Barry D Trentham Ltd v Lawfield Investments Ltd [2002] Adj.L.R. 05/3

OPINION OF Lord Drummond Young : Outer House Court of Session. 3rd May 2002.

1. The pursuer is a building contractor. The defender is a property developer. In the summer of 2000 the defender embarked on the conversion of buildings at 70 Howard Street, Glasgow, into a block of shops and flats. On 17 June 2000 the parties entered into a contract whereby the pursuer undertook to carry out the construction work and part of the design work necessary to effect the conversion. The contract was entered into on the terms of the Scottish Building Contract Contractor's Designed Portion (without quantities) (January 2000 revision). The pursuer embarked upon the necessary works of design and construction under the contract. No quantity surveyor was ever appointed under the contract, however, with the result that the valuation, certification and payment mechanism of the Scottish Building Contract and JCT Standard Conditions could not be operated. In place of that mechanism, the parties agreed to substitute for the price payable to the pursuer by the defender under the contract the sum of (a) the pursuer's liability to subcontractors for works performed by them in carrying out the contract with the addition of a 7½% uplift and (b) the value of work carried out by the pursuer itself under the contract with the addition of a 5% uplift. Each month the pursuer issued interim valuations on the foregoing basis, and it appears that the defenders had those valuations checked by a quantity surveyor retained by Dunbar Bank PLC, who have provided the defender with finance for the development. Ultimately the defender made payment to the pursuer of most of the interim valuations. The pursuer avers, and the defender does not dispute, that the sum payable under the contract has been varied in the foregoing manner. The pursuer further avers that the contract as varied was a "construction contract" within the meaning of the Housing Grants, Construction and Regeneration Act 1996. Accordingly section 114 that Act implied into the contract the provisions of the Scheme for Construction Contracts (Scotland) Regulations 1998, which relate to the due date for payment and the final date for payment of interim payments under the contract. I did not understand this contention to be disputed by the defender.

2. By the time the present action was raised, on 8 March 2002, the contract works were almost complete. On 7 February 2002 the pursuer sent to the defender its interim valuation no. 17, which valued the work performed up to 31 January 2002 at £3,303,581 exclusive of VAT. After deduction of prior payments and retention, the sum due under that certificate is averred to be £364,864.29. The pursuer avers, and the defender accepts, that no notice was issued by the defender under section 110 or section 111 of the Housing Grants, Construction and Regeneration Act 1996. Consequently the pursuer avers that, by virtue of the terms implied into the contract by the 1996 Act and 1998 Regulations, the sum claimed in the interim valuation became due for payment on 8 February 2002. On that basis, it is averred, the final date for payment of the sum due was 25 February 2002. No payment was made, and the pursuer now sues for the sum of £364,864.29.

3. The summons contains the usual warrant for inhibition on the dependence of the action. The use of this diligence is supported by detailed averments in the summons. I was informed that these were made following my opinion in **Karl Construction Limited v Palisade Properties** PLC, 2002 S.L.T. 312, to enable the pursuer to establish that there was a significant risk of the defender's insolvency, and in that way to justify the use of the diligence. The substance of those averments was as follows. Firstly, the most recent audited accounts of the defender lodged with the Registrar of Companies, those for the year ended 28 February 2001, showed that the defender had a net deficiency of assets to liabilities of £35,140. Secondly, the contract works had been paid for by way of borrowings by the defender from Dunbar Bank PLC, and the pursuer was not aware of any assets held by the defender apart from the subjects of the present development. The valuations made by the quantity surveyors appointed by Dunbar Bank PLC showed the contract price as being £2,677,660, and the pursuer accordingly believed that figure to be the defender's funding limit with the bank. It was understood that £2,613,832 had been paid to the defender by the bank. Consequently, the pursuer feared that the defender had reached, was on the point of reaching, its funding limit, a view which was supported by the fact that the defender had failed to pay interim valuation no. 17 in full. Thirdly, in a letter to the pursuer dated 28 February 2002 the defender offered to agree the pursuer's final account at a figure of £3,200,000. In view of that expression of view, and the absence of notices under s110 and 111 Housing Grants, Construction and Regeneration Act 1996, the pursuer was not aware of any defence that the defender

might have to the present claim. Consequently, given the non-payment of the sum sued for, the pursuer was apprehensive that the defender was practically insolvent and vergens ad inopiam.

4. After signeting of the summons, the case called before me on an ex parte motion for warrant to inhibit on the dependence of the summons. After hearing argument from the pursuer's counsel, I granted the motion on the basis that, on the information then before me, there appeared to be a significant risk of the defender's practical insolvency.

5. The defender has now moved for recall of the inhibition on the ground that the continued use of inhibition is contrary to the European Convention on Human Rights, the defender having adequate funds to meet the pursuer's claim in the event that that claim is successful. In support of its motion the defender has produced a substantial amount of material relating to its financial position, and on the basis of that material it submitted that there was no significant risk of the defender's insolvency. Consequently it was argued that, following my observations in **Karl Construction Limited v Palisade Properties PLC**, supra, in particular those at paragraphs [54], [56] and [79], inhibition on the dependence was not justified. The pursuer did not seek to challenge the approach taken in **Karl Construction**, but argued that on the basis of the available information on the defender's financial position there remained a significant risk of practical insolvency; consequently the defender's motion should be refused. A number of distinct issues were canvassed in the course of the argument, and it is convenient to deal with these individually. Because the approach taken in Karl Construction was not challenged, I have followed it throughout the present opinion.

Approach to the issue of whether there is a significant risk of insolvency

6. Counsel for the defender argued that both at the stage of an initial application for inhibition on the dependence and at the stage of a motion for recall, the onus of demonstrating that there is sufficient justification for the use of the diligence lies on the pursuer. Consequently, at the hearing of a motion for recall, if a defender puts forward credible evidence that there is no significant risk of its insolvency, the onus is placed back on the pursuer to justify or validate the continued use of inhibition. I did not understand this approach to be seriously disputed by counsel for the pursuer. In my opinion it is quite clear that the onus of justifying the use of diligence on the dependence is on the pursuer both at the stage of an initial application and at the stage of a motion for recall. That is logically inherent in the proposition that a pursuer must establish that there is a specific need for such a remedy.

7. At a motion for recall of diligence on the dependence, it is obviously likely that substantially more information about the defender's financial position will be available than at the stage of an ex parte application. The court's task in that situation is in my opinion to look at the whole of the material available and, on the basis of that material, to consider whether the pursuer has established that there is a significant risk of the defender's insolvency. Either absolute insolvency, in the sense of an excess of liabilities over assets, or practical insolvency, in the sense of inability to pay debts as they fall due, will suffice for this purpose. In the context of diligence in support of a consistorial claim, **Pow v Pow**, 1987 S.C. 95, is authority for the proposition that practical insolvency is as good as absolute insolvency in justifying diligence. In that case, reliance was placed on **Campbell v Cullen**, 1848, 10 D. 1496, where Lord Fullerton stated (at 1498):

> *"It may be true, that in the case of a future debt something more may be required than the mere allegation in the diligence, that the debtor is vergens ad inopiam. But on the other hand, if the debtor acts in such a way as to give the creditor reasonable ground to believe that he is in difficulties, I do not think that the diligence can be objected to, or recalled without caution. Now, here the debtor has so dealt. The last terms' payment of interest, for which the Petitioner is bound, has never been paid without an action and a charge for payment. In these circumstances, I must hold that there was such a prima facie case of pecuniary embarrassment made out by the acts of the Petitioner, as fairly to warrant the diligence".*

The important point, as the foregoing passage makes clear, is that either a deficiency of assets as against liabilities or an inability to pay debts as they fall due means that there is a significant risk that the pursuer's debt or claim will not be paid following decree.

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8. In either event, however, what is material is the risk that the defender will not be able to satisfy the pursuer's claim at the conclusion of the action. For that reason it is not appropriate to look only at the defender's present financial situation; future events must be taken into account, so far as they can be predicted with some degree of accuracy, because they will have an important bearing on whether funds will be available if decree is pronounced in favour of the pursuer.

The defender's financial position

9. The defender produced a report dated 21 March 2002 prepared by its auditors, Sinclair Wood & Company, Chartered Accountants, in which the author concluded that the defender was neither practically insolvent nor absolutely insolvent. A statement of affairs was appended to the report. This valued the defender's total assets at £5,461,861, which comprised the property at Howard Street, valued at £5,435,000, and cash in an account with Lloyds TSB amounting to £26,861. The defender's total liabilities were valued at £4,497,589.95. That left a surplus of assets over liabilities of £514,271.05. The figure for liabilities included a loan from Dunbar Bank amounting to £3,275,524, and a loan from Barry Trentham (a former director of the pursuer but now unconnected with that company) amounting to £983,201.66. It also included the sum of £364,864.29 as representing the pursuer's present claim.

10. In the course of the hearing the defender produced its audited statutory accounts for the year ended 28 February 2002. The balance sheet as at that date disclosed total assets amounting to £4,904,229. These comprised stocks amounting to £4,760,501, debtors amounting to £28,505 and cash at bank and in hand amounting to £115,223. The stocks figure, which was essentially a work in progress figure, was calculated on the basis of the development costs to date of the property at Howard Street plus the defender's share of the anticipated profit on the sale of the individual flats and commercial units less the sum of £50,000 for contingencies. That form of calculation takes account of the costs of completing the development and marketing and selling the individual properties. The defender's liabilities as stated in the balance sheet amounted to £4,782,230. That figure included secured bank loans amounting to £3,308,644. The balance sheet thus disclosed a surplus of assets over liabilities of £121, 999. I was informed that the liabilities figure included the pursuer's present claim, valued in this case at £415,000. In addition to the report from Sinclair Wood & Company and its audited statutory accounts, the defender produced a Schedule prepared by Sinclair Wood & Company showing the calculation of the stocks figure in the audited balance sheet.

11. Counsel for the defender founded primarily on the balance sheet contained within its statutory accounts. It disclosed a surplus of assets over liabilities of £122,000, which he described as a comfortable margin. He emphasised that that surplus was arrived at after making provision of £415,000 for the pursuer's present claim. It was thus an appropriate factual basis for the court to determine whether there was a significant risk of the defender's insolvency. He submitted that the court should conclude that there was truly no such risk. The audited balance sheet disclosed that the defender was absolutely solvent. In relation to practical solvency, the defender's financial state did not look parlous, in view of the surplus of assets after making provision for the pursuer's claim. In addition, £60,000 remained of the defender's bank facility. While that meant that the defender was fairly close to the facility limit, that was not surprising, as the building was close to completion. Counsel supplemented the foregoing argument with two further submissions. Firstly, he submitted that the pursuer's present claim was disputed, and an application for winding up on the ground of practical insolvency would be refused if it were based on failure to pay a claim of that nature; only an undisputed debt will suffice for that purpose the pursuer did not point to any other debts that had not been paid as they fell due. Secondly, he submitted that, if practical insolvency were used as a justification for inhibition against a defender whose stock in trade was heritable property, the result was circular; the inhibition prevented the sale of the defender's stock in trade, and thus prevented from paying its debts as they fell due. I consider these two arguments in subsequent sections of this opinion.

12. Counsel for the pursuer submitted that the question of whether was a significant risk of the defender's insolvency did not turn merely on the state of its latest balance sheet. A pursuer was entitled to some protection against the possibility that things might go wrong in future. Thus if the state of solvency

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disclosed in the defender's balance sheet was close to the line, inhibition might still be proper. In relation to the financial documents produced by the defender, counsel pointed out a number of discrepancies in the figures. I deal below with those that I consider significant for present purposes.

13. The critical question is whether there is a significant risk of the defender's insolvency at the time when the present claim, if it is sustained by the court, will require to be paid. The notion of risk is crucial; it looks to the possibility of insolvency, not actual insolvency. It is also crucial in my opinion to bear in mind that the particular risk is that any award made in favour of the pursuer may not be paid; that involves looking into the future. For these reasons I do not consider that the existence of an audited balance sheet showing a present state of solvency is in any way conclusive

14. In the present case, notwithstanding the financial position disclosed in the defender's latest audited balance sheet, I am of opinion that there is a significant risk of insolvency. I reach this conclusion for the following reasons.

    1. The audited balance sheet does not disclosed a large surplus of assets over liabilities in relation to the figures for total assets and total liabilities. The surplus of £122,000 is approximately 2.5% of total assets, and 2.55% of total liabilities.
    2. It is of great importance that the company is, at present at least, carrying out a single development. Consequently its solvency is hazarded on the success of that single development. That in itself involves a substantial risk.
    3. It follows from the last two points that, if the defender is to remain solvent, it is essential that the whole of the development should be sold at the prices assumed in the work in progress calculation that underlies the stocks figure in the audited balance sheet. That calculation assumes that the residential flats will be sold for a total of £4,917,000 and the commercial property for £475,000. In a further production, however, namely a report on the development prepared by the defender's agents, the prices at which the flats were being offered are set out. These totalled £4,829,000, or £88,000 less than the amount assumed in preparing the audited balance sheet. That is in itself a significant discrepancy, in view of the size of surplus disclosed in the balance sheet. In addition, it appears from the same report that the flats are typically sold at prices ranging between £112,000 and £155,000, with a few selling for larger sums. It follows that, if only one or two of the flats fail to sell, the defender may be rendered insolvent. Once again, that seems a material risk.
    4. The calculations underlying the audited balance sheet appeared to make little or no allowance for the bank interest payable in future. Counsel for the pursuer stated that, in a version that he had seen of the facility letter issued by Dunbar Bank, interest was payable at 31/2% over base, with a minimum base rate of 5%. While that version of the facility letter had been superseded by a later version, it was submitted that it could be assumed that there were similar provisions in the current version. Counsel for the defender did not dispute that interest at that rate would be due. The current indebtedness to Dunbar Bank was said, in a letter from the bank dated 20 March 2002, to be £3,275,524 as at that date, with interest being applied on a daily basis. Interest on that sum would be of the order of £65,000 per quarter. Counsel for the pursuer submitted that, on the basis of the version of the facility letter that he had seen, interest of that order would be payable on 31 March. Whether or not that is correct, it is clear that interest of approximately that amount would be payable quarterly. Once again, that would clearly have a material effect on the defender's financial position.
    5. The statement of affairs prepared by Sinclair Wood & Company disclosed a loan of £983,201.66 made to the defender by Barry Trentham. In an affidavit by Mr Trentham, produced by the defender, it is stated that this loan attracted interest at 2% over the Royal Bank of Scotland base rate. The affidavit further appeared to indicate that no interest had yet been paid on that loan. Such interest was not taken into account in the statement of affairs produced by Sinclair Wood & Company. In the work in progress calculation that underlies the audited balance sheet, Mr Trentham is shown as receiving part of the profit on the development, amounting to £355,133. It was not clear whether this figure was in lieu of the interest. At the very least, however, it can be said that there was considerable uncertainty about the sum that was due to Mr Trentham.

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6. The audited balance sheet included cash at bank and in hand amounting to £115,223. One of the documents produced by the defender was a bank statement from Lloyds TSB which disclosed that, as at 28 February, the defender had a credit balance of £20,462.40. No other bank statements were produced, apart from the statement of indebtedness from Dunbar Bank. Various explanations might exist for the difference of £89,000 between the figure in the balance sheet and the figure in the Lloyds TSB statement, but none was given. The difference between the two figures, if unexplained, is clearly material.
7. It was stated by counsel for the pursuer that value added tax would ultimately the payable by the defender to the pursuer in respect of the commercial part of the development and the white goods installed in the residential part. The amount of such liability was said to the approximately £79,000. Counsel for the defender submitted that I should be cautious in taking VAT liability into account, but he was unable to state that no such tax would be payable. It seems clear, on the general principles of the value added tax legislation, that there will be some liability to value added tax. I accordingly consider it appropriate to take some account of such a liability.

15. When all of the foregoing matters are taken into account, I am of opinion that there is a significant risk that the defender will not be able to pay the pursuer's present claim, if it is upheld by the court, at the time when payment will fall due. The problem facing the pursuer is exacerbated by the fact that the defender's other indebtedness is likely, generally speaking, to be payable before anything can be paid to the pursuer. The indebtedness to Dunbar Bank is heritably secured, and the indebtedness to Mr Trentham is protected to some extent by a mandate given by the defender to its agents to pay the free proceeds of sale of the properties to him. Debts for professional fees are also likely to be paid directly out of the proceeds of sale. For these reasons I am of opinion that the pursuer is entitled to retain the present inhibition.

Relevance of alleged defence to pursuer's claim

16. Counsel for the defender stated that the pursuer's claim was disputed. The pursuer had intimated a further claim, consequent upon a further valuation, no 18, and in response the defender had issued a notice of intention to withhold payment under section 111 of the Housing Grants, Construction and Regeneration Act 1996. That notice intimated deductions totalling £1,058,171 from the pursuer's claims. That cancelled the sum presently claimed by the pursuer. A debt that was disputed would not be a valid basis for a motion for winding up. Consequently it was inappropriate to draw the conclusion that the defender was practically insolvent from the existence of the present claim. In addition, the pursuer did not point to any other debts owed by the defender that had not been paid as they fell due. Thus there was no basis for saying that the defender was practically insolvent.

17. In response, counsel for the pursuer referred to a letter from the defender to the pursuer dated 28 February 2002 in which the defender offered to agree the pursuer's final account at a figure of £3,200,000. The amount stated to be due in valuation no 17, exclusive of value added tax, was £3,303,581. Thus, it was said, the defender's offer involved an admission that the greater part (all but £103,581) of the pursuer's present claim was due. The amount claimed by the pursuer was £364,864.29, and accordingly £261,283.29 of that was accepted as being due. The defender had not paid or offered to pay that amount, and as a result the court could draw an inference of practical insolvency. So far as the section 111 notice was concerned, it related to valuation no 18, and had not been timeously issued in respect of valuation no 17, on which the present action was based. Consequently it had no effect in relation to the present action. Authority for that result was found in **SL Timber Systems Limited v Carillion Construction Limited**, [2001] B.L.R. 516.

18. The question thus arises of the relevance of the defender's statement that the pursuer's claim was disputed. In my opinion the existence of a defence to the pursuer's claim is potentially relevant in two ways. In the first place, the existence of a defence may be relevant in the type of case discussed in **Karl Construction Limited v Palisade Properties PLC**, supra, at paragraph 79. Those are cases where an inference of practical insolvency is drawn from the defender's failure to pay a liquid debt after demand for payment has been duly made. In such cases the existence of a prima facie defence to the whole, or substantially the whole, of the claim will normally mean that the inference of practical

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insolvency cannot be drawn. In that event, the reason for non-payment is the existence of a defence, and not the defender's inability to pay. For this purpose, the existence of a counterclaim or a right of retention will amount to a defence. Of course, if the defence, on proper scrutiny by the court, appears to be insubstantial or dilatory, it should be disregarded, and the inference of insolvency should be drawn. If there is substance in the defence, however, that will not be possible.

19. In the second place, the existence of a defence may cast doubt on the pursuer's prospects of success in the action. If the doubt is sufficiently substantial, it may not be reasonable to grant judicial security in respect of the pursuer's claim. In **Karl Construction Limited v Palisade Properties PLC**, supra, I suggested that, before inhibition on the dependence could be granted, the pursuer required to establish a prima facie case on the merits of the action. I intended this test to be a substantial hurdle for the pursuer to surmount. The expression "good arguable case", used in English law in relation to Mareva injunctions, may give a good idea of what is intended. If, at the stage of a motion for recall, an apparently substantial defence is put forward to the pursuer's claim, it is my opinion appropriate for the court to scrutinise the claim and the defence and to determine whether in all the circumstances inhibition is appropriate, or whether it should be recalled, either absolutely or subject to conditions. This is in my view an aspect of the requirement of a prima facie case, in the sense of a good arguable case; if there is an apparently substantial defence to the pursuer's claim it is difficult to say, on the basis of the whole of the material before the court, that that claim amounts to a good arguable case. If no substantial defence is put forward, of course, all that the court requires to consider is whether the pursuer has set out a good prima facie case.

20. In the present case, for the reasons discussed in paragraph [14] above I am of opinion that there are good grounds for holding that there is a significant risk of the defender's insolvency. These grounds do not depend to any significant extent on the defender's failure to pay the pursuer's present claim. For that reason the considerations discussed in paragraph [18] above do not seem relevant.

21. In relation to the considerations discussed in paragraph [19], the pursuer founds strongly on the offer made by the defender on 28 February 2002 to agree the pursuer's final account at £3,200,000. The defender argued that the letter was merely a commercial settlement offer, and was in any event approximately £100,000 less than the pursuer's present claim. In my opinion the letter is significant, in that it clearly indicates acceptance on the defender's part that substantial amounts remain due to the pursuer. On that basis, I consider that the pursuer has indeed established a good prima facie case, and that it is likely that substantial sums will ultimately be due by the defender to the pursuer. That by itself is sufficient for me to hold that the existence of a defence to the present action is not a ground for recalling the inhibition.

22. In addition, when the substance of the defence that has been put forward is scrutinised, I am of opinion that there is an insufficient basis for holding that the pursuer does not have a good arguable case. The nature of the defence is disclosed in general terms in the notice intimated under section 111 of the Housing Grants, Construction and Regeneration Act 1996. The total deduction referred to in that notice is £1,058,171. Of that sum, however, £629,155 relates to items for which there is said to be "no substantiation". The context is one where certificates have been issued by the contractor and checked by a surveyor appointed by the employer's main financier. In that context, I consider it likely that pursuer would be able to substantiate most, if not all, of these items, if indeed it has not done so already. A further £289,650 relates to preliminaries, in respect of which it is stated "No extension of time granted", and a further £74,000 relates to liquidated and ascertained damages, which are obviously based on alleged delay in completion of the works. The contract, as it ultimately worked in practice, was a cost plus contract. On that basis, preliminaries would normally be payable in full, regardless of delay, and the employer's remedy would be to claim liquidated and ascertained damages or other financial compensation for delay. It therefore seems likely that the deduction of £289,650 is not well-founded. The claim for £74,000 by way of liquidated and ascertained damages is truly a counterclaim. For that reason, if it is to be a valid ground for withholding payment, it must be referred to in a timeous notice under section 111 of the 1976 Act: see **SL Timber Systems Limited v Carillion Construction Limited,** supra, at paragraphs 19, 20 and 22 on the scope of that section. The section 111 notice referred to by the defender, however, relates to valuation no 18, whereas the present

claim is based on valuation no 17. For that reason, the notice is not timeous, and the claim for liquidated and ascertained damages disclosed in the notice is not relevant to the present claim. For the foregoing reasons I consider that the withholding of at least £992,805 (£629,155 plus £289,650 plus £74,000) is unlikely to be well founded. The remaining sum, £65,406, is substantially less than the pursuer's present claim.

The defender's circularity argument

23. Counsel for the defender submitted that, in cases where a defender's stock in trade consisted of heritable property, and practical insolvency was used as the justification for inhibition, the result was circular. The result of inhibition was to prevent the defender from realising its stock in trade, and in consequence it was inevitably incapable of paying debts as they fell due

24. This argument undoubtedly draws attention to a practical difficulty when inhibition is used against a defender whose stock in trade consists of land or buildings, but in my opinion it is misconceived. In the present case, the doubts about the defender's solvency, which I summarise in paragraph [14] above, do not arise from the difficulties caused by the present inhibition. They arise rather from the defender's underlying financial position, and from the financial risks involved in the particular development with which the case is concerned. Moreover, the practical difficulty itself is not new. If inhibition is available automatically, a practical solution must be found to enable the defender to realise its stock in trade, but in such a way as to preserve the judicial security accorded to the pursuer. Normally that would be achieved by the defender's offering caution or consignation to obtain recall of the inhibition. That would enable the property to be sold, but at the same time would preserve security in favour of the pursuer. Alternatively, it would be possible to recall the inhibition property by property, to permit sales to take place, with the proceeds being consigned in a manner appropriate to protect the pursuer's position. Either of these solutions is available even if inhibition is not granted automatically. In the present case, accordingly, I am of opinion that the practical difficulty can be solved either by the defender's offering caution or consignation for the sum sued for or by the recall of the inhibition in relation to individual properties, with an appropriate condition as to the disposal of the proceeds. No motion to that effect was made by the defender, however; the only motion was for outright recall.

25. For the foregoing reasons I am of opinion that the pursuer has established that there is a specific need for inhibition on the dependence of the present action. I will accordingly refuse the defender's motion for recall of the inhibition.

Pursuer: Howie, Q.C.; MacRoberts
Defender: Borland; McGrigor Donald