FIRST DIVISION, INNER HOUSE, COURT OF SESSION

[2018] CSIH 33
CA97/16

Lord President
Lord Drummond Young
Lord Malcolm

OPINION OF LORD CARLOWAY, the LORD PRESIDENT

in the reclaiming motion

in causa

J H & W LAMONT OF HEATHFIELD FARM AND OTHERS

Pursuers and Respondents

against

CHATTISHAM LIMITED

Defenders and Reclaimers

Pursuers and Respondents: DM Thomson QC; Dentons
Defenders and Reclaimers: Upton; Gilson Gray LLP

1 May 2018

Introduction

[1] This is a reclaiming motion (appeal) against an interlocutor of the commercial judge, dated 5 October 2017, ordaining the defenders to deliver to the pursuers a duly executed discharge of a standard security granted on 1 February 2010 in terms of an Option Agreement. The issue is whether the defenders are obliged to discharge the security or

entitled to refuse to do so pending the resolution of their counterclaim for damages for alleged breaches of the Agreement.

The Option Agreement

[2] The pursuers are the heritable proprietors of 73 acres in Gartcosh, North Lanarkshire. The defenders are developers. The parties entered into an Option Agreement dated 21 December 2009 and 1 February 2010, whereby the defenders were granted an option to purchase the land, or parcels of it, from the pursuers in return for two non-refundable payments of £60,000 and £75,000 (section 3 Option Grant). The defenders were to promote the land for private residential development. This included securing that it would be allocated for such development on the local plan (section 4). If not more than 10 acres were allocated by a particular date, either party could resile "without penalty". If only part of the 73 acres were allocated, the provisions of the Agreement would "only apply to the Allocated Subjects and the Non Allocated Subjects shall not be constrained in any manner whatsoever by this Agreement" (clause 4.8.2).

[3] Once land had been allocated, the defenders were to apply for planning permission "in principle" (section 5) and the pursuers were required to assist in that process (clause 5.4). The pursuers were prohibited from assisting any objector to the application or supporting any competing application (clause 5.5). Both parties required to act in good faith and fairly towards each other (clause 20). If planning permission were not obtained by a longstop date, either party could, again, resile without penalty (clause 5.11).

[4] Assuming that all went well, the defenders would be entitled to sell parcels of the land to third party developers (section 7). The pursuers would convey the parcels to the buyers and each party would obtain a share of the sale proceeds (the defenders' share being

14% plus certain defined expenses). The defenders would require to discharge the standard security, in so far as relating to the particular parcel, granted in their favour pursuant to clause 11 (*infra*) (clause 7.4.2). If no re-sale were achieved before another longstop date, once more either party could resile without penalty (clause 7.5). The payments already made to the pursuers would not, as already noted, be refunded.

[5] Clause 11 of the Agreement required the pursuers to provide a security to the defenders as follows:

> "11. Chattisham Security
>
> 11.1 As security for implementation of [the pursuers'] obligations under this Agreement, [the defenders] shall be entitled to require and [the pursuers] shall be obliged to provide ... the [standard security] which shall be released (and progressively restricted in its application) both pursuant to Clause 11.2 and on completion of Disposals.
>
> 11.2 The ... Security Subjects shall initially equate with the Subjects but following upon the Allocation Date shall thereafter be restricted to the Allocated Subjects together with such other part or parts of the Subjects to which any planning gain provisions (previously sanctioned by [the pursuers]) might apply and [the defenders] shall upon demand by [the pursuers] subsequent to the Allocation Date execute and deliver to [the pursuers] a Deed of Restriction duly executed in a Self Evidencing Manner which shall be reflective of the foregoing provisions in this Clause 11.2".

The Agreement provided that the security should be in the form of an annexed draft. This provided that it was granted "in security of performance of *all* obligations undertaken [by the pursuers to the defenders] in terms of the [Option Agreement]" (emphasis added). The security was executed in those terms on the same day as the pursuers signed the Agreement. It specifically prohibited the granting of real rights over the subjects without the defenders' consent.

[6] Clause 11.3 provided that:

> "11.3 Upon the earlier to occur of (a) the expiry of the Option Period and (b) the termination of this Agreement, [the defenders] shall deliver to [the pursuers] a discharge duly executed ... of the [standard security]."

[7] The Agreement contained (section 24) provisions relating to defaults; being failures "in a material respect to perform or comply with the obligations and liabilities undertaken". A notice of termination could be served "without prejudice to any other right or remedy available ... in terms of this Agreement or otherwise" (clause 24.2). Unless a disagreement arose, the Agreement would thereby terminate. If the defenders were the defaulting party, they required to discharge the security (clause 24.3.2). The Agreement specifically prohibited the pursuers from selling, or otherwise disposing of, the land without the defenders' consent (clause 26.1.2).

[8] In 2012, the relationship between the parties deteriorated. Access to the land was a particular problem. The third party sale longstop date had been 28 September 2015. No sales had been concluded by then. The pursuers terminated the Agreement under clause 7.5 by notice dated 30 September 2015. The pursuers asked the defenders to discharge the standard security. The defenders refused and counterclaimed for £5 million in respect of losses suffered as a result of alleged breaches of express and implied terms of the Agreement. The defenders averred that the pursuers had obstructed the development by, amongst other things, entering into an agreement with the owner of the land over which access had to be taken. That claim has been sent for a proof before answer.

Commercial judge's reasoning

[9] Following debate in the principal action, the commercial judge sustained the pursuers' plea to the relevancy of the defences and granted decree *de plano* ordering the

defenders to execute the discharge. The issues had focussed on two principal questions. First, under the terms of Clause 11, did the security cover all of the obligations owed by the pursuers to the defenders, or solely the obligation to convey the land to the defenders when the defenders exercised an option to purchase? Secondly, were the defenders entitled to refuse to grant the discharge, either in exercise of the remedy of "retention" or by withholding performance at common law, or was this excluded by the clear and unambiguous terms of the Agreement?

[10] On the first question, the commercial judge reasoned that clause 11.1 defined the purpose of the security as being "for implement of [the pursuers'] obligations under the Agreement". The language was clear and straightforward. It encompassed primary obligations brought into existence by the Agreement. It did not extend to secondary obligations which resulted from a breach. The pursuers' primary obligation was to convey the land on a phased basis, if the option were exercised. Clause 11.2 provided for the restriction of the security to those parts of the land which were allocated for residential development. Any parts of the land not allocated would be excluded. This suggested a correlation between the security and the primary obligation.

[11] On the second question, the commercial judge recorded that there was little consensus on whether the defenders were seeking to exercise a right of retention or a right to withhold performance. "Retention" was a shorthand way of describing the withholding performance of obligations, which were accepted as subsisting, according to the principle of mutuality. The defenders had failed to set out a basis for holding that the requirement of interdependency was satisfied. The express or implied obligations, which were said to have been breached by the pursuers, were not the counterparts of the defenders' obligation to grant the discharge of the standard security.

[12] The defenders' attempt to rely on mutuality was excluded by the clear terms of the Agreement. Clause 7.5 conferred a right to resile if there had been no sale of the land within the relevant period. It was commercially sensible that, if progress had not been made within that period, the pursuers would be free to deal with the land. The right to terminate the agreement, under clause 7.5, would be of no use to the pursuers without the right to receive a discharge. The security now secured an option which had not been, and could never be, exercised.

Submissions

Defenders

[13] The defenders contended that a party to a contract could withhold performance of an obligation in security for payment of damages for a breach of a contract which had been terminated (Gloag: *Contract* (2nd ed) 623, approved in *Inveresk* v *Tullis Russell* 2010 SC (UKSC) 106 at para 35; cf *McNeill* v *Aberdeen City Council* 2014 SC 335 at para [29]). The commercial judge had erred in holding that the terms of the Agreement breached by the pursuers were not counterparts to the defenders' obligation to discharge the security. The pursuers' obligations under clauses 5.4, 5.5 and 20 were co-extensive in both content and time with the defenders' obligation to discharge the security under clause 11.3. The obligations were presumed to be reciprocal, in the absence of a cogent reason for holding otherwise (*Inveresk* v *Tullis Russell* (*supra*) at paras 42-43). The defenders had secured the performance of "all" of the pursuers' obligations under the Agreement. The scope of the security included pecuniary secondary obligations. Excluding the right to damages would be arbitrary. The security contemplated the possibility of a breach of obligations. It was a mechanism for the enforcement of pecuniary obligations owed by the pursuers.

[14] The commercial judge had erred in holding that the parties had excluded the common law right to withhold performance of an express contractual obligation on the ground of material breach by the other party. In order to exclude common law rights, a contract had to contain clear and unambiguous words (*Pollock & Co* v *Macrae* 1922 SC (HL) 192; *Gilbert-Ash (Northern)* v *Modern Engineering (Bristol)* [1974] AC 689; Lewison: *Interpretation of Contracts* (6th ed) at para 12.19; *Novasen* v *Alimenta* [2013] 1 Lloyd's Rep 648; *Forster* v *Ferguson & Forster, Macfie & Alexander* 2010 SLT 867 at para [16]). There was no reference in the contract to the exclusion of common law rights. The judge had erred in finding that clauses 7.5 and 11.3 taken together excluded the common law right, when clear and unambiguous words would have been required. Clause 24.2 had expressly preserved common law remedies.

[15] The commercial judge had erred: (1) in considering that the pursuers' interpretation was commercially sensible; (2) in failing to notice that the security expressly covered "all" obligations, which would include damages claims; and (3) in relying on the clause relating to non-refundable option payments, which had been included in the counterclaim. The plea of retention which the defenders advanced was an equitable one, subject to control by the court. It did not extinguish the right to a discharge.

Pursuers

[16] The pursuers submitted that the commercial judge had been correct to find that there was no interdependency between the obligations. The presumption of mutuality was rebutted by a consideration of the terms of the Agreement. The contractual scheme demonstrated that the Agreement was that, come what may, the defenders were obliged to execute and deliver a discharge of the security in certain specified circumstances. There was

no general rule that any material breach by one party disentitled him from enforcing any obligation by the other party (*Macari* v *Celtic Football Club* 1999 SC 628). Regard had to be given to the terms of the contract (*Bank of East Asia* v *Scottish Enterprise* 1997 SLT 1213 at 1216 under reference to *Turnbull* v *McLean* (1874) 1 R 730; Gloag: *Contract* (2nd ed) 594). The interdependence of obligations was a matter of circumstances. In contracts which were to be performed in stages, the counter obligation and consideration for payment was the completion of the work for that stage (*Bank of East Asia* (*supra*) at 1217). Applying these principles, the purpose of the security was to secure performance of the primary obligation during the currency of the agreement. The parties had agreed that, on termination, the defenders were obliged to discharge the security. Upon termination, performance of the primary obligation was no longer available. It followed that the defenders' obligation to discharge the security could not be a counterpart of the contractual obligations which the pursuers were alleged to have breached.

[17] The task was to identify and give effect to the parties' intentions based on established principles of construction. The Agreement did not contain an exclusion of liability clause. A less exacting standard than that suggested by the authorities was required (*Ailsa Craig Fishing Co* v *Malvern Fishing Co* 1982 SC (HL) 14). It was not possible to construe the Agreement in any other way than that determined by the judge. Effect required to be given to its terms *(@SIPP Pension Trustees* v *Insight Travel Services* 2016 SC 243). The contractual obligation on the defenders, under clause 11.3, was the subject of the two contractual triggers of: (i) the expiry of the option period and (ii) the termination of the agreement.

Decision

[18] The remedy of withholding performance is available to a party in an ongoing

contract where the other party has failed and refuses or delays to perform a reciprocal obligation in that contract. The first party can withhold performance until the second party performs (see generally Gloag: *Contract* (2nd ed) 623). It is, at least as a generality, an alternative to rescission on the grounds of material breach, although it may also be used where the failure by the second party is not material and rescission is not possible. The remedy is not normally available when a contract has come to an end, whether by rescission following upon repudiation, or in terms of the contract itself. It is a remedy intended to compel performance in a subsisting contract. It is not one normally available to a party who does not seek performance by the other party, but has resiled and/or only seeks damages for a past breach of contract which is unlikely to be repeated (*McNeill* v *Aberdeen City Council* 2014 SC 335, Lord Drummond Young at para [29]).

[19] *Inveresk* v *Tullis Russell* 2010 SC (UKSC) 106 was concerned with the different situation where liquid and illiquid sums were due under a contract. In that situation, it has long been recognised that one party can refrain from paying the other (commonly known as retention) pending the resolution of a compensatory or "offsetting" counterclaim for damages in respect of breaches arising out of the same (or a related) contract (*ibid* Lord Hope at paras [30] and [33]; Lord Rodger at paras [57] and [104] *et seq*). This is an exception to the general rule that payment of a liquid debt cannot be withheld in respect of an illiquid debt. As such the right was not disputed (see Lord Hope at para [27]).

[20] Withholding performance is a remedy available where the obligation, in respect of which performance is being withheld, is the counterpart of the obligation breached. Whether such interdependence exists is a matter of contractual construction, even if, as a generality, all the obligations on one side of the contract must normally be seen as reciprocal to those on the other in the absence of a clear indication to the contrary (*Bank of East Asia* v

Scottish Enterprise 1997 SLT 1213; *Forster* v *Ferguson & Forster, Macfie & Alexander* 2010 SLT 867; cf *Macari* v *Celtic Football Club* 1999 SC 628).

[21] In this case the scheme of the contract is plain. The defenders had a right to oblige the pursuers to convey parcels of land to third parties in the event of the defenders being able to arrange a sale to those parties. Such sales were to involve a financial benefit being paid to the defenders (section 7). This was the primary obligation to be secured *under* the Agreement (clause 11.1, emphasis added). Although there are ancillary obligations on the pursuers to assist, and not to obstruct, the process leading to the sales, these are not enforceable, and enforcement of them cannot be compelled, once the contract has been lawfully terminated and such sales cannot occur. Withholding performance cannot be used to compel performance even of a reciprocal obligation when it is no longer extant by virtue of that termination.

[22] The provisions (clause 4.8.2) which permit the release of parcels of land from the security, in the event that they are not allocated for development, make it clear that the word "*all*" relative to "obligations" in the draft, and as executed, standard security (and which does not appear in the Agreement) is intended to relate only to obligations which remain prestable and not those which have ceased because they can no longer be performed. Once land was no longer capable of being developed, it could not remain covered by the security relative to other obligations under (or arising from) the Agreement. The same is clear from the terms of clauses 7.5 and 11.3. Once the exercise of an option to purchase ceased to be possible, either because of the passing of the longstop date for doing so or the contract was lawfully terminated, with the same practical result, there was a counter obligation to discharge the security. Put another way, the existence of the security is the counterpart of

the subsistence of the option itself. Once it becomes impossible to exercise that option, the security must be discharged.

[23] The above construction is the only one which emerges from the wording of the contract when looked at as a whole. It is also the only one which makes commercial sense. If the defenders were correct, the land could potentially be tied up for years pending the resolution of a litigation, of the type encapsulated in the counterclaim. The Agreement (clause 24) made it clear that, if a notice of termination had followed upon the defenders' default, the security required to be discharged. That does not carry with it an implication that, if it were a pursuers' default, the security need not be discharged notwithstanding termination. The security was intended to preserve the land pending the exercise of the option. Once that exercise became impossible, a discharge was required in terms of clause 11.3. The parties did not intend that clause to be suspended until the resolution of a damages claim.

[24] Finally, even if it were competent to withhold performance, it is not equitable to permit that to occur in the circumstances occurring here. If the defenders wish security for their damages claim, they are at liberty to apply for a diligence on the dependence of the action; for example, one inhibiting the pursuers from dealing with the land. If the defenders were entitled to retain the benefits of the security pending resolution of the dispute, they would escape the rigours of the modern regime relating to the grant of such diligence (Debtors (Scotland) Act 1987, ss 15A-N inserted by the Bankruptcy and Diligence (Scotland) Act 2007). Had it been necessary to do so, I would have moved your Lordships to exercise the court's equitable jurisdiction accordingly.

[25] The reclaiming motion should accordingly be refused and the commercial judge's interlocutor of 5 October 2017 adhered to.

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OPINION OF LORD DRUMMOND YOUNG

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1 May 2018

[26] I agree with your Lordship in the chair that this reclaiming motion should be refused. I do so for two reasons which correspond to those given by your Lordship. The first and primary reason is that the pursuers' obligation under clause 11 of the Option Agreement to grant the Chattisham Security is not, for the purposes of the law of retention, the counterpart of the other provisions of the Option Agreement. The second reason is that, even if the obligation to grant the Chattisham Security is the counterpart of the other

provisions of the Agreement, it would not be equitable to permit the defenders to exercise a right of retention in security of the claim for damages that they have put forward against the pursuers.

[27] I will consider each of these reasons in turn. Before that, however, I should make some general observations about the context in which the principle of contractual retention typically operates; by "contractual retention" I mean the principle whereby one party to a contract may in certain circumstances withhold performance of its obligations because of a breach of contract by the other party. Retention in this sense serves as a form of security for contractual performance. Security is a protection against insolvency, whether absolute insolvency on a balance sheet test or practical insolvency, in the sense that the grant of the security is having difficulty in paying debts or fulfilling other obligations as they fall due. A security is of assistance in the event of actual insolvency, in either of these senses, but it may also be of utility in dealing with the threat or material risk of insolvency; as a matter of commercial practice it is used as a matter of course to deal with such risks.

[28] In one sense insolvency is inevitably unfair: it is a trite observation that those who have had dealings with the insolvent do not receive what is due to them. Most typically, a debtor of the insolvent only receives a dividend (if anything is left after payment of secured and preferential debts), and the same is true of a creditor with a damages claim. The adverse effect of insolvency is not confined to monetary obligations, however; the insolvent's obligations to perform services or to supply goods or other property are usually not implemented. A security may be a straightforward security for payment of a debt, but it may equally be a security for an obligation *ad factum praestandum* or for an obligation to pay damages *in lieu* of such an obligation. These considerations illustrate the wide range of situations in which security may be of commercial importance. In this connection, I would

note that the right of contractual retention is a very flexible form of security, applicable to a great range of obligations in a wide range of circumstances. It should in my opinion be applied in the light of the consideration.

[29] A further factor is in my opinion of importance. While the normal rule on insolvency is that creditors are dealt with according to their strict legal rights, either by enforcing their real rights or by receiving a dividend for their established personal rights, in the practical administration of insolvency the strict application of rules can have unfair results. For this reason equity plays a significant part in the application of the law of insolvency and in the associated area of offsetting debts. An illustration of equity's role is found in the development of the principle of balancing accounts on insolvency. The right of compensation or set-off normally applies only to liquid debts. Where one of the parties is insolvent, however, the right of offsetting is extended on equitable grounds, with the result that illiquid obligations can be set off against liquid debts: Gloag, *Contract*, at 626; Bell, *Commentaries*, ii. 122. A further intervention by equity which is relevant in this area, although it does not require actual insolvency, is the extension of the right of compensation beyond liquid debts, in the strict sense, to debts that can easily be verified: Gloag, *Contract*, 625. The reasoning here is that, even if a debt is not strictly liquid, if a creditor can readily establish the amount of his debt it is considered unfair to prevent him from offsetting the amount due to him against the amount that he owes to the insolvent. The contractual right of retention is also equitable in nature, a matter to which I will return. This is in my opinion an important aspect of the right; the unthinking application of strict legal rights on insolvency frequently leads to manifest injustice.

Contractual retention

[30] Contractual retention is the right of one party to a mutual contract to withhold performance in response to a breach of contract by the other party. A classic definition is that of Gloag and Irvine (The Law of Rights in Security, 303; approved in *Inveresk PLC* v *Tullis Russell Papermakers Ltd*, *supra*, per Lord Hope at paragraphs [30]-[33]):

> "Retention may be defined as a right to resist a demand for payment or performance till some counter obligation be paid or performed ... Thus the right of a party to withhold performance of his obligations under a mutual contract, if the counter obligation is not performed, is often spoken of as a right of retention, and may result in a right to retain money or goods".

Retention permits the withholding or the temporary non-performance of the substantive obligations under a contract, those are obligations such as the supply of goods, or the provision of services, or the payment of the price: *McNeill v Aberdeen City Council*, *supra*, at [26]-[27]. It is important that the right should be confined to the substantive obligations under the contract, such as the obligations to supply goods or provide services and the correlative obligations of payment; the dangers of extending the right of retention more widely to incidental and ancillary obligations are clearly illustrated by the specific facts of *McNeill*.

[31] Retention typically takes the form of a withholding of payment, but it must be distinguished from two other important rights that defeat an obligation to make payment: compensation and balancing accounts on insolvency. Compensation is the right to set off one monetary claim against another, with the result that the smaller claim is extinguished and the larger claim is extinguished *pro tanto*. It is generally regarded as founded on the Compensation Act 1592: see Gloag, Contract, 644. For compensation to operate it is normally essential that the two debts should be liquid, although as noted above the right has been extended, essentially on equitable grounds, to debts that can readily be verified. For

this reason a damages claim can never be the subject of compensation. There are I think two fundamental policy reasons for confining compensation to liquid debts. First, compensation involves an offsetting of the debts, and for that purpose it is essential that the amount of the debt can be instantly verified, so that the necessary entries can be made in the parties' books and the debt extinguished. Secondly, if compensation were not confined to liquid debts, there would be an obvious risk of abuse. If, for example, A owes a liquid debt to B that is payable immediately, he could delay the need to make payment to B by advancing a damages claim, perhaps of a contrived or spurious nature, and claim to offset that illiquid claim against the liquid debt obligation. Confining compensation to cases where both debts are liquid, or are capable of immediate verification, avoids this difficulty.

[32] Balancing accounts on insolvency is another form of set off. Bell describes it as "not merely an arrangement of convenience, but an equitable adjustment of mutual debts and credits, to avoid gross and manifest injustice": Commentaries, ii.124 (5th ed); ii.122 (7th ed). In balancing accounts on insolvency liquid and illiquid debts, including damages claims, may be set off against each other. Such a right is regarded as an equitable extension of the right of compensation. Two reasons exist for the extension. The first is the fundamental equitable reason adverted to by Bell: if a debtor who is obliged to pay a debt to an insolvent estate has a claim against the estate, whether liquid or illiquid or merely in the form of a claim for damages or unjustified enrichment, it is considered unfair that he should be compelled to pay his debt in full without offsetting the claim that he has against the insolvent estate. The alternative would be that, while the debtor had to pay the debt due by him in full, he could only rank for a dividend in respect of the debt due to him. That might be a logical way of treating the two obligations, but the law has decided on equitable grounds that offsetting should be permitted.

[33] The second reason for permitting an extension of the right of balancing accounts on insolvency to illiquid debts and other obligations is that, on insolvency, all claims made by and against the insolvent estate will be under the control of the trustee in bankruptcy, liquidator or other insolvency practitioner. This has two important consequences. First, because of the intervention of an insolvency practitioner the risk of contrived or spurious claims is significantly reduced. Secondly, on insolvency all debts due to and by the insolvent require to be valued; in the case of claims for damages or other illiquid obligations, the liquidator or trustee is obliged to place a value of the claim. This means that offsetting is possible, and indeed offsetting is essential if the affairs of the bankrupt or insolvent company are to be wound up. I should add that the principle of balancing accounts on insolvency does not apply to a debt due to the insolvent estate that depends on a contingency so remote that it is impossible to estimate its present value: Gloag, *Contract*, 626.

Retention and mutuality

[34] Compensation and balancing accounts on insolvency are conceptually quite distinct from contractual retention. Contractual retention is based not on the commercial and accounting convenience of offsetting debts, as with compensation, or on the need to secure an equitable adjustment of accounts on insolvency, but on the principle of mutuality of contract. The classic statement of the doctrine is perhaps that of Lord Justice Clerk Moncrieff in *Turnbull* v *McLean & Co*, 1874, 1 R 730, at 738:

> "I understand the law of Scotland, in regard to mutual contracts, to be quite clear: 1st, that the stipulations on either side are the counterparts and the consideration given for each other; 2nd, that a failure to perform any material or substantial part of the contract on the part of one will prevent him from suing the other for performance; and, 3rd, that when one party has refused or failed to perform his part of the contract in any material respect, the other is entitled to insist for implement,

> claiming damages for the breach, or to rescind the contract altogether – except in so far as it has been performed".

The importance of the principle of mutuality is emphasized in the two short concurring opinions of Lord Benholme and Lord Neaves, at 1 R 739, and by the opinion of Lord Justice Clerk Inglis in the earlier case of *Johnston* v *Robertson*, 1861, 23 D 646, at 656. Mutuality is fundamental to the notion of a bilateral or multilateral contract in Scots law. The underlying principle is thus that the provisions of a contract are normally taken to be interdependent. It follows from this that, if one party fails to implement its substantive obligations under the contract, the other party is entitled to refuse to perform its substantive obligations.

[35] The function of retention is to provide security for future contractual performance. If one party commits a sufficiently material breach of contract, the other may exercise the right to withhold performance of his own substantive obligations. For example, in a contract for the supply of goods by instalments, if the purchaser fails to pay for one instalment the seller will normally be entitled to withhold delivery of further instalments until payment is made. In the reverse position, where a party fails to deliver goods or services in accordance with his contractual obligations, the innocent party may utilize the right of retention to withhold payment. In principle I do not think that there is any difference between withholding performance of obligations such as the supply of goods or the provision of services and the withholding of performance in the form of payment. For the purposes of the law of retention payment is merely one form of contractual obligation. When obligations other than payment are withheld, the party exercising the right of retention ensures that as long as the breach continues he is not required to incur the work and expense necessary to fulfil his own side of the contract. In this way he reduces the scale of any claim for damages that he may have following on a breach of contract, which may be important if the party in breach is

in financial difficulties. When an obligation of payment is withheld, the element of security is quite straightforward, in that the funds withheld are available for offsetting against any claim for damages for breach of contract. The security function of retention is in my opinion of considerable importance in the present case, for reasons that I will discuss subsequently.

[36] *Turnbull* v *McLean & Co* makes it clear that the normal rule of Scots law is that the whole of the obligations on one side of a contract are regarded as the counterparts of the whole of the obligations on the other side of the contract. There are obvious practical reasons for such an approach; a contract is negotiated and concluded as a unity, and if it is not implemented and enforced as a unity a central and vital feature of the parties' bargain will be lost. In the words of Lord Benholme in *Turnbull* v *McLean & Co*, at 739:

> "It is very important that we should express our determination to abide by the well-established rule of Scotch law that in mutual contracts there is no ground for separating the parts of the contract into independent obligements, so that one party can refuse to perform his part of the contract, and yet insist upon the other performing his part. The unity of the contract must be respected".

On occasion the principle of mutuality of contract has been extended beyond the provisions of a single contract, to cover rights and obligations under a related contract; an example of this is found in in *Inveresk PLC* v *Tullis Russell Papermakers Ltd*, *supra*, where the parties concluded two contracts, one for the sale and purchase of a brand of paper and related assets, and the other whereby the seller undertook to continue to manufacture, sell and distribute certain products during a period of five months following the agreement. It was held that the obligations in one of those contracts were the counterparts of the obligations in the other, as the two contracts in reality represented a single transaction.

[37] At this point I should observe that the law relating to contracts performed in stages is quite clear from cases such as *Turnbull* v *McLean*, which concerned a contract for the sale of coal to be delivered in instalments, with each instalment being paid for after it was

delivered. The purchaser refused to make payments for two instalments and the seller withheld further deliveries and ultimately rescinded the contract. It was held that the seller was entitled to withhold payment. The statements of the law in that case are very clear. The speech of Lord Jauncey in *Bank of East Asia* v *Scottish Enterprise*, *supra*, must I think be read subject to the well-established existing law on this matter, and should not be construed as suggesting that in instalment contracts the presumption of interdependence is in some way reduced. Indeed, if the principle of mutuality were not applied in its traditional way to contracts to be performed in stages, the result would be commercially nonsensical. For example, in a contract for the supply of goods by instalments, the seller might be compelled to provide successive instalments even when the purchaser had ceased paying and it was clear that there was a serious risk that he was insolvent. Similar practical difficulties would arise in other forms of contract that are performed in stages, including building contracts and leases. The practical importance of these forms of contract hardly requires stating, and it would be most regrettable if the doctrine of retention were not to be applicable to them, or were only to be applicable in the restricted manner that appears to be contemplated by Lord Jauncey. In practice the right of retention is usually the most effective practical security for contractual performance, including securing the right to damages in the event of breach of contract. In this connection the fact that English law does not appear to have the same doctrine is quite irrelevant. English law, or more technically equity, provides security for contractual performance through the concept of the equitable interest, but that concept has no place in Scots law. In Scots law security for contractual performance is provided primarily by the principle of retention, based on the mutuality of contractual obligations.

[38] Nevertheless, although the norm is that contractual obligations are mutually interdependent, parties may frame a contract in such a way that one or more obligations are

independent of the other obligations; in such a case one party may demand performance without tendering performance himself: see Gloag, *Contract*, 594-595. In the present case I am of opinion, in accordance with your Lordships, that clause 11 of the Option Agreement, dealing with the Chattisham Security, falls into this category. The result is that the provisions for discharge of the Security may be enforced by the pursuers independently of the other obligations of the parties under the contract. I reach that conclusion for the two reasons expressed at the beginning of this opinion.

[39] First, the Chattisham Security is an express security, in the form of a standard security in the form set out in Part 2 of the Schedule to the Option Agreement. That standard security is in ordinary form, and is granted in security of the performance of all obligations undertaken by the pursuers to the defenders under the Option Agreement. When an express security is granted in respect of one party's obligations under a contract, it can reasonably be inferred that the express security is intended to supersede the implied security conferred by the right of contractual retention. That is especially so where the express security is conferred over land, rather than merely relying on the withholding of contractual rights.

[40] Secondly, the Option Agreement in clauses 7 and 11 makes express provision for the restriction or termination of the Chattisham Security in defined circumstances. Restriction is contemplated by clause 11.2, which defines the "Chattisham Security Subjects". These were initially to comprise the whole of the subjects in respect of which planning permission was to be sought, as shown on a plan appended to the Option Agreement, but they were to be restricted to the Allocated Subjects, that is to say subjects in respect of which planning permission was obtained, once that had happened. Once Subjects had been allocated in this way, the pursuers might request that the defenders should execute and deliver a Deed of

Restriction, restricting the scope of the Chattisham Security to the Allocated Subjects. Further provision for restriction of the security subjects is contained in clause 7.4.2, which provides that the defenders should deliver a discharge of the Chattisham Security to the pursuers upon each disposal of a Sale Parcel, that is to say, a parcel of housing land sold or capable of being sold to a third party developer. Thus the Security contained express provisions regulating its own restriction, which were not related to the performance by the pursuers of their obligations under the Option Agreement.

[41] Clause 11.3 of the Option Agreement makes express provision for the termination of the Chattisham Security. It states that "Upon the earlier to occur of (a) the expiry of the Option Period and (b) the termination of this Agreement, Chattisham shall deliver to [the pursuers] a discharge duly executed… of the Chattisham Security". Termination of the Option Agreement typically occurs in the circumstances specified in clause 7.5, which provides that, if no contract for the sale of land to a developer had been concluded by the date known as the Third Party Land Sale Longstop, either party is entitled to result from the Agreement without penalty. The expression "Third Party Land Sale Longstop" is defined as meaning either the third anniversary of the Allocation Date or a subsequent date agreed by the parties in accordance with clause 7.6. In the present case, the third anniversary of the Allocation Date had passed; that occurred on 28 September 2015, and no land had been sold to third party developers by then. The result of that was that either party was entitled to resile from the Agreement after that date. The pursuers gave notice to terminate the agreement on 30 September 2015 and requested the defenders to discharge the Chattisham Security. The provisions of clause 11.3, taken with clause 7.5 and the relative definitions, contained express and specific provision for the termination of the Chattisham Security in defined circumstances, and it is those provisions that were invoked by the pursuers.

Clauses 11.3 and 7.5 were not related to the parties' performance of their obligations under the contract in any general sense. The fact that specific provision was made to terminate the Security, in a manner independent of the mutuality principle, indicates in my opinion that the discharge of the Security was intended to operate in defined circumstances regardless of the parties' performance of other obligations under the contract.

[42] I accordingly conclude that the provisions of clause 11.3 and clause 7.5 are not interdependent with other provisions of the contract. This result appears to me to accord with commercial common sense. The Chattisham Security Subjects were a major asset of the pursuers. The Chattisham Security was granted to provide express security for the pursuers' obligation to convey land to third party developers once planning permission was obtained. When the Option Agreement was terminated in accordance with its terms that was no longer possible. Consequently there was no commercial reason why those subjects should remain subject to the Chattisham Security; the purpose for which that security was granted had ceased to exist. These commercial considerations in my view provide clear support for the conclusion that the provisions governing the Chattisham Security were independent of the other provisions of the Option Agreement, and that the Security was to be discharged if one of the parties resiled from the agreement, regardless of any other claims that the parties might have against each other.

Equitable nature of retention

[43] Apart from the question of interdependence, it is important in my opinion to take account of the equitable nature of the right of retention. Retention is equitable in nature. That is explained by Lord President Cooper in *Stobbs & Sons* v *Hislop*, 1948 SC 216, at 223:

> "The latest view is that retention of rents does not rest on any principle peculiar to the law of leases, but is simply one of the many instances of the general equitable rule of Scots law that reciprocal obligations arising under a mutual contract are the counterparts of each other, and that, under suitable circumstances, a party to such a contract will be permitted to withhold performance of his obligations unless and until the other party has performed his, or, to put it from the opposite angle, that failure to perform a material part of the contract on the part of one party will prevent him from suing the other for performance… The equitable nature of the rule and the discretionary control asserted by the Court in allowing or refusing retention in mutual contracts according to the circumstances are illustrated by the cases cited by Gloag, at page 627".

Lord Russell also referred to the equitable nature of retention (at 229). Other cases where the equitable nature of retention was recognized are cited in Gloag on *Contract* (2nd ed) at 627; these include *Graham* v *Gordon*, 1843, 5D 1207; *Ferguson* v *Ardrossan Dry Dock Co*, 1910 SC 178; and *Earl of Galloway* v *McConnell*, 1911 SC 846.

[44] In my opinion the equitable nature of retention is important. Retention may be invoked in a wide range of circumstances, and it is essential that it should not be allowed to become an instrument of abuse, in such a way as to enable a party to a contract to avoid implementing obligations that are clearly due because of a possible counterclaim of uncertain merit or for an uncertain amount. That consideration appears to me to be particularly important in the present case. As I have indicated, an important policy consideration in restricting the principle of compensation to liquid debts is the risk that payment of a debt that is clearly due and payable may be resisted because the debtor has a claim for damages that is uncertain as to liability or amount. In my opinion similar considerations apply to the principle of retention. This can be illustrated by an example based on a building contract. Suppose that the contractor is entitled to a stage payment duly certified by the architect. The employer does not wish to pay, and advances a damages claim of uncertain merit based on alleged defective work or delay or some other factor that requires to be established by evidence. In such a case there may be clear equitable grounds

for holding that the employer should not be able to refuse payment of the certified sum on the ground of a damages claim, notwithstanding that the obligation of the employer to make payment and the obligations of the contractor to perform work properly and timeously are counterparts of each other. This is not to say that equity would deny the defence of retention in every such case. For example, the delay might be clear, and the compensation payable might be fixed by a provision for liquidate damages. Everything depends on the particular circumstances. The fundamental point is that, when a damages claim is put forward as supporting a defence of retention, the claim must be looked at critically, and it must be determined whether it is fair and just that it should be allowed as a defence to a counterpart obligation that is clearly defined and clearly due.

[45] The present case appears to me to be one where considerations of equity are important. The defenders' damages claim is set out to some extent in the pleadings, but the averments are inspecific and the critical averments are not founded on written documents. The defenders' claim is based on alleged acts by the pursuers that were intended to frustrate the Option Agreement by persuading a neighbour to deny access to the development land. Those acts are said to be a breach of the pursuers' obligation to assist the defenders in connection with their planning applications (clauses 5.4 and 5.5 of the Agreement), and also a breach of the pursuer's obligation to deal with the defenders in good faith for the purposes of the agreement (clause 20). In summary, it is averred that difficulties were experienced in obtaining planning permission for the site, and that the neighbour declined to grant access over his land, giving as a reason an agreement that he claimed to have made with the pursuers which precluded him from granting the accessory rights. Those averments are based on inferences, largely from oral conversations, and they are denied by the pursuers. No attempt seems to have been made to recover documentation to establish the defenders'

claim. I also observe that the defenders' averments of loss are seriously lacking in specification.

[46] Furthermore, the defenders may be able to obtain security for their damages claim by applying for diligence, in the form of an inhibition, on the dependence of their counterclaim. Alternatively, they may raise a separate action and seek an inhibition on the dependence of that action. Inhibition is, of course, subject to sections 15A-15N of the Debtors (Scotland) Act 1987, introduced by the Bankruptcy and Diligence (Scotland) Act 2007. The defenders would accordingly require to satisfy the requirements of those provisions, relating both to the arguability of that case and the need for security in the light of the pursuers' financial position. If they can satisfy the statutory requirements, however, inhibition would be available to provide security for their claim. That in my opinion strongly supports the view that use of the contractual right of retention on the basis of the defenders' damages claim would not be equitable in present circumstances.

[47] For both of the foregoing reasons I agree with your Lordships that the defenders should not be permitted to avail themselves of the contractual right of retention in the present case. The reclaiming motion should accordingly be refused.

FIRST DIVISION, INNER HOUSE, COURT OF SESSION

[2018] CSIH 33
CA97/16

Lord President
Lord Drummond Young
Lord Malcolm

OPINION OF LORD MALCOLM

in the reclaiming motion

in causa

J H & W LAMONT OF HEATHFIELD FARM

Pursuers and Respondents

against

CHATTISHAM LIMITED

Defenders and Reclaimers

Pursuers and Respondents: D M Thomson QC; Dentons
Defenders and Reclaimers: Upton; Gilson Gray LLP

1 May 2018

[48] I agree with your Lordship in the chair that the reclaiming motion should be refused. I wish to add the following in support of the views expressed by your Lordship. The issue in this reclaiming motion can be resolved on a construction of the parties' contract. In this regard, I reject the submission for the defenders to the effect that a common law right of retention will apply unless it is expressly excluded; and this for the reasons explained by Lord Drummond Young in *Melville Dundas Limited* v *Hotel Corporation of Edinburgh Limited*

2007 SC 12 at paragraphs [14]-[16]. If such a right would otherwise arise, it can be excluded if such is the clear implication of the parties' agreement.

[49] In clause 11 the parties provided for a standard security to be granted in favour of the defenders in respect of certain obligations incumbent upon the pursuers. Clause 11.3 stated that the standard security shall be discharged on the earlier of the expiry of the option period or the termination of the agreement. Presumably this was upon the basis that the security's purpose was then over – its purpose being to provide reassurance that the option subjects would not be alienated or burdened, thereby defeating the defenders' rights under the agreement.

[50] With regard to the proposition that the standard security was intended to cover damages claims arising out of an alleged breach of the contract, clauses 11.2 and 11.3 demonstrate that it was not part of the agreement that the security would cover ongoing and outstanding damages claims. The time-limited nature of the standard security was part and parcel of the parties' bargain. I do not consider that it is open to the defenders to retain the security notwithstanding that, as is admitted, the circumstances provided for in clause 11.3 have occurred. (The only possible exception to this in terms of the contract would have been if the defenders had terminated it under the self-contained default provisions in clause 24 in respect of a default on the part of the pursuers which had been established as a result of an exercise of the provisions in clause 16.)

[51] The above is sufficient for the disposal of this appeal, but even if it is erroneous, I am not persuaded that the defenders' claim to retain the standard security should be upheld. In an area of the law bedevilled by overlapping and confusing terminology, it might be helpful to review certain recent authoritative decisions in an effort to provide some clarity. I have in mind particularly the speech of Lord Jauncey in *Bank of East Asia Limited* v *Scottish Enterprise*

1997 SLT 1213 and the judgment of Lord Rodger in *Inveresk Plc* v *Tullis Russell Properties Limited* 2010 SC (UKSC) 106.

[52] Where stipulations are imposed on the parties in a bilateral agreement which are conditional upon each other, performance of one of them cannot be demanded by the other party unless that party has performed or is able and willing to perform the counterpart obligation incumbent upon him. Thus, for example, a supplier of goods need not deliver unless the purchaser has paid or is willing and able to pay the price. A tenant can retain the rent if the landlord has excluded him from all or part of the leased subjects; his obligation to pay being suspended by the landlord's non-performance of a duty upon which the right to rent is conditional. This kind of retention is sometimes called "mutuality retention". Absent the necessary mutuality or conditionality, retention of this kind does not arise.

[53] In *Bank of East Asia Limited*, Lord Jauncey (page 7) cited with approval Lord Shand in *Pegler* v *Northern Agricultural Implement and Foundry Co Ltd* (1877) 4 R 435 at 442.

> "I venture to think the sound principle is rather this, that if the defence be founded on an obligation fairly arising out of the contract, and the performance of which is reciprocal to and contemporaneous (*viz.* exigible or prestable at the same time) with the obligation which is the foundation of the action, then the defence is good."

His Lordship commented that Lord Shand "was clearly envisaging not the totality of obligations due under a contract but rather specific obligations which were the direct counterpart of other obligations due thereunder." It is not the case that each and every obligation by one party to a mutual contract is necessarily and invariably the counterpart of each and every obligation by the other. "It must be a matter of circumstances". Thus his Lordship rejected the proposition that any claim under a mutual contract can be set against any other claim thereunder howsoever and whensoever such claim may arise. Counter obligations, in the sense of mutually interdependent duties, are "corresponding and

contemporaneous claims" which must be "exigible or prestable at the same time." In *Macari* v *Celtic Football and Athletic Co Ltd* 1999 SC 628, Lord President Rodger described Lord Jauncey's explanation of mutuality retention as an "authoritative gloss" on somewhat "sweeping" statements in earlier decisions (pages 639/41).

[54] Applying the above to the present case, it becomes clear that the defenders cannot rely on mutuality retention. They are not attempting to force the pursuers to perform a contractual duty, let alone one that is the counterpart of the defenders' current obligation to discharge the standard security. That obligation came into existence only on the termination of the option agreement, and cannot be characterised as reciprocal or conditional upon any of the pursuers' duties under the contract. (The document itself was not a counterpart of the pursuers' duties, but was granted by them in security of their performance of those obligations.)

[55] The defenders are seeking to withhold performance of an admitted obligation to discharge the standard security because of their disputed claim for damages for alleged breach of the pursuers' duties under the contract. At best for the defenders, this is related, not to retention based on mutuality of contract, but to a wholly different concept, confusingly also called retention, of the type described in detail by Lord Rodger in *Inveresk*.

[56] Plainly non-performance of a contractual obligation can trigger a remedy in damages. Until established and ascertained, such is an illiquid claim. In *Inveresk* Lord Rodger observed that it is "beyond all doubt that in certain circumstances, the court does permit a defender to retain a liquid debt which he would otherwise be required to pay to the pursuer" (paragraph 77). Earlier in his speech, having described when a defender has a right to withhold or retain payment, at paragraph 57 he explained the concept as follows:

> "… the term 'retention' is also applied to the (different) situation where a defender admits that, say, the price of goods is due. In that situation he cannot have any right to withhold payment of the price. But he can submit to the court that he should not be obliged to pay the price until some unliquidated claim which he has against the pursuer (here a claim for damages) is resolved. In effect, the defender asks the court to allow him to 'retain' the price meantime so that, if his claim for damages succeeds, he can offset the liquid damages against the liquid price."

Lord Rodger considered that the case before their Lordships could be analysed on the basis that, even if the additional consideration claimed was liquid, it would be just and equitable to allow the defenders to retain it until their damages claim was resolved. Though it had not been argued on that basis, his Lordship discussed the matter at some length, given its "general importance".

[57] Lord Rodger commented that the case law and literature on defenders' claims for damages in actions for the price of a contract are "notoriously confusing" (paragraph 66). His major contribution in the *Inveresk* judgment was to take the time and effort to chart a course through these difficult matters and offer reasoning and conclusions which his colleague, Lord Clarke, described as "convincing". His Lordship's general approach can be summarised as follows. Retention of debts is allowed "where that would be equitable having regard to the essential purpose of the Compensation Act" (paragraph 81). The general rule is that a liquid claim will not be held up pending the resolution of an illiquid claim. However that general rule can be set aside on "a matter of sound judicial discretion and equity", this not being limited to bankruptcy cases. Once the illiquid claim is ascertained it can then be set off against the debt owed to the pursuer.

[58] It is well established that one of the recognised circumstances in which this form of retention can arise is when both claims arise out of the same contract. However, discussion of the law in such a context often fails to notice the different types of retention, namely (a) in respect of reciprocity under a mutual contract or (b) because one party is using a damages

claim based on the pursuer's breach of the contract to resist payment. Regarding the latter, necessarily there are competing monetary claims, one unliquidated and the other ascertained and due. The two kinds of retention have different legal origins, one the doctrine of mutuality in bilateral contracts, the other an equitable extension to statutory compensation allowing, ultimately, the setting off of both claims against each other. Mutuality retention is an aspect of the law of contract. Where it applies, it is available, not by way of an exercise of an equitable discretion by the court, but as a matter of right (albeit the court can regulate issues of procedure). This is because the parties have agreed that the performance of one obligation is dependent upon the performance of the other. It is not a question of setting off claims against each other.

[59] In *Inveresk* Lord Rodger made it clear that the non-mutuality "different kind" of retention, which has been dubbed "special retention", is to be operated with regard to the equities of the particular circumstances. That both claims arise out of the same contract is a favourable factor for allowance of this kind of retention; but in itself this is not sufficient to hold up payment of the liquid claim. The full circumstances of the case, including the structure of the agreement, must be considered. Importantly, in the circumstances of the present case, and as the common use of the term "retention of debts" illustrates, this kind of retention concerns the ultimate set off of competing monetary claims. Plainly, obligations of a wholly different kind cannot be set off against each other.

[60] Reverting to the circumstances of the present case, the pursuers are not seeking payment from the defenders. They want a discharge of the standard security, as per the agreement. Neither the pursuers' obligations while the agreement was in force, nor any potential liability in damages for a breach thereof, are the counterpart of the defenders' obligation to grant the discharge. It follows that "mutuality" retention does not arise. Nor

can there be any question of one claim being set off against the other, hence "special retention" is not applicable. Even if there was, as your Lordship in the chair has observed, the equities are plainly in favour of the pursuers. In any event, as explained earlier, if some form of retention would otherwise arise, it is excluded by the clear terms of the parties' agreement.