# Chaly Chee Kheong Mah and Others v The Liquidators of Baring Futures (Singapore) Pte Ltd [2003] SGCA 28

**Case Number** : CA 145/2002

**Decision Date** : 07 July 2003

**Tribunal/Court** : Court of Appeal

**Coram** : Chao Hick Tin JA; Tan Lee Meng J; Yong Pung How CJ

**Counsel Name(s)** : Haridass Ajaib, Randhir Ram Chandra, Serena Yogalingam (Haridass Ho & Partners) for the Appellants; V K Rajah, Lee Eng Beng (Rajah & Tann) for the Respondents

**Parties** : Chaly Chee Kheong Mah — The Liquidators of Baring Futures (Singapore) Pte Ltd

*Contract – Contractual terms – Incorporation of terms – Whether relevant term in articles of association incorporated into contract between company and accounting firm appointing the latter as its auditors*

*Contract – Contractual terms – Interpretation of terms – Scope of indemnity – Whether indemnity extends to costs incurred in defending actions*

*Insolvency Law – Winding up – Priority – Whether indemnity costs awarded against liquidators of company entitled to priority against other claims in winding up*

***Delivered by Chao Hick Tin JA***

1 The appellants are partners in an accounting firm known as Deloitte & Touche (D&T). D&T was appointed by Baring Futures (Singapore) Pte Ltd (BFS) as its auditors in 1986. In 1994, D&T ceased to be the auditors of BFS and Coopers & Lybrand, Singapore [C&L(S)] was appointed in its place. The parent company of BFS is Baring plc of London (PLC). Both BFS and PLC are now under liquidation. The respondents to the present appeal are the liquidators of BFS. The issues in this appeal concerned in the main the terms of appointment of D&T as auditors of BFS.

**Background**

2 The facts giving rise to the present proceedings are as follows. Due to the fraudulent activities of a rogue trader in BFS, massive losses were incurred, which in 1995 led to the collapse of the entire Barings group.

3 The liquidators of BFS, PLC and their related company, Bishopscourt Ltd (BL) ('the three companies'), instituted proceedings in London to recover damages from D&T and C&L(S) and C&L(London) for negligence in the discharge of their duties as auditors of BFS. A settlement was eventually reached with C&L(S) and C&L (London) under which part of the moneys received, amounting to some £24 million, would be set aside to enable the three companies to continue their proceedings against D&T.

4 The action in London instituted by BFS against D&T (the BFS action) is nearing completion. However, the PLC action against D&T was struck out by the English High Court and an appeal has been lodged against that order although the appeal process is currently being stayed.

5 In the meantime, pursuant to a complaint received, the Singapore Public Accountancy Board (PAB) initiated an inquiry against a partner of D&T, Mr Chaly Chee Kheong Mah, who was responsible for the audit of BFS. But eventually the PAB ruled on 16 November 2001 that Mr Mah had not been guilty of any professional misconduct.

6 The sufficiency or otherwise of the £24 million fund set aside would depend on whether, if D&T were to succeed in defending the BFS action, they would be entitled to costs on the indemnity or the standard basis. Because of this, D&T brought two motions seeking certain reliefs which, in essence, raised the following three main issues for the consideration of the court:-

(i) whether Article 110 of the Articles of Association of BFS was incorporated into the contract between BFS and D&T when the latter was appointed auditors.

(ii) If Article 110 formed a term of the contract, did the indemnity provided therein extend to costs incurred by D&T in defending the BFS action?

(iii) whether any indemnity costs which might be awarded to D&T in the BFS action would be entitled to any priority against other claims in the winding up of BFS.

7 Lai Kew Chai J gave a negative answer to all the three issues enumerated above and refused the reliefs prayed for in both motions.

**Incorporation issue**

8 To better appreciate the issue as to whether Article 110 had been incorporated into the terms of appointment of D&T as auditors, it is necessary for us to set out the circumstances under which the appointment was made.

9 The appointment originated from a letter of 6 October 1986 from the solicitors of BFS to D&T, the material part of which reads:-

"The Company wishes to appoint your firm as its auditors and this is a formal request to seek your consent.

The Company was incorporated on 17th September 1986 with an authorised capital of …(illegible in part)… shares of S$1/- each were issued and fully paid up.

We enclose a copy each of the following documents for your information:-

1. Certificate of Incorporation (FORM 9)

2. Memorandum and Articles of Association

3. FORM 49 showing the particulars of the

directors.

We look forward to your early reply."

10 On 15 October 1986 the Board of Directors of BFS passed a resolution to appoint D&T, subject to its consent, as auditors and the appointment was to last until the first Annual General Meeting of BFS at a remuneration to be thereafter determined.

11 On the same day, D&T wrote to the Board of BFS accepting the offer in these terms:-

"We are pleased to confirm our consent to act as auditors for your company pursuant to s 10

subsection 7 of the Companies Act, Cap 185.

Until advised to the contrary, please accept this letter as our consent to act in future years."

12 Also on the same day, D&T wrote a second letter to the Board of BFS which began with these words:-

"Following our appointment as auditors of the company we are writing to confirm our responsibilities as auditors, and also our understanding of the other services that we should perform."

13 In the letter, under the subheading "Audit", D&T set out how it would go about its audit functions. Next under the subheadings, "Accounting and other Services" and "Taxation Services", it described the services which it could provide. Finally, under the subheading "Fees", D&T stated:-

"Our fees are computed on the basis of the time necessarily occupied on your affairs by partners and staff of different seniority depending on the degree of responsibility, scope and skill involved.

Our fees and the related out-of-pocket expenses will be charged separately for each of the main classes of work mentioned above. We shall bill our fees and out-of-pocket expenses on a periodic basis during the engagement and we shall agree the frequency and amount of such billing with you and you agree to observe our payment terms."

14 The letter ended with the following paragraph:-

"We shall be grateful if you will kindly sign and return to us the duplicate of this letter as acknowledgement of your understanding of the terms of our engagement which will continue to apply until varied by a subsequent letter. However, if there are any aspects of our letter which are not in accordance with your requirements, we shall be pleased to discuss them with you."

15 In coming to its decision that Article 110 had not been incorporated into the contract of appointment of D&T, the High Court had taken into account the following:-

(i) In general, articles of association only bind the company and its members *inter se* and not third parties, including auditors.

(ii) A copy of the Articles of Association of BFS was only forwarded to D&T for information.

(iii) In the second letter of D&T to BFS of 15 October 1986, it was stated that the letter set out the "terms of our engagement". This was unlike the case where there was no separate document setting out the terms of appointment.

16 The High Court had also relied very much on the following passage of Warrington LJ in *In re City Equitable Fire Insurance Company* [1925] CH 407 at 521:-

" (where) auditors are engaged without any special terms of engagement … then if the articles contain provisions relating to the performance by them of their duties and to the obligations imposed upon them by the acceptance of the office, I think it is quite plain that the articles must be taken to express the terms upon which the auditors accept their position. Of course, if the terms of their employment are expressed in a separate document, then that document must be taken to define the conditions of their engagement, and it would not be proper to assume any implied terms either from the provisions of the articles or elsewhere."

17 The case of *City Equitable Fire Insurance* arose out of the collapse of a notable reinsurance company brought about by the fraud of its Chairman, who was convicted and sentenced for his wrongdoings. The liquidator later brought actions against the directors and the auditors for their default or negligence. He failed before the High Court and appealed only against that part of the decision which held that the auditors were not liable because of the protection afforded to them under Article 150 of the articles of association unless they were guilty of "wilful neglect or default". The bulk of the discussions in the case addressed the issue of what would constitute "wilful neglect or default". The other two members of the quorum did not address the issue as to how Article 150 had become incorporated into the contract with the auditors. They assumed so.

18 In our opinion, we do not think Warrington LJ was in any sense laying down any strict principle of law in that pronouncement. He was merely offering a commonsensical approach that where there were no written terms of appointment, then it was sensible to assume that the parties intended to contract on the terms of the articles. In every such case it will always be a question of construction. By saying that "if the terms of their employment are expressed in a separate document" we do not think Warrington LJ intended to suggest that so long as a document record only some terms of the contract that would necessarily preclude the relevant terms in the articles from being applicable to the auditors.

19 Another pertinent case is *Isaacs' Case* [1892] 2 CH 158 where the articles of association of the concerned company provided that the qualification of a director would be the holding of shares of the nominal amount of £1000, and that a first director might act before acquiring his qualification but should in any case acquire it within one month from his appointment, and, unless he should do so, he would "be deemed to have agreed to take the said shares from the company, and the same should be forthwith alloted to him accordingly." One, H.I., who signed the memorandum and articles of association and was alloted one share, was also appointed one of the first directors. H.I. never applied for nor were any qualification shares alloted to him. The question that came up for a decision was whether H.I. should be placed in the list of contributories in respect of the qualification shares which he should have applied for and been alloted. Stirling J said (at 164):-

> "I think, then, that where a man has accepted the office of director, and acted as such, there ought to be inferred an agreement between him and the company, on his part that he will serve the company on the terms as to qualification and otherwise contained in the articles of association, and on the part of the company that he shall receive the remuneration, and all the benefits which those articles provide for directors. To use the language of the present Master of the Rolls in *Swabey v Port Darwin Gold Mining Company*, "the articles do not themselves form a contract, but from them you get the terms upon which the directors are serving."

Stirling J then went on to add that the article in question was very clear and that H.I. was required to take up the qualification shares.

20 In *John & Ors v Price Waterhouse (a firm) and Anor* [2002] 1 WLR 953, the first defendant, Price Waterhouse (PW), successfully defended an action brought by four claimants, the second, third and fourth claimants being companies, and an order for costs on the standard basis in favour of PW was made and perfected. At the time of hearing, PW had only asked for standard costs. Subsequently, PW sought to have the costs order varied to that of an indemnity basis on the ground, inter alia, that under the articles of association of those companies, PW was entitled to indemnity costs. Ferris J did not think he should at that stage vary the order as it was not absolutely clear that there would be no defence to the contractual claim for indemnity costs as there were factual issues to be gone into to determine whether the articles of the companies were incorporated into the contract between

PW and the companies. What is germane are the following views expressed by Ferris J on the question of incorporation (at 960):-

> "The articles of a company constitute a contract between the members of the company inter se and between each of them and the company but they do not, without more, constitute a contract between the company and its directors or auditors. Nevertheless the terms of regulations 136 and 118 appear clearly to contemplate that directors and auditors (amongst others) will have a right, which could only be a contractual right, to be indemnified as there mentioned. It seems to me that comparatively little will be required to satisfy the court that, in particular cases, the indemnity provided for by regulations 136 and 118 is incorporated in the contract which is made when the company appoints a director or an auditor."

21 Ferris J was of the view that, in the circumstances, a fresh action by PW would be the proper course. In taking this approach he had regard to the decision in *Gomba Holdings (UK) Ltd v Minorities Finance Ltd (No. 2)* [1993] CH 171, where the Court of Appeal held that the fact that some orders were made for the mortgagor to pay some of the mortgagee's costs taxed on the standard basis did not preclude the mortgagee from claiming costs on the indemnity basis pursuant to contractual rights.

22 The High Court in the instant case quite rightly observed (at ¶8) that the second letter of 15 October 1986 was "post-contractual". Therefore, at the time the appointment was accepted by D&T, there were simply no written terms of appointment, other than what were set out in the Articles of Association, a copy of which was forwarded to D&T. Although the Articles of Association were forwarded "for information", in the context, they were for information of D&T to the extent relevant to the appointment. For example, the particulars of directors were furnished to D&T for information. One may ask what those particulars had to do with the appointment. We think plentiful. The auditors might not want to deal with some directors because of questionable background or for some other reasons. The circumstances here are no different from those in *City Equitable Fire Insurance,* or in *In re New British Iron Company ex parte Beckwith* [1898] 1 CH 324 where, in the words of Wright J, the directors accepted their appointment "on the footing of the articles". As noted by Ferris J in *John v Price Waterhouse*, relatively little would be required to incorporate the articles by implication.

23 As far as the second letter is concerned, in our view, it was really a proposal to add terms to a contract already made. But there was nothing therein which was inconsistent with what was provided in Article 110 so as to render the latter inapplicable. The terms set out in the second letter could not be considered to be exhaustive bearing in mind the opening words "we are writing to confirm our responsibilities as auditors and also our understanding of the other services that we should perform." It merely stated the ambit of D&T's responsibilities. We note that, in the last paragraph of the letter, BFS was asked to acknowledge the "terms of our engagement". That was to get BFS' agreement to those terms. But obviously many essential terms would still have to be filled in or implied. Thus, we would respectfully differ from the court below and hold that Article 110 did form part of the contract of appointment of D&T.

24 In this regard we would hasten to add a qualification. In this instance, the additional terms proposed by D&T were set out in a subsequent letter. But even if the additional terms were set out in the letter of acceptance itself, it did not necessarily follow that it would preclude the incorporation of the relevant Articles of Association as terms of appointment. Ultimately, it would be a matter of construction. It is true that articles of association constitute a contract between a company and its members and they do not bind third parties: see *Hickman v Kent Or Romney Marsh Sheep-Breeders' Association* [1915] 1 CH 881. But the articles do provide for appointment and duties of, *inter alia*, directors and auditors. Thus, whether a particular appointment of such a third party incorporates the provisions in the articles relating to that appointment is to be inferred from all the circumstances. As

we have stated before, we do not think Warrington LJ intended to lay down any rigid rule to the effect that so long as some terms are set out in a document that would *per se* mean that other relevant provisions in the articles of association could not be incorporated. In each case, the document or documents would have to be looked at as a whole to determine the real intention of the parties.

**Scope of Article 110**

25 We now turn to consider the second issue concerning the scope of Article 110 which reads:-

> "Every Director or other officer of the Company shall be entitled to be indemnified out of the assets of the Company against all losses or liabilities (including any such liability as is mentioned in the Act), which he may sustain or incur in or about the execution of the duties of his office or otherwise in relation thereto, and no such Director or other officer shall be liable for any loss, damage or misfortune which may happen to be incurred by the Company in the execution of the duties of his office or in relation thereto. But this Article shall only have effect in so far as its provisions are not avoided by the Act."

26 In coming to his conclusion that Article 110 did not cover the indemnity costs incurred by D&T in defending an action brought by DFS for negligence, the court below relied very much upon two cases: *David John Rowland & Ors v Gulfpac Limited* [1999] Lloyd's Rep 86 and *Tomlinson v Adamson* (1935) SC 1.

27 It would be noted that the crucial words in Article 110 are "losses or liabilities (including any such liability as is mentioned in the Act) which he may sustain or incur in or about the execution of the duties of his office or otherwise in relation thereto." In defending the DFS action, D&T was not doing anything in execution of its duties as auditors or "in relation to" those duties. It was defending an action brought well after it ceased to be auditors which alleged that while D&T was DFS' auditors it did not perform its duties as it should. The costs were not incurred in execution of its duties as auditors or in relation thereto.

28 In this connection, it is pertinent to compare Article 110 with Article 113 in Table A of the Companies Act where the relevant part reads:

> "Every director … auditor … shall be indemnified out of the assets of the company against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour …"

29 The fact that the promoters of BFS decided to adopt a different set of wording from that spelt out in Article 113 of Table A is significant. In our opinion, the change clearly indicated that the promoters had something different in mind. There is no reference to "proceedings". We think D&T's argument is speculative when it says that in adopting the formula in Article 110, the promoters had something wider in mind.

30 This view of Article 110 is entirely consistent with the authorities. In *Rowland & Ors v Gulfpac Ltd* (supra) the plaintiffs were directors of both Gulfpac UK and its parent company, Gulf USA. Gulf USA brought an action in Idaho, USA claiming that during the plaintiffs' stewardship of Gulf USA, they had fraudulently depleted the group's assets. In an action in England, the directors claimed an indemnity against Gulfpac UK under a provision in its articles of association in respect of the Idaho proceedings. Among the reliefs claimed in the English proceedings was an order for a Mareva injunction, which was initially granted on an *ex parte* basis. On an application by Gulfpac UK heard inter-partes, Rix J held

that there was no good arguable case capable of sustaining a Mareva injunction that the claim for indemnity sought in respect of the Idaho proceedings fell within the indemnity contained in Gulfpac UK's articles of association, although he declined to strike out the action.

31 In *Gulfpac* case, the relevant indemnity article read as follows:-

> "Subject to the provisions of the Companies Act 1985 every director … shall be entitled to be indemnified out of the assets of the Company against all costs, charges, expenses, *losses or liabilities which he may sustain or incur in or about the execution of his duties to the Company or otherwise in relation thereto*." (Emphasis added).

32 It would be seen that the italicised portion of the above clause is very similar to Article 110 of our present case. Rix J held that since the Idaho proceedings were brought by Gulf USA against the plaintiffs as directors of Gulf USA and not of Gulfpac UK, whatever costs incurred in defending the Idaho proceedings could not be said to have been "incurred in or about the execution of their duties to Gulfpac UK or otherwise in relation thereto." What, however, are of relevance to us are the views, no doubt *obiter*, expressed by Rix J on the general scope of that indemnity clause where he said (at p. 93):-

> "But costs incurred as an expense, as occurs in the United States, where it is common ground there are no adversarial orders for costs, or in England as part of the directors' own English proceedings, <u>are costs incurred in defending or prosecuting actions and are not, it seems to me, costs incurred or sustained in or about the execution of a director's duties to Gulfpac or otherwise in relation thereto</u>.
>
> This view is to my mind fortified by two other considerations. The first arises out of the terms of section 310(3)(b) of the Companies Act 1985. Section 310(1) and (2) provides that any provision contained in a company's articles or in any contract with a company indemnifying an officer of the company from any liability in respect of any negligence, default, breach of duty or breach of trust, is to be void. However, section 310(3) then provides as follows:
>
> > This section does not prevent a company …
> >
> > (a) from indemnifying any such officer or auditor against any liability incurred by him
> >
> > > (i) in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or he is acquitted.
>
> <u>It seems to me that that subsection emphasises both by its function and by its language that a liability for costs incurred in the successful defence of any proceedings is something different from a liability for costs sustained or incurred in the execution of the directors' duties to a company or, indeed, in relation thereto</u>.
>
> The second matter which seems to me to fortify the conclusion to which I have arrived concerning "good arguable case" arises from the authority of *Tomlinson v Adamson* [1935] SC 1. That authority shows at least that the costs of successfully defending a prosecution for fraud does not easily come within a different version of an article 31 type indemnity. Whether or not the analysis in that authority is close, and granted that the wording of the provision there is probably narrower than article 31, the case does at least illustrate the difficulty of providing by general language for the indemnifying of a successful defendant." (Emphasis added).

33 The English section 310(1)(2) and (3) corresponds very much with s 172(1) and (2) of our Companies Act, which reads:-

> "172(1) Any provision, whether in the articles or in any contract with a company or otherwise, for exempting any officer or auditor of the company from, or indemnifying him against, any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void.
>
> (2) Notwithstanding anything in this section, a company may pursuant to its articles or otherwise indemnify any officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in relation thereto in which relief is under this Act granted to him by the Court."

34 In our opinion, the reasoning of Rix J applies with equal force to our present case as the material portions of the indemnity clause in Article 110 and s 172(2) of our Companies Act are substantially the same as those under consideration by Rix J.

35 As far as the case of *Tomlinson v Adamson* (supra) is concerned, while the indemnity clause there is somewhat different, and it read,

> "Every Director .. of the Company shall be indemnified by the Company against … all costs, losses, and expenses which any such Director … may incur or become liable to by reason of any contract entered into, or act or deed done by him as such Director … in any way, in the discharge of his duties, including travelling expenses."

its relevance lies in the reasoning given by Lord Tomlin, in the House of Lords, where he said:-

> "Here the allegation against the agent was that he had done something which he did not in fact do, and which would have been against his duty to do, are expenses incurred by him by reason of any act done by him as a director in the discharge of his duty. Upon the true construction of the article I am unable to see how that can possibly be maintained. In my view the expenses incurred by reason of the allegations made against (the director), being allegations of matters which would have been a breach of his duty and which were held to be disproved or non-proven, are not expenses incurred by him by reason of any act done by him as a director in the discharge of his duties.
>
> If the case does not fall, as I think it does not fall, within the language of article 160 of the articles of association, it is difficult to see upon what principle it can possibly be brought within the common law rule".

36 Adopting the approach taken in *Tomlinson v Adamson,* and the views expressed in *Rowland v Gulfpac*, we hold that in defending the action brought by BFS for negligence, D&T's costs would not be losses incurred in or about the execution of its duties as auditors, or in relation thereto, but were expenses incurred for alleged non-performance of its duties. There is a clear parallel between the situation in *Tomlinson* and that in our present case. In the former the director had to defend himself against charges of fraud and here the auditors against charges of negligence. The two situations are analogous.

37 Finally, the point was made that the words in parenthesis in Article 110, namely, "including any such liability as is mentioned in the Act", differentiate Article 110 from the indemnity clause in

*Rowland v Gulfpac*. The argument goes briefly in this way. Section 172(1) prohibits a company in any article or contract from, *inter alia,* indemnifying an officer or auditor for any negligence or default. But s 172(2) qualifies that by providing that subsection (1) does not prevent a company from indemnifying such officer or auditor against any liability incurred by him in defending "any proceedings whether civil or criminal … in which judgment is given in his favour." Emphasis is placed on the fact that in the parenthesis the word "mentioned" is used rather than "created by" or "imposed by". The costs incurred by D&T in successfully defending a negligence action would be a liability mentioned in s 172(2) and by virtue of the words in parenthesis, the substance of s 172(2) would be incorporated by reference. Accordingly a liability of the nature mentioned in s 172(2) would come within Article 110 and should be indemnified by BFS.

38 The problem with this argument is that whatever might have been the scope of the words in parenthesis, they cannot be construed to import into Article 110 the substance of s 172(2). That would amount to reading Article 110 to mean very much like Article 113 of Table A. This is wholly unwarranted. The words in parenthesis cannot justifiably be read to include such a wholesale incorporation. The fact remains that the "liability" referred to by the words in parenthesis is still subject to the qualifying words that followed, namely, "which he may sustain or incur in or about the execution of the duties of his office or otherwise in relation thereto." As noted by the judge below, this is the hurdle which stands in the way of D&T's submission.

39 Under this issue, the last point raised in argument by D&T is that Article 110 should be interpreted in accordance with the spirit of it. In this regard, D&T relied upon principles of common law that an agent is entitled to be indemnified by his principal and cited the case of *In re Famatina Development Corporation Limited* [1914] 2 CH 271. There, a third party unsuccessfully instituted an action against an agent of the company, who had suffered loss on account of the costs incurred to defend the action. The agent, who was also a member of the company, sought indemnity from the company under a provision in the articles of association and under common law. The High Court ruled that the agent was not entitled to any indemnity. However, the Court of Appeal allowed his claim on the common law principle that "an agent had a right against his principal, founded upon an implied contract, to be indemnified against all losses and liabilities, and to be reimbursed all expenses incurred by him in the execution of his authority."

40 The judge below noted that in *Famatina* the proceedings against the agent were brought by a third party. In our opinion, this is a relevant point of distinction. Otherwise it would mean that whenever a principal takes action unsuccessfully against an agent for what the latter had allegedly done negligently, the principal would have to indemnify the latter for the costs incurred. There cannot be such an implied term. There is no reason why a contract of agency should be any different from any other contract in so far as disputes between the parties are concerned.

41 Moreover, *Famatina* was also distinguished by Lord Tomlin in *Tomlinson v Adamson* on the basis that in *Famatina* the expenses arose directly out of that which it was the duty of the agent to do and which he had in fact done. In *Tomlinson* the allegation against the agent was that he had done something which he did not, in fact, do and which it would have been against his duty to have done (similar to our case).

42 In the light of our views above, the costs incurred by D&T in successfully defending the PLC's action, as well as those incurred by Mah (or D&T) in the disciplinary proceedings, would similarly not fall within the scope of Article 110.

**Question of priority**

**(i) Estate Costs Rule**

43 We now turn to the third issue of priority. As far as standard costs are concerned, the parties are in agreement that such costs would be entitled to priority under the Estate Costs Rule. However, as the BFS action against D&T is proceeding in England and should the English court decide to award indemnity costs to D&T, whether on the basis of Article 110 (in other words disagreeing with us), or on some other grounds, the question of priority of the indemnity element of such costs will remain a live issue and must be addressed.

44 The judge below ruled that indemnity costs are not entitled to priority under the Estate Costs Rule on the ground that this would breach the *pari passu* principle of distribution on liquidation. He similarly held that the liquidation expense principle could have no application to such costs as the costs of D&T could not be considered to be incurred by BFS for the benefit of the estate. He also felt that this principle was always meant to cover the use of property by a liquidator and had never been applied in relation to costs.

45 Counsel for D&T submitted that there would be no breach of the *pari passu* rule if priority was given to the indemnity costs. Unsecured claims that exist at the date of the liquidation should be treated alike. Similarly, claims that accrue during the liquidation, as a result of actions taken by the liquidator in the discharge of his duties, should also be treated alike. Counsel argued that it would be wrong to treat this latter category of claims in the same way as the former category of claims.

46 The rationale for the Estate Costs Rule is that where an action is taken by a liquidator for the benefit of the insolvent estate, it is only fair that the defendant's costs should rank in priority over the liquidator's expenses and remuneration and the claims of the unsecured creditors in general. The liquidator should take the risk for his own actions: see *Re Home Investment Society* (1880) 14 Ch D 167 at 169-170.

47 As mentioned before, the parties are not in dispute that the standard costs incurred by D&T would enjoy priority under the Estate Costs Rule. The dispute centres only on the indemnity portion of the costs: whether that portion should be similarly treated. The reason for distinguishing the two portions of costs is that if indemnity costs were to be awarded on the basis of Article 110, that would be a free-standing pre-liquidation contractual debt, which should not enjoy priority.

48 We would at this juncture observe that the judge below, quite rightly, accepted that if the English Court were to award indemnity costs on a basis other than Article 110, both portions should be entitled to priority. This is because the indemnity portion of the costs would not have been brought about by any commitment made prior to liquidation, but by the conduct of the liquidators or their solicitors.

49 It would appear that there is no authority which has addressed this very issue. We appreciate that until the liquidator commenced action and failed, there could be no question of any costs being payable. We agree that the action having been commenced for the benefit of the estate of the company in question, the estate and the liquidator must bear the consequences that follow therefrom. The question is, what consequence or consequences. The normal consequence is standard costs unless the court in exercise of its discretion wishes to award indemnity costs for any other good reasons. We are not here concerned with indemnity costs awarded pursuant to the court's discretion. It is the contractual obligation to pay indemnity costs that is in issue. As that is a right under a pre-liquidation contract, although that right is contingent, it is no less a right which derives from that contract. It is also a right which is capable of being sued upon separately: see *John v Price Waterhouse*. Such a right should rank *pari passu* with rights under other existing

contracts.

50 While it is true that when the liquidators in the present case commenced the action, they would have been aware of Article 110, and would also have been aware that but for the action instituted, the contingent obligation in Article 110 would not have been triggered, we do not think that those considerations are decisive. The fact is that Article 110 is not a commitment they had made, although what they had done post-liquidation triggered it. The liquidators should not have to choose between taking no action or taking action and risking indemnity costs being paid in priority to their expenses. Accordingly, we would uphold the decision of the judge below and rule that the indemnity element of any costs awarded to D&T pursuant to Article 110 would not be entitled to priority under the Estate Costs Rule.

**(ii) Liquidation expense principle**

51 Priority is also claimed by D&T in respect of indemnity costs on the basis of the liquidation expense principle. This principle relates to post-liquidation liabilities incurred by a liquidator for the purposes of the winding-up. Liabilities under pre-liquidation contract would not be liquidation expenses and such liabilities should be proved like all other unsecured claims.

52 However, historically this principle of priority has been extended to apply to expenses incurred by a liquidator over the continued use of property. The rationale for this principle was enunciated by Lindley LJ in *In re Oak Pits Colliery Co* (1882) 21 Ch D 322 at 330 as follows:-

> "If the liquidator has retained possession for the purposes of the winding up or if he has used the property for carrying on the company's business, or has kept the property in order to sell it or to do the best he can with it, the landlord will be allowed to distrain for rent, which has become due since the winding-up. …. When the liquidator retains the property for the purpose of advantageously disposing of it, or when he continues to use it, the rent of it ought to be regarded as a debt contracted for the purpose of winding up the company, and ought to be paid in full like any other debt or expense properly incurred by the liquidator for the same purpose, and in such a case it appears to us that the rent for the whole period during which the property is so retained or used ought to be paid in full without reference to the amount which could be realised by a distress. "

53 However, it is important to note that Lindley LJ was not saying that the liability to pay rent had been incurred as an expense of the winding up. This was clarified by Lord Hoffmann in *In re Toshoku Finance UK plc* [2002] 1WLR 671 at 679:-

> "My Lords, it is important to notice Lindley LJ was not saying that the liability to pay rent had been incurred as an expense of the winding up. It plainly had not. The liability had been incurred by the company before the winding up for the whole term of the lease. Lindley LJ was saying that it would be just and equitable, in the circumstances to which he refers, to treat the rent liability *as if* it were an expense of the winding up and to accord it the same priority. The conditions under which a pre-liquidation creditor would be allowed to be paid in full were cautiously stated. Lindley LJ said, at p. 329, that the landlord "must show why he should have such an advantage over the other creditors". It was not sufficient that the liquidator retained possession for the benefit of the estate if it was also for the benefit of the landlord. Not offering to surrender or simply doing nothing was not regarded as retaining possession for the benefit of the estate."

54 Indeed, in *Toshoku* Lord Hoffmann also gave a historical account of the development of the

principle, as extended, and stressed that the principle was, in fact, restrictive in its application. He said (at 679):-

> "I give two modern examples which illustrate this restrictive application of the principle. In *In re ABC Coupler and Engineering Co Ltd (No 3)* [1970] 1 WLR 702, the liquidator on appointment closed down the business which had been conducted on the premises, had the company's plant and machinery valued and thought about what he should do. It was only from the time he decided to put the lease on the market that Plowman J held that he was retaining the premises for the benefit of the winding up and was liable to pay the rent in full. In *In re HH Realisations Ltd* (1975) 31 P&CR 249 Templeman J held that a company ceased to be liable to pay the rent in full from the time it gave notice to the landlord that it was seeking authority to disclaim the lease, even though it remained in occupation for nearly two months longer (See also *In re Downer Enterprises Ltd* [1974] 1 WLR 1460).
>
> The principle evolved from *Exhall Coal Mining Co Ltd* 4 De GJ&S 377 and *Lundy Granite Co* LR 6 Ch App 462 is thus one which permits, on equitable grounds, the concept of a liability incurred as an expense of the liquidation to be expanded to include liabilities incurred before the liquidation in respect of property afterwards retained by the liquidator for the benefit of the insolvent estate. Although it was originally based upon a statutory discretion to allow a distress or execution against the company's assets, the courts quickly recognised that its effect could be to promote a creditor from merely having a claim in the liquidation to having a prior right to payment in full. As in the case of other equitable doctrines, the discretion hardened into principle. By the end of the 19th century, the scope of the *Lundy Granite Co* principle was well settled."

55 However, based on *Re Atlantic Computers System plc* [1992] CH 505 where Nicholls LJ said (at 522) "(the principle") applies also to continuing obligations under existing contracts such as leases which the liquidator chooses to continue for the benefit of the winding up", D&T argued that the expenses incurred in defending the BFS action would come within that proposition. Whatever may be the scope of the formulation of Nicholls LJ, it is difficult to imagine that in this case BFS liquidators had *continued the Article 110 obligation* for the benefit of the winding up. The liquidators had no choice in the matter once they decided to institute an action against D&T.

56 We do not think it is warranted to extend the scope of the principle further to cover costs when standard costs incurred are already covered by the Estate Costs Rule. Moreover, it is extremely doubtful that, in instituting the action against D&T, the liquidators of BFS had continued the Article 110 obligation for the benefit of the estate.

**Judgment**

57 In the result, D&T's appeal is dismissed with costs. However, as the liquidators of BFS have not succeeded on the incorporation issue, they should not be entitled to costs for work done in that respect. Accordingly, and taking a broad view, we would order the appellants to pay only 2/3 costs, here and below. The security for costs, together with any accrued interest, shall be released to the respondents to account of their costs.