court cannot prevent Gamma and Euro from relying on it and there is no scope for ordering security for costs of the counterclaim merely because the amount claimed could exceed the amount of Thistle's claim. He relies on the observations of Stuart-Smith LJ in *Ashworth v Berkeley-Walbrook* [1989] CA Transcript 896 in relation to set-off:

> '... where the counterclaim can be relied upon as a defence--as plainly it can here because it is relied upon, and properly relied upon, as a set-off--and where it arises out of the same matter and transaction, then the general rule is that the counterclaiming defendant ought not to be required to give security for costs unless there are some exceptional circumstances which make it just for him to do so.'

[30] It seems to me that Mr Downes's approach is too simplistic. In *Samuel J Cohl Co v Eastern Mediterranean Maritime Ltd*, *The Silver Fir* [1980] 1 Lloyd's Rep 371 there was a claim and counterclaim by both parties to an arbitration over a charterparty. Both were foreign companies and each regarded itself as the injured party. Both applied for security for costs. Parker J at first instance accepted that the issues arose out of one transaction and ordered security for the costs of the claim but not of the counterclaim. The Court of Appeal ordered the defendant to pay a similar amount by way of security for the costs of the counterclaim as that payable by the claimants. In giving the judgment of the court, Lawton LJ said (at 374):

> '... Mr. Justice Parker accepted that he had a discretion, but that if the basic issues arising on both the claim and counterclaim were the same then the discretion should not be exercised in favour of the claimant.

> He did not have, as we have had, the benefit of examining all the authorities ... All [the earlier] cases were considered by the Court of Appeal in *Neck v Taylor* ([1893] 1 QB 560). The facts of that case were very different from the facts of this case. It was not a commercial case at all, but the Court did consider basic principles. I invite attention to a passage in the judgment of Lord Esher, M.R. ([1893] 1 QB 560 at 562): "Where however, the counterclaim is not in respect of a wholly distinct matter, but arises in respect of the same matter or transaction upon which the claim is founded, the court will not, merely because the party counterclaiming is resident out of the jurisdiction, order security for costs; it will in that case consider whether the counterclaim is not in substance put forward as a defence to the claim, whatever form in point of strict law and of pleading it may take, and, if so, what under all the circumstances will be just and fair as between the parties; and will act accordingly." What Lord Esher, M.R., was saying was that there is a discretion to award security for costs even in cases which arise out of the same subject matter. But if the counterclaim is a defence and nothing more then normally the discretion should not be exercised in favour of ordering security ... The problem now arises as to how the discretion should be exercised in this case. Considerations of equity arise. What is fair and just in all the circumstances? In my judgment where, as in this case, both parties carry on business outside the jurisdiction, both are claiming against the other as parties who have been badly treated and have suffered damage, and it was mere chance that one started the arbitration before the other could get in a claim, then both should be treated alike.'

[31] In *Hutchison Telephone* (*UK*) *Ltd v Ultimate Response Ltd* [1993] BCLC 307 the Court of Appeal considered both *The Silver Fir* and *Ashworth v Berkeley-Walbrook* (above) and confirmed the test laid down by Lord Esher MR in *Neck v Taylor* (above). Bingham LJ said ([1993] BCLC 307 at 316) that once the applicant had shown that the case fell within one of the classes specified by the rules of court, it was 'a largely discretionary area' (part of the issue whether it was just and right) whether an order for security was to be made against a counterclaiming defendant. He went on ([1993] BCLC 307 at 317):

> 'The trend of authority makes it plain that, even though a counterclaiming defendant *may* technically be ordered to give security for the costs of a plaintiff against whom he counterclaims, such an order should not ordinarily be made if all the defendant is doing, in substance, is to defend himself. Such an approach is consistent with the general rule that security may not be ordered against a defendant. So the question may arise, as a question of substance, not formality or pleading: is the defendant simply defending himself, or is he going beyond mere self-defence and launching a cross-claim with an independent vitality of its own? It appears to me that Field J put his finger on the appropriate question when he pithily observed in *Mapleson v Masini* (1879) 5 QBD 144 at 147: "The substantial position of the parties must always be looked at." For my part, I think that no simple rule of thumb exists to determine the answer to the question. An order for security against a counterclaiming defendant is

> not precluded because the counterclaim arises out of the same transaction as the claim. Otherwise no order could have been made in *The Silver Fir*. It is again not conclusive that the counterclaim overtops the claim, although I venture to think that the relative quantum of the counterclaim and the claim is not in all circumstances irrelevant. It is clearly a relevant consideration that, if the plaintiffs had not issued proceedings, the defendants would have done, as in *The Silver Fir*, because in such a case it may be almost a matter of chance whether a party happens to be the plaintiff or the defendant; and if the proper inference is that the defendants would have sued anyway, that fortifies the inference that the counterclaim has an independent vitality of its own and is not a mere matter of defence.' (Emphasis in original.)

[32] In the same case, Dillon LJ (who also affirmed the 'overriding discretion' of the court) referred to the two types of case where a counterclaim is really only part of the defence. One is where the relief claimed is the automatic counterpart of the failure of the claimants' claim. The other ([1993] BCLC 307 at 316):

> '... is the case of equitable set-off where the defendant asserts ... that a sum of money is in any event due to him under some other aspect of the very agreement or transaction on which the plaintiff is suing whether the plaintiff's claim be valid or not, and there is a plea of equitable set-off of the moneys so due and claimed by the counterclaim against the moneys claimed by the plaintiff in his claim, should those be held otherwise to be payable. In such a case it may be (and there are suggestions that that could be the case with the commission aspect of the present case) that quantifying the amount of the counterclaim, the sum that would be set off, is no very difficult matter. In such circumstances, it may be easy to say that in truth the set-off was the defence, the counterclaim is pleading the defence, and it would not be appropriate to grant security.'

In *Hutchison*'s case, there were complex discrete issues on the counterclaim, including claims for injurious falsehood, by which the ambit of the action was very substantially enlarged and which would be time-consuming and expensive to explore. Indeed the amount sought by the counterclaim was several times that claimed by the plaintiff. Security was ordered, and Dillon LJ stated the test as whether '... in the particular case the counterclaim is a cross-action or operates as a defence, that is to say merely operates as a defence' (see [1993] BCLC 307 at 313).

[33] It is true that in the present case the parties are to some extent (although Thistle says not entirely), concerned with the net entitlement as between the parties arising out of a single transaction and that there are set-off claims by Gamma and Euro which are relevant to the defensive nature of the counterclaims. However, that does not conclude the matter in the defendants' favour. In some circumstances, indeed, the court could decide that both sides are claimants and either side could well have started the litigation. The authorities to which I have referred require the substance of each claim to be considered and whether, and if so how far, the counterclaim enlarges the ambit of the action in terms of issues, time and costs.

Discretion applicable to all claims

[34] If the counterclaim is not merely a defence, the court in exercising its discretion whether to grant security

must take into account all the circumstances of the case. These might include such matters as the prospects of success of the relevant claim, any admission by the defendant as to whether money is due, whether the application for security is being used oppressively, the time when the application was made and whether the defendant has contributed by its conduct to the company's want of means (see *Sir Lindsay Parkinson & Co Ltd v Triplan Ltd* [1973] 2 All ER 273 at 285-286, [1973] QB 609 at 626 per Lord Denning MR). However, consideration of prospects of success is subject to the principle that the court should not investigate the merits of a claim in detail unless it is clear that there is a high probability of success or failure (see *Keary Developments Ltd v Tarmac Construction Ltd* [1995] 2 BCLC 395 at 401, [1995] 3 All ER 534 at 540 per Peter Gibson LJ).

The breach of warranty counterclaim

Defence or independent cross-claim?

[35] Does the breach of warranty counterclaim, in the words of Dillon LJ, 'merely operate as a defence' or, in the words of Bingham LJ, has it 'an independent vitality of its own'? Is it right, as Mr Downes submitted, that the same evidence will be relied on for the defence as for the counterclaim? Or is it right, as Mr Blayney submitted, that the counterclaim is a true cross-claim and there is no substantial overlap in relation to the costly expert and other evidence about deferred tax, the principal accounts and the effect on NAV?

[36] It seems to me that much of the factual matrix on which Mr Downes relied in support of his construction argument is not directed to the meaning of the words 'deferred tax arising in accordance with FRS 19' as contained in the SSA at all but to the question of reliance on the principal accounts and the actual intention of the parties to the negotiation as to whether and in what circumstances deferred tax should be included in the completion accounts. On that basis it is my view that the issues about whether the warranted accounts give a true and fair view of deferred tax are properly referable to the counterclaim for breach of warranty, or the claim to rectify Sch 7, para 11.7, rather than a matter of mere defence.

[37] Further, as in *Hutchison*'s case, this is not a case where a set-off in relation to the breach of warranty claim is straightforward to quantify: on the contrary, significant evidence of fact (including expert evidence) is necessary to investigate both the issue whether the £54m deferred tax was likely to crystallise (and thus should have been included in the principal accounts) and the issue (arising on all the relevant counterclaims) as to the effect on the NAV.

Set-off

[38] Mr Blayney pressed two arguments as to the court's discretion in relation to the breach of warranty claim. First, he submitted that this claim is not available in any event as a set-off to Thistle's claim to the balance due pursuant to the completion accounts. He relied on SSA cl 21.8, which provides as follows:

> 'Except as otherwise provided in this agreement, any payment to be made by any party under this agreement will be made in full without any set-off restriction condition or deduction for or on account of any counterclaim.'

Mr Downes relied on SSA cl 8.10 as an express contrary provision:

> 'Any payment made by the Seller in respect of a claim under the Warranties is, to the fullest extent possible, to be treated as a reduction in the price for the Shares ...'

Thistle maintains that cl 8.10 is intended to effect the characterisation of any payment actually made in respect of a warranty claim, and does not allow a claim for breach of warranty to be set up as a defence of set-off. I have not been taken to the full terms of the SSA (let alone any other part of the contractual arrangements between the parties) but have merely been shown these clauses in isolation. I am not prepared to make a finding of construction on such a central matter on an interim application without full argument on consideration of the documents as a whole.

Alleged weakness of the breach of warranty claim

[39] Mr Blayney further submitted that the warranty claim is bound to fail. He relied on SSA cl 9.7.11, which provides as follows:

> 'The Seller will have no liability under this agreement in respect Of any claim for breach of the Warranties other than the Tax Warranties ... to the extent any such claim would not have arisen but for any voluntary winding up or cessation after Completion of the trade or business as carried on by the relevant Group Company as at or immediately prior to Completion.'

He submitted that Gamma's claim is formulated and quantified in its expert report (to which Thistle claims to be able to refer under the principle in *Somatra Ltd v Sinclair Roche &Temperley* (*a firm*) [2000] 1 WLR 2453) on the basis of crystallisation of deferred tax to be caused by a voluntary cessation for redevelopment in 2006 and that the claim is precluded by cl 9.7.11. Thistle also says that redevelopment is a matter for the purchaser, and the plans of an actual purchaser (or indeed the existing plans of the vendor) are irrelevant to the value of the shares. A hypothetical purchaser would not assume a development which would produce negative cash-flow consequences reducing the value of the business but, on the contrary, would purchase the business with a view to running it in a manner which would prevent crystallisation of deferred tax liabilities.

[40] Much was said in argument about SSA para 9.7.11 with reference to the expert evidence. It seems plain to me that the issue of what the intentions are that have to be taken into account in making reasonable assumptions as to probability of crystallisation for the purposes of SSAP 15 involves detailed investigations into, and decisions on, law and fact. Accordingly the question whether this provision defeats the defendants' case is another which in my judgment ought not to be decided on an interim application.

Misrepresentation and rectification claims

Defence or independent cross-claim?

[41] The first question for present purposes is, again, how far do the misrepresentation and rectification claims really constitute or replicate the defence? It is my judgment that the facts required to be proved to establish these counterclaims go well beyond the facts required to make good the defence. Mr Downes submitted that the misrepresentation, if established, is sufficient to support an estoppel to Thistle's reliance on the strict construction of Sch 7, para 7.11 and indeed to defend Thistle's claim to an estoppel by convention as to e-mail service of the completion accounts. The former argument seems to me merely a reformulation of the rectification claim. In the latter case the claims can to my mind only tenuously be categorised as a mere defence. In my judgment these counterclaims too have the 'independent vitality' specified by Bingham LJ as the essence of cross-claims.

SSA cl 8.5

[42] As to the misrepresentation claim, and the connected claim for rectification, Mr Blayney submits that the defendants are estopped from bringing such claims by SSA cl 8.5. This provides:

> 'The Buyer acknowledges that it has not relied on or been induced to enter into this agreement by a warranty or representation other than the Warranties and, except in the case of fraud on the part of the Seller in respect of any representation or warranty unless such representation or warranty is expressly set out in this agreement.'

There is no claim that reliance on cl 8.5 is contrary to s 3 of the Misrepresentation Act 1967 as amended by the Unfair Contract Terms Act 1977. However it seems to me that questions of fact arise, first, as to whether the alleged representation was made, and, secondly, whether (as alleged by Gamma and Euro, although I note not expressly pleaded) Mr Clark knew that the acknowledgment of non-reliance contained in cl 8.5 did not reflect the true position: see *E A Grimstead & Son Ltd v McGarrigan* [1999] CA Transcript 1733. I am not prepared to rule on the strength or otherwise of the defendants' case on this issue which again involves a

detailed examination of the merits inappropriate on an interim application.

Other matters affecting discretion

Delay

[43] Gamma and Euro contend that the application is an abuse of the process of the court. On 12 February 2003 the master directed that any application for summary disposal should be made by 5 March. The purpose of the direction, submitted Mr Downes, was to provide certainty as to whether there would be summary disposal and enable the parties to prepare for trial. However the fact that the application was made after the deadline for summary judgment does not in my view constitute an abuse: the claimant can elect not to proceed summarily but still apply for security.

[44] Secondly, it is said that the claimant has been guilty of undue delay in any event by making the application after listing for trial. This is another of

the circumstances relevant to the exercise of the court's discretion: see *Sir Lindsay Parkinson & Co Ltd v Triplan* Ltd [1973] 2 All ER 273, [1973] QB 609. However I am satisfied after considering the chronology prepared by Mr Kosky that there was in fact no undue delay. Thistle did not receive requested particulars of the counterclaims until 23 May 2003, Euro was acquired by Atlantic at the end of May (as a result of which acquisition Thistle needed to assess the defendants' ability to meet an order for costs) and a request was made for security on 6 June. Thistle agreed to hold its hand pending the financial information to which I have referred. The pro forma balance sheets were not provided until 19 August. The application was issued on 2 September.

[45] Further, Gamma and Euro have not demonstrated that they have suffered any prejudice as a result of the alleged delay. In particular, it has not been argued that they have been deprived of the opportunity to collect security, or that they have been led to expend costs on a claim which, if security is ordered, they will be unable to pursue.

Stifling

[46] In this context I would add that another circumstance relevant to the exercise of discretion whether or not to grant security is an oppressive use of the application to try and stifle a genuine claim: see *Sir Lindsay Parkinson & Co Ltd v Triplan Ltd* [1973] 2 All ER 273, [1973] QB 609. The court must balance the injustice to a claimant prevented from pursuing its claims against the injustice to the defendant in incurring costs which it is unable to recover. However, before deciding that this balance lies in the claimant's favour, the court must be satisfied that the claim would indeed be stifled: *Keary Developments Ltd v Tarmac Construction Ltd* [1995] 2 BCLC 395, [1995] 3 All ER 534, *Petromin SA v Secnav Marine Ltd* [1995] 1 Lloyd's Rep 603. No evidence at all has been adduced indicating that the claims of Gamma and Euro would be stifled if an order for security were made in this case.

Conclusion

[47] It is in my judgment just in all the circumstances that Thistle should obtain protection against potentially irrecoverable costs of litigating the substantial issues raised by the relevant counterclaims. I propose to make an order for security for costs accordingly.

Order accordingly.

Mary Rose Plummer Barrister.