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FIRST-TIER TRIBUNAL
TAX CHAMBER

In public Face to Face

Appeal reference: TC/2015/05860
TC/2017/7022

Heard on: 8 November to
6 December 2021
Judgment date: 4 August 2023

THE GALA FILM PARTNERS, LLP **Appellant**

- and -

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE & CUSTOMS **Respondents**

AND IN THE MATTER OF
A JOINT REFERENCE BY:

BARRY LEWIS
CHRISTOPHER MALLETT
JONATHAN SUMMERS
MOHAMMED YUSEF
WILLIAM CADOGAN

- and –

THE COMMISSIONERS FOR HER
MAJESTY'S REVENUE AND CUSTOMS

TRIBUNAL: JUDGE HARRIET MORGAN
MEMBER SUSAN STOTT

The hearing took place in public from 8 November to 6 December 2021, with the consent of the parties, for part of the time as a face to face hearing with some participants attending by video and for the remainder as a video hearing. Prior notice of the hearing was published on the gov.uk website, with information about how representatives of the media or members of the public could apply to join the hearing remotely in order to observe the proceedings.

Mr Richard Vallat KC and Ms Calypso Blaj, counsel, instructed by Pinsent Masons LLP, for the Appellant and the Referrers

Mr Jonathan Davey KC, Mr Imran Afzal, Mr Nicholas Macklam and Mr Sam Chandler, counsel, instructed by HM Revenue and Customs' Solicitor's Office, for the Respondents ("HMRC")

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DECISION

1. The decision relates to:

(1) An appeal by Gala Film Partners, LLP ("**Gala**") against amendments made by HMRC to its partnership tax return for the 2003/04 tax year. In a closure notice dated 28 August 2015, HMRC concluded that Gala did not, as it had claimed, incur a loss in that tax year of £110,755,060.68 in the course of carrying on a trade of film distribution ("**the loss**") and that it had taxable profits of £552,570.52.

(2) A referral made by HMRC and the individual members of Gala listed above ("**the Referrers**") (under s 28ZA Taxes Management Act 1970) for the tribunal to determine whether they are, as they have claimed, entitled to relief by set-off against their other income for (a) their allocated share of the loss, under ss 380 and 381 of the Income and Corporation Taxes Act 1988 ("**ICTA**"), and (b) the interest paid on the bank loans made to them to finance their contributions to Gala, under ss 353 and 362 ICTA.

Part A Overview and summary of conclusions

Section 1 - Overview of the arrangements

2. Gala was set up by Invicta Capital Limited ("**Invicta**") on 7 May 2003 as a vehicle to be used for high-net-worth individuals ("**HNWIs**") to invest in arrangements which Invicta devised. On the face of the documents, the arrangements relate to the distribution of films produced by entities related to Sony Corporation (we refer to any and all such entities as "**Sony**"). At all relevant times, Mr Mohammed Yusef was the Chief Executive Officer and Chairman of Invicta, Gala's "designated members" were two subsidiaries of Invicta (Gala Releasing Limited ("**GRL**") and Gala Distributors Limited ("**GDL**")) and its "operator" was WJB Chiltern Wealth Management Services Limited ("**Chiltern**"). Mr Yusef invested in the arrangements.

3. The arrangements and their intended tax effects are summarised in a summary of the structure which was issued, together with an Information Memorandum ("**IM**"), on 23 June 2003 with a view to attracting HNWIs as investors in Gala:

> "The following is a summary of events in relation to an individual ("the Partner") contributing £10 million to the Partnership.
>
> 1 The Partner contributes £10 million to the Partnership. £7.754 million of the contribution can be borrowed by the Partner on a full recourse basis from Société Générale ("the Partner's Loan").
>
> 2 The Partnership borrows £1.35 million ("the Partnership Loan") for every £10 million gross contribution of the Partner.
>
> 3 The Partnership acquires certain distribution, sequel and remake rights for a portfolio of films from the studio for a period of 21 years by paying in advance on the purchase price of £1.35 million. The Partnership also spends £10 million on prints and advertising expenditure for the portfolio of films and other trading expenses of the Partnership. The prints and advertising expenditure is a normal trading expense that is incurred by the owners of the distribution rights for films.
>
> 4 The Partnership will enter into a distribution agreement with an affiliate of the studio for a period of 8 years. The studio affiliate will be required to pay an annual Minimum Royalty Payment during the term of the Distribution Agreement. This Minimum Royalty Payment will be an amount equal to the difference between the income received by the Partnership in the normal course of distribution in any year and a sum equal to the interest due in that year on the Partner's Loan and the interest due in that year on the Partnership Loan. In year 8 this minimum payment

increases to ensure repayment of both the Partnership's Loan and the Partner's Loan of £7.754 million.

5 As it is expected that no distribution income will be received by the Partnership until its second period of trading the Partner's share of the first year's trading loss would be £10 million.

6 By utilising Section 380 and Section 381 of [ICTA] the Partner would be able to claim tax relief at 40%, assuming the income in which he is setting the trading loss against was taxable at 40%.

7 In the event that the studio does not take up the option to acquire the business from the Partnership, the Partnership will receive income from the distribution of the portfolio of films for a total of 21 years. The Partnership will also have the right to exploit all sequel and remake rights to those films. In this event it is anticipated that income in excess of Minimum Royalty Payments will be received by the Partnership and thus the Partner will share in the profits of the Partnership.

8 There is a possibility during year 3 of the distribution of the agreement and in subsequent years that the studio will exercise an option to buy the Partnership's business including the distribution rights for a purchase price being the greater of the market value of the Partnership's interest in the portfolio of films and the net present value of the unpaid Minimum Royalty Payments at the date the option is exercised. In this example the net present value of these unpaid Minimum Royalty Payments would approximate to £9.19 million in year 3 enabling the Partner's Loan and the Partnership's Loan to be repaid.

9 The purchase by the studio of the Partnership's business during year 3 would result in a capital gain of about £7.98 million (£9.19 million received less £1.35 million as the base costs of the rights originally acquired, adjusted accordingly by the wasting asset rules).

10 The capital gains tax liability would ordinarily be £798,000 (tapered capital gains tax rate of 10%), however any capital losses brought forward would extinguish the capital gain of £7.98 million.

11 *Should the studio exercise its option and no further income in excess of the Minimum Royalty Payments is received by the Partnership from the distribution of the films the net outcome for the Partner is a positive cashflow of approximately 10.2% of his original capital contribution*." (Emphasis added.)

4. As HMRC emphasised, as is apparent from the summary set out above, it was central to the design of the structure, as envisaged from the outset, that the arrangements would operate as follows:

(1) Distribution rights in selected films would pass from one studio entity to another via Gala on the basis that:

(a) Under the terms of licence agreements, Gala would pay the studio a fee for its participation in the arrangements, in the form of licence fees stated to be due in return for the grant of distribution rights in the selected films to Gala. The fee would be equal to 13.5% of the total capital contributed to Gala by the members ("**the contributions**").

(b) Under the terms of a distribution agreement, (i) Gala would (A) put a sum equal to 91.6% of the contributions ("**the Initial Expenditure**") into a designated account ("**the expenditure account**"), on the basis that it could be used only to meet certain types of costs of distribution of the selected films, as set out in marketing plans prepared by the studio, and (B) sub-licence the distribution rights back to a studio entity, and (ii) the studio sub-licensee would agree to pay Gala (A) "minimum royalties" over the term of the agreement, which would be due regardless of the success of the selected films, and (B) a share of "gross receipts" generated by the selected films (being, broadly,

monies generated from cinema ticket sales and other commercial exploitation of the films) as determined under contractual provisions which the parties referred to as "the waterfall".

(2) Gala would grant a studio entity a call option to enable it to acquire Gala's "business", which it could exercise on specified dates, the first of which would fall in the third year of the arrangements.

(3) Gala would pay the Initial Expenditure, licence fees and other costs and expenses of putting the structure in place using (a) the contributions, as financed in part by a bank loan, and (b) a bank loan obtained by Gala:

(a) The members and Gala would obtain bank loans of a total amount equal to the Initial Expenditure: (i) The members' loans would be equal to 77.54% of the contributions, and (ii) Gala's loan would be equal to the licence fees (of a sum equal to 13.5% of the contributions).

(b) The members would fund the remaining 22.46% of their contributions from their own resources ("**the cash contributions**").

(4) The "minimum royalties" would comprise (a) sums due annually, and (b) a large "minimum amount" due at the end of the term of the distribution agreement, which would be calculated to be sufficient to enable Gala/the members to repay interest on, and the total principal, of the bank loans respectively and, over the term, for Gala to realise a small profit from their receipt. These sums would be due when the corresponding payment of interest or principal was due. If the studio exercised the call option, the option price would be at least equal to the "minimum amount".

(5) The studio would (a) arrange for a bank to issue a letter of credit to Gala, in effect, to guarantee the payment of the "minimum royalties"/option price and (b) deposit an amount equal to the Initial Expenditure/total principal of the loans with the issuer in an interest bearing account for the issuer to use to meet its obligations under the letter of credit.

(6) Therefore, the arrangements would be such that from the outset:

(a) There would be a high degree of certainty that Gala would recoup the Initial Expenditure plus interest on it and that the bank loans would be repaid in full. In effect, therefore, (i) the members/Gala would not have material risk of suffering an economic cost as regards this aspect of their outlay under the arrangements, and (ii) their risk of economic loss would be confined to a sum equal to the cash contributions (of a sum corresponding to the licence fees and other fees). Gala contended that the aim and expectation was for Gala and the members to recoup that cost, and for the members to make a return on their investment, from Gala's share of "gross receipts" from the selected films.

(b) The studio would receive no economic benefit from the transactions other than the licence fees. The benefit of it receiving the Initial Expenditure to meet distribution costs on the selected films would be negated by it placing a sum equal to the Initial Expenditure on deposit with the issuer of the letter of credit.

(7) On Gala's analysis, the arrangements would generate a substantial loss in the 2003/04 tax year, broadly, of a sum equal to the Initial Expenditure and costs of putting the arrangements in place, for which the members of Gala would seek relief under ss 380 and 381 ICTA. The loss would arise on the basis that, so Gala says (a) its activities, as conducted in accordance with and pursuant to the distribution agreement, would constitute a trade of the exploitation of distribution rights in respect of the selected films, and (b) Gala would incur the Initial Expenditure, as its full agreed contribution to the studio's costs of distribution of

the films, in 2003/04, before the films were likely to generate any significant "gross receipts", which may generate income for Gala.

5. In fact, Sony exercised the call option in the third year after the closing of the transactions and Gala did not receive any income under the distribution agreement apart from the "minimum royalties" paid before the call option was exercised. In summary, therefore, the overall financial effect of the arrangements for the members was as follows, using the illustrative figures set out in the summary of the structure:

(1) The members claimed loss relief on a sum equal to their total contributions of £10 million, of which only £2.24 million was provided from their own resources as cash contributions.

(2) The members obtained a total tax repayment in the first year of the arrangements of £4 million, £1.754 million more than their cash contributions ("**the tax relief**"). As the summary states this meant that their position in the first year after tax relief was received at 40% (the highest rate of income tax at the time) was "17.54% cash positive".

(3) The members were liable to capital gains tax ("**CGT**") on the price paid by Sony on the exercise of the call option of only £798,000 due to taper relief. A member's charge could be reduced or eliminated if the member had capital losses.

(4) Therefore, even though Gala did not receive any sums from the arrangements in excess of the "minimum royalties" and the option price (as calculated to ensure the repayment of all sums due under the bank loans), the members received a net benefit purely from tax relief of approximately £1 million. We refer to this as "**the tax benefit**".

6. By contrast, if the arrangements had continued for the 8 year term of the distribution agreement and Gala had received only the "minimum royalties", Gala would have made a small profit but, in cash terms, the members would have made a significant loss. In that case, the income tax which the members would have had to pay on the "minimum royalties" (in particular, that due on the final "minimum amount") would, in effect, cancel out in full the benefit of the tax relief. A key part of HMRC's case is their argument that, under the terms of the distribution agreement, there was no realistic prospect of Gala receiving income in excess of the "minimum royalties", and it was expected and inevitable from the outset that the call option would be exercised at the first opportunity (as it was) so that the members would suffer only a CGT charge on the option price and thereby obtain the tax benefit. In their view, that was the only realistic way of the members making a return from their investment in Gala. Gala contends that it believed that it and the members had a reasonable prospect of making a profit through receiving a share of "gross receipts", it had reasonable grounds for that belief, obtaining the tax relief was not the driver for the transactions, and there was genuine uncertainty as to whether the call option would be exercised.

Section 2 - Overview of the issues

Issues in Gala's appeal - Legislation and case law

7. The loss constitutes a trading loss of Gala realised in the 2003/04 tax year only if:

(1) (a) During that tax year, Gala was carrying on a trade the profits of which are taxable under Case I of schedule D (see s 18 ICTA), and (b) the Initial Expenditure (and related costs and expenses) can be deducted in computing the profits of that trade for tax purposes on the basis that they constitute "money wholly and exclusively laid out or expended for the purposes of the trade…" (under s 74 ICTA).

(2) The loss was computed in accordance with generally accepted accounting practice in the United Kingdom ("**GAAP**"), as required by ss 42(1) and 46(2) Finance Act 1998 which, at the relevant time, provided as follows:

> "42 Computation of profits of trade, profession or vocation
>
> (1) For the purposes of Case I or II of Schedule D the profits of a trade, profession or vocation must be computed in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in computing profits for those purposes".
>
> "46 Minor and consequential provisions about computations
>
> (2) Except where otherwise expressly provided, the same rules apply in computing losses of a trade, profession or vocation for any purposes of the Tax Acts as apply in computing profits."

8. If the loss meets the requirements set out above, it can be allocated amongst the members of Gala in the manner claimed only if Gala is treated as a transparent limited liability partnership for tax purposes under s 118ZA ICTA. This provides as follows:

> "118ZA Treatment of limited liability partnerships
>
> (1) For the purposes of the Tax Acts, where a limited liability partnership *carried on a trade, profession or other business with a view to profit–*
>
> (a) all the activities of the partnership are treated as carried on in partnership by its members (and not by the partnership as such),
>
> (b) anything done by, to or in relation to the partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to members as partners; and
>
> (c) the property of the partnership is treated as held by the members as partnership property.
>
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or other business with a view to profit."

9. There are some differences in view between the parties as to how these legal tests are to be applied but the dispute is largely a factual one. We have found the facts on the basis of the documents in the bundles and the evidence given by Mr Yusef, Mr Ackerman (whose role is described below) and the Referrers, all of whom attended the hearing and were cross-examined. Our views on the credibility of the witnesses were formed at the time of the hearing and confirmed in discussions which took place shortly after. We note that the witnesses were evidently very conscious of the appellant's/ Referrers' own case and (a), on occasions and to varying degrees, at the hearing had a tendency to put forward that case rather than focussing on the specific question they were asked, and (b) it appears in their desire to present the case in its best light, in their witness statements or at the hearing, made some statements that lack credibility in light of the design of the arrangements and overall evidence. This comment applies in particular to Mr Yusef whose evidence we find to be implausible in a number of material respects as set out in detail in our findings. Whilst we do not accept and/or find much of Mr Yusef's extensive commentary lacking in relevance, we have recorded it in some detail, in case of any appeal from this decision, as Gala relies heavily on it in support of its case.

10. We have set out the guidance from the relevant case law on how the relevant tests are to be applied in Part C but have briefly set out the main principles here. It is useful to have them in mind in reading the sections in this decision that deal with the evidence. The parties both referred to the summary of how the concept of "trade" is to be interpreted in 2 decisions of the Court of Appeal which concerned circumstances with some similarity to those in this case: *Eclipse Film Partners (No.35) LLP v HMRC*

[2015] STC 1429 ("*Eclipse CA")* and *Ingenious Games LLP and ors v HMRC* [2021] STC 1791 ("*Ingenious CA*"). In those cases, individual investors in LLPs claimed to be entitled to substantial tax relief for losses which they claimed were incurred by the LLPs in the course of a trade of film or games distribution and exploitation.

11. As Sir Terence Etherton MR explained in *Eclipse CA*, at [112], the Income Tax Acts have never defined trade or trading further than to provide, in the words of s 832(1) ICTA, that trade includes "every trade, manufacture, adventure or concern in the nature of trade" and:

> "As an ordinary word in the English language "trade" has or has had a variety of meanings or shades of meaning. Its meaning in tax legislation is a matter of law. Whether or not a particular activity is a trade, within the meaning of the tax legislation, depends on the evaluation of the activity by the tribunal of fact. These propositions can be broken down into the following components. It is a matter of law whether some particular factual characteristic is capable of being an indication of trading activity. It is a matter of law whether a particular activity is capable of constituting a trade. *Whether or not the particular activity in question constitutes a trade depends upon an evaluation of all the facts relating to it against the background of the applicable legal principles.* To that extent the conclusion is one of fact, or, more accurately, it is an inference of fact from the primary facts found by the fact-finding tribunal." (Emphasis added.)

12. The parties were agreed that the correct approach to determine whether Gala acted "with a view to profit" for the purposes of s 118ZA ICTA is that set out by the Court of Appeal in *Ingenious CA*:

(1) As set out at [121] and [156] of that decision, the words used import a wholly subjective test which, as regards an LLP, is to be assessed by reference to the subjective views of its "controlling mind".

(2) As set out at [123] of that decision, the term "profit" has "the basic meaning of an excess of income over costs over a possibly indefinite period". That is the sense in which we use the term "profit" when in this decision we refer to Gala's prospects of receiving a profit.

13. Gala did not appear to dispute that, as HMRC submitted, as a general proposition, as an LLP, (a) Gala's "controlling mind" is to be identified according to its constitution, which determines how the entity is to carry on its business (see *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500 where it was held that a company's primary rules of attribution will generally be found in its constitution), and (b) an LLP's constitution, which determines how it is governed and operated, is a matter of contractual agreement between its members (see ss 5, 6 and 15 of the Limited Liability Partnerships Act 2000 and regulations made thereunder and *F&C Alternative Investments Holdings Ltd v Barthelemy and anor* (No 2) [2012] Ch 613 at [208]). As considered in section 3, the parties took different views on who the controlling mind was. Gala said it was Invicta whereas HMRC said it was Chiltern.

14. It was common ground that:

(1) (a) There is no difference in meaning between "laid out or expended", the wording in s 74 ICTA as it applied at the time, and "incurred", the term used in the later version of s 74 to which much of the relevant case law relates, and (b) the question whether Gala "laid out or expended" or "incurred" expenditure depends on the obligations it incurred and discharged under the relevant agreements and whether Gala bore "the economic burden of an expense". This was the approach taken by the tribunal in *Ingenious Games LLP and ors v HMRC* [2017] SFTD 1158 ("*Ingenious FTT"*) (see [864]) as endorsed by the decision of

the Upper Tribunal ("**UT**") in that case (see [2019] UKUT 0226 (TCC) ("*Ingenious UT*") at [434]).

(2) The relevant legal principles applicable in determining whether expenditure is incurred "wholly and exclusively for the purposes of a trade" are succinctly summarised in *Ingenious FTT* at [839] as follows:

> "… it is well known, and there was no dispute that:
>
> (1) by "for the purposes of the trade" is meant for the purposes of enabling a person to carry on the trade and earn profits in it;
>
> (2) a dual purpose, where not saved by section 34(2),was not exclusively a trading purpose; as a result an expense incurred both for the purposes of trade and another purpose is not deductible;
>
> (3) the purpose referred to is that of the taxpayer subjectively determined;
>
> (4) the purpose of the taxpayer must be distinguished from the effect of the expense. Thus a private benefit which is merely a consequence or an incidental effect does not give rise to a dual purpose;
>
> (5) although the purpose is to be subjectively determined this does not limit the investigation to the taxpayer's conscious motives; a pinch of salt is necessary – some consequences are so inevitably and inextricably involved in a payment that unless merely incidental they must be taken to be a purpose for which the payment is made."

15. The parties were also agreed that the accounting issue should be determined with the benefit of expert accounting evidence. Expert reports were provided by Mr Luke Steadman for Gala and Mr Peter Donhue for HMRC and they both attended the hearing and were cross-examined on their evidence.

General approach to statutory and contractual construction

16. There was no dispute that the correct approach to statutory interpretation is set out in the line of cases starting with the seminal decision in *WT Ramsay Ltd v IRC* [1982] AC 300 ("*Ramsay*"), as briefly summarised by Sir Terence Etherton MR in *Eclipse CA*:

(1) He remarked, at [110], that there is no special rule for interpreting tax legislation and the decision in *Ramsay* "marked the end of an unduly literal interpretative approach to tax statutes and a formalistic insistence on examining steps in a composite scheme separately". He noted that, as Lord Nicholls, giving the judgment of the Judicial Committee, said in *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL, [2005] 1 AC 684 ("*BMBF*") at [32]:

> "the essence of the new approach was to give the statutory provision a purposive interpretation in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. This brought the interpretation of tax statutes into line with general principles of statutory interpretation and required notice to be taken of the reality of the transaction in issue…."

(2) He added that the effect of the *Ramsay* case and the modern approach was elegantly summarised by Ribeiro PJ in the following statement (approved by the Appellate Committee in *BMBF*) in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 ("*Arrowtown*"), at [35]:

> "the driving principle in the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."

17. HMRC submitted that in determining the issues in this case the tribunal should pay regard to the comments of the UT in *Ingenious UT*, as to how a tribunal is to approach contractual construction of contracts and how that approach interacts with the correct approach to statutory construction, as set out in the line of cases following *Ramsay*. The main points of relevance in the UT's decision, which we have in mind in making this decision, are as follows:

(1) At [108], the UT said that (a) where a number of contracts are entered into together, at the very least the existence of the other contracts is part of the factual background known to the parties at or before the date of the contract, as referred to by Lord Neuberger, at [10] of *Wood v Capita Insurance Services Ltd* [2017] UKSC 24 and commonly referred to as the "factual matrix". The existence of the other contracts is therefore a relevant part of the factual matrix when construing any one of them, and (b) where the contracts specifically cross-refer or there are other indications that they are intended to operate only as a package, then that fact will be relevant.

(2) At [109], they cited Lewison on the Interpretation of Contracts, 6th edition, paragraph 3.03 where it is said:

> "Many transactions take place by the entry into a series of contracts…In such cases, where the transaction is in truth one transaction all the contracts may be read together for the purpose of determining their legal effect. This principle is a more specific example of the general principle that background is admissible in interpreting a written contract. It applies to other documents executed as part of the same transaction, whether they happen to be executed before, at the same time as, or after the document requiring to be interpreted."

(3) At [110], the UT continued that, therefore, "where there is in truth one transaction, the tribunal is entitled to read the contracts together for the purpose of determining their legal effect". In their view, that is not the same as saying that "where there is a series of contracts to implement a transaction there is a single composite agreement"; the "composite agreement" approach is not correct as a matter of contractual construction. However, "what must not be done is to adopt blinkers in looking at each agreement".

(4) In determining the legal rights and obligations acquired by the LLPs pursuant to the contractual arrangements, the tribunal was entitled and correct to look at the entirety of each set of transaction documents, which it found (at [91]) were entered into at the same time and as a single package:

> "That set of documents…reflected what was undeniably a single, albeit multi-party, transaction as a commercial matter. Even though it was common ground that none of the documents in question could be regarded as a sham, the absence of any allegation of sham does not prevent the tribunal following the approach outlined above or, for example, examining critically whether the written provisions of the documents had the effect when read together that the LLPs maintained that they did. This is consistent with the principle, illustrated in *Antoniades v Villiers* as discussed above, that the tribunal is not bound by labels that the parties have chosen to apply if those labels do not reflect the true nature of the legal rights and obligations created pursuant to the contractual arrangements."

(5) As regards the *Ramsay* approach, at [111], the UT rejected the view that, at the first stage of contractual construction, the *Ramsay* approach is to be ignored provided its scope is properly understood and the principles are correctly applied. There is no reason why the tribunal should not come to a conclusion as to the overall effect of the arrangements through a process of construing the relevant contracts alongside a consideration of the extent to which the application of the

Ramsay principle affects the position. Nevertheless, in their view, it is equally permissible to take the approach of first construing the relevant contracts conventionally, and then considering whether and to what extent the *Ramsay* principle applies. Whichever process is followed, "the facts must be analysed in the light of the particular statutory provision being applied and taking account of the need (depending on the relevant question) to view the transaction realistically".

Parties' submissions

18. Gala's stance was that (1) during the 2003/04 tax year, it carried on a trade of the acquisition and exploitation of distribution rights in the selected films in return for a share of the "gross receipts" arising from those films, (2) it did so "with a view to profit"; the controlling mind of Gala, Invicta (primarily acting through Mr Yusef), acted with a view to Gala realising a profit, (3) the Initial Expenditure was incurred in the tax year 2003/04, wholly and exclusively for the purposes of that trade, as, under the distribution agreement, it was used to meet Gala's agreed share of the costs of distributing the films and the costs of putting the arrangements in place, such as the fees paid to Invicta, were similarly tax deductible, and (4) the resulting loss was properly accounted for under GAAP.

19. HMRC challenged each of these contentions. As regards [18(3)], they argued that (1) the Initial Expenditure was not "laid out or expended" by Gala in the first place, (2) if the tribunal finds to the contrary, it was not laid out expended "wholly and exclusively for the purposes of the trade" nor were the related costs, such as Invicta's fees, (3) if the tribunal finds that is not correct, (a) Gala has not proven to the required standard (on the balance of probabilities) that all of the Initial Expenditure and Invicta's fees was "laid out or expended" in the tax year 2003/04, and (b) in any event, all of the "expenditure" in dispute is capital in nature.

20. HMRC emphasised that, in establishing whether the arrangements had the effect contended for by Gala, it is necessary to view the facts realistically. They noted that the House of Lords and Supreme Court have endorsed Ribeiro PJ's succinct expression of the principles of statutory construction in *Arrowtown* in *BMBF* at [36] and *Tower MCashback LLP 1 and another v Revenue & Customs Commissioners* [2011] STC 1143 ("*Tower*") at [47]. At the heart of their position is the view that, in substance and reality, Gala's activities constitute fundamentally entirely uncommercial arrangements the purpose of which was solely to obtain the tax relief and the tax benefit on the basis that that would, by itself, result in members making a profit. In their view, everything else is window-dressing: a pretence, designed to give the impression of meaningful activity where no such activity existed. In summary, they made the following main points:

(1) Under the transaction documents, the distribution rights in relation to the selected films were held by Sony, Gala was not entitled to exploit rights to distribute the selected films in any meaningful sense and Gala had no realistic prospect of receiving any income in addition to the "minimum royalties". The rights licensed back and forth between the various studio entities simply went around in a circle, passing through Gala en route.

(2) Those who controlled Gala knew that there was no real prospect of Gala making a profit and that it was inevitable that Sony would exercise the call option at the earliest opportunity. It was an inherent feature of the scheme that it would be wound up in a manner which attracted a CGT charge, on the price paid on the exercise of the call option, rather than an income tax charge (as would apply to the final "minimum amount") thereby ensuring that the individual investors

would (if the scheme worked as intended) be able to make a profit on their cash contributions purely from tax relief.

(3) In effect, the bank borrowings were placed on deposit in a blocked account in year 1 and, as was intended and inevitable from the outset, were returned in year 3 with guaranteed "minimum royalties" paid in the interim. The bank borrowings were never truly at Gala's disposal given that (a) they were paid into a blocked bank account over which Sony exercised a substantial degree of control, (b) an equal amount was simultaneously deposited by Sony with the bank which issued the letter of credit, and (c) that amount was and could only be used, in effect, to meet interest and capital payments on the bank loans. The loaned monies essentially went in a circle from the lending bank and back to it (via Gala, the members, Sony and the bank which issued the letter of credit) and were only included in the structure to inflate Gala's loss, as a necessary ingredient in the attempted raid on the Treasury. The only monies genuinely at Gala's disposal were the cash contributions which was used to pay fees for putting the scheme in place.

21. Gala dispute that the evidence supports HMRC's view and rely, in particular, on the evidence of the witnesses of fact as demonstrating the substantive nature and commerciality of the arrangements and Gala's activities. Gala emphasised that, as Mr Yusef and the Referrers all said in their evidence, (a) the loss and the tax relief provided a form of downside protection in the event that Gala's business was not successful and was not the driver for investors entering into the arrangements, and (b) Invicta/Gala/the members could not know that Sony would exercise the call option so that the tax benefit would be realised.

22. HMRC has accordingly sought to disallow the loss and considers that Gala's turnover for the 2003/04 tax year is taxable under Case VI of schedule D (as contained in s 18 ICTA) on the basis that no deduction should be made from that sum for interest on Gala's bank loan or other related costs. Case VI applies to:

> "any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income".

Issues in Gala's appeal - summary of conclusions

23. In summary, we have concluded that for all the reasons set out in Parts B and C, during the tax year 2003/04, Gala did not carry on any trade and if, contrary to our view, it did carry on a trade, it did not do so "with a view to profit".

24. On that basis, we do not need to decide the issues regarding the deductibility of the Initial Expenditure and other sums set out in [18] and [19] above. However, as we heard full evidence and argument on these issues and, in case they become relevant on any appeal, we have considered them:

(1) For all the reasons set out in Parts B and D, our view is that (a) Gala "laid out or expended" the Initial Expenditure but (b) neither that sum nor the relevant costs and expenses of setting up and operating the arrangements were "laid out or expended" by Gala "wholly and exclusively" for the purposes of any trade relating to film distribution which Gala carried on, (c) if our view in (b) is not correct, contrary to HMRC's stance, Gala has established that the majority of the relevant sums were "laid out or expended" in the tax year 2003/04, but (d) in any event, all of the relevant sums are capital in nature.

(2) For all the reasons set out in Part F, Gala's asserted loss for the 2003/04 tax year was not computed in accordance with GAAP.

Referral

Relief for loss under ss 380 and 381 ICTA

25. Under s 380(1), any person who sustains a loss in any trade carried on by him, either solely or in partnership, in any year of assessment may make a claim for relief from income tax on so much of his income for that year or the last preceding year (a) as is equal to the amount of the loss, or (b) where the income is less than the amount of the loss, the whole of that income. That is subject to the proviso that relief is not given for the loss under both of these provisions and relief claimed under (a) is given priority to that claimed under (b).

26. Under s 381(1) to (3) an individual who carries on a trade and sustains a loss in the trade in the year of assessment in which it is first carried on by him or any of the next 3 years of assessment may make a claim for relief from income tax against income for the 3 years of assessment last preceding that in which the loss is sustained, taking income for an earlier year before income for a later year, essentially on the same basis for the relevant year as applies under s 380. That is subject to the proviso that relief is not available for the same loss or same portion of a loss both under s 380(1) and under any other provision of the Income Tax Acts.

27. A loss is not available for relief:

(1) under s 380(1) unless for the year of assessment in which the loss is claimed to have been sustained, "*the trade was being carried on on a commercial basis and with a view to the realisation of profits in the trade….*" (under s 381(1)). A trade is treated as being carried on "with a view to the realisation of profits" where at any time it is "*carried on so as to afford a reasonable expectation of profit*" (under s 384(9)), or

(2) under s 381 unless the trade was carried on throughout the period in which the loss was sustained "*on a commercial basis* and in such a way that *profits in the trade...could reasonably be expected to be realised in that period or within a reasonable time thereafter*."

28. The questions put in the referral are, essentially, whether, on the assumption that Gala carried on a trade during the tax year 2003/04, the conditions highlighted in [27] are satisfied. For all the reasons set out in Parts B, C and E, we have decided that these conditions are not met.

Relief for interest

29. A member would be entitled to claim relief for interest paid on the bank loans obtained to finance this structure by deduction or set off from or against his income for the year of assessment in which the interest is paid (under s 353 ICTA) if the conditions of s 362 ICTA are satisfied. This provides that (1) relief is available for interest on a loan to an individual to defray money where, amongst other circumstances, it is applied "in contributing money to a partnership by way of capital or premium, or in advancing money to a partnership, where the money contributed or advanced is used wholly for the purposes of the trade, profession or vocation carried on by the partnership" (sub-s(1)(b)), and (2) if, as set out in s 362(2), "throughout the period from the application of the proceeds of the loan until the interest was paid, the individual has been a member of the partnership" subject to certain exceptions which are not in point.

30. HMRC argued that relief is not available, on the basis that (1) the monies borrowed by the individual members and contributed to Gala were not "used wholly for the purposes of the trade" within the meaning of s 362(1)(b) ICTA or (2) relief is prohibited by s 787(1) ICTA which provides that relief for payments of interest is not available to a person:

> "if a scheme has been effected or arrangements have been made (whether before or after the time when the payment is made) such that the sole or main benefit that

might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief."

31. For all the reasons set out in Parts B, C and E, we have concluded that the requirement in s 362(1)(b) is not met and there is no need to consider HMRC's alternative argument.

Section 3 - Arrangements for the operation of Gala

Terms of the agreements

32. On 24 June 2003, the designated members, Gala and Chiltern entered into a members agreement ("**the MA**"). This contains the following main provisions:

(1) It was stated that the sole object of Gala:

> "shall be to carry on the Business and any business activity relating thereto or arising therefrom including without limitation:
>
> (a) entering into the Transaction Documents and any agreements pursuant thereto;
>
> (b) engaging in the acquisition of distribution rights and sequel and remake rights in theatrical films and arranging for the distribution of those theatrical films and entering into and performing and exercising the LLP's obligations and rights under the Transaction Documents relating thereto and other agreements entered into pursuant thereto or in connection therewith;
>
> (c) lending money, giving credit or providing any other form of credit on such terms as the Ordinary Members determine;
>
> (d) carrying out the duties of the LLP in relation to the rights and obligations of a rights holder and film distributor; and/or
>
> (e) acting as distributor of theatrical films."

The Ordinary Members are defined as the members other than the designated members and we refer to them as "**the members**". Gala's "Business" is defined as:

> "the acquisition of a portfolio or portfolios of distribution rights and remake and sequel rights in theatrical films, such portfolio or portfolios to be acquired in the course of trading with a view to gain, and the exploitation of the distribution rights by means of the Distribution Agreements in consideration of a share of the distribution receipts arising therefrom all as more particularly described in the IM."

(2) Each of the members agreed to use "all its reasonable and prudent endeavours to perform the Business at all times in such a way so as to maximise the profitability of the Business".

(3) It was stated that (a) the agreement was conditional upon Gala receiving duly completed applications for admissions by prospective members whose prospective "Contributions" (defined as "any money or assets paid into the accounts of or transferred into the ownership of [Gala] by [a member]..") committed unconditionally to Gala were in aggregate not less than £50 million, (b) if that condition was not met by 28 February 2004, any monies received from the members would be reimbursed with any interest earned thereon, (c) no new members would be admitted to Gala after 5 April 2004, and (d) admission of a member would be effective on Gala receiving his Contribution in cleared funds and the counter-signature and dating of his admission form by or on behalf of Gala.

(4) It was stated that (a) a member would acquire a "Member's Share", defined as a share of and interest in Gala's capital (its excess of assets over liabilities as shown in its accounts) equal to the amount of his "Contribution", plus or minus a

share of the profit or loss of Gala to be attributed to him, and (b) members would share any profits and bear any losses relating to "the Slate" (defined as "a set of distribution rights and sequel and remake rights in theatrical films acquired by" Gala), as shown in the profit and loss account for "the Slate" drawn up each year, pro rata to their "Individual Slate Contributions". Such contributions were, broadly, computed by attributing the distribution expenses Gala agreed to pay in respect of "the Slate" between the members in the proportions that their cash contributions bore to the aggregate of their contributions.

(5) The members agreed that (a) the working capital, capital expenditure and other funding requirements would be met out of (i) the proceeds of the subscription for "Members' Shares", and (ii) the loan from "the LLP Lender" (the bank which provided a loan to Gala (on terms negotiated by Invicta in accordance with the MSA) "for the purpose of augmenting the LLP's working capital" and, (b) subject to the provisions relating to winding-up, no member would be required to make any further funding available to Gala.

(6) It was provided that (a) members could appoint any person to provide administrative or other services to Gala and entrust to and confer upon any such person so appointed any of the powers, duties and/or functions exercisable by them as members, upon such terms and conditions, including the right to remuneration payable by Gala, and with such restrictions, as they thought fit, (b) an operators agreement ("**the OA**") and a media services agreement ("**the MSA**") would be duly executed on that day, (c) subject to certain exceptions which are not in point, any matters which were not entrusted to any person pursuant to these provisions would be determined by the members by their votes by simple majority at a duly convened meeting (on the basis that each member would have one vote for each £1 of capital contributed to Gala), and (d) no member could "exercise any of the powers exercisable by them which have been entrusted to and conferred upon the Operator pursuant to the [OA] or [Invicta] pursuant to the [MSA]".

(7) It was provided that members would not be permitted to (a) sell or otherwise deal with their interests in Gala in any way, other than by way of security assignment to "the Lender", (being "an entity that provides a loan to a member for the purpose of financing their Contribution") and save as otherwise stated in the MA, or (b) withdraw their capital without the consent of the members given by way of a simple majority vote. Members could be expelled in certain limited circumstances and, depending on the trigger event, may receive their "Member's Share".

(8) It was provided that, if Gala was wound-up each member (a) would be liable to contribute to its assets an amount equal to his aggregate contributions (which was not to be treated, for this purpose, as reduced by any withdrawal of capital or drawings), and (b) any surplus of assets of Gala over its liabilities remaining at the conclusion of the winding up, after payment of all creditors and all expenses of the winding up, would be paid by the liquidator to the members in such proportions as their respective "Member's Shares" bore to each other on the day of the commencement of the winding up.

33. On the same day, Gala entered into the OA under which it appointed Chiltern to be exclusively responsible for the provision to Gala of services including administrative services and:

(1) to establish, operate and, if required by Gala, to wind-up Gala (as those terms are defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001),

(2) to report to Gala on all matters pertaining to its interests in the Slates acquired in order to enable Gala to meet its obligations under the MA,

(3) to approve and control all withdrawals from any bank account of Gala,

(4) to ensure that the members were provided every 6 months with adequate information about Gala's proceeds from film distribution receipts, as broken down by member,

(5) to provide such other services as may be necessary in pursuing the purpose of the Business, and

(6) to provide such other services as may be agreed from time to time between the parties.

34. Also on the same day, Gala entered into the MSA whereby Gala appointed Invicta to be exclusively responsible for the provision to Gala of the following services:

> "1. To investigate, evaluate, identify, recommend and advise in respect of Slates which may be suitable for acquisition, exploitation and realisation by Gala.
>
> 2. To negotiate the terms and conditions of any agreement or arrangement on which each Slate shall be so acquired (provided that such acquisition terms and conditions shall not be binding on [Gala] without prior Members' consent as set out in the [MA]), and on which each theatrical film shall be distributed by [Gala] with a view to the receipt of distribution income by [Gala].
>
> 3. To negotiate the terms and conditions for loan financing to [Gala], whether on a secured or unsecured basis (provided that such terms and conditions shall not be binding on [Gala]).
>
> 4. To represent [Gala] in all negotiations and dealings with studios, producers, distributors, banks, institutions and persons having prior interest in or security over each Slate (and rights therein) to be acquired, exploited and realised by [Gala].
>
> 5. To provide [Gala] with the benefit of contacts, know-how and specific expertise in film distribution.
>
> 6. To advise on employment of such agents, investment advisers, employees, managers, accountants, lawyers, consultants and other persons necessary or appropriate to carry out the Business and to advise [Gala] on the terms of all relevant contracts and documents (whether or not any such persons so employed are affiliated or related to any Member).
>
> 7. To advise [Gala] in relation to the exercise of any and all rights, privileges and powers available to [Gala] or any trustee or nominee of [Gala], in connection with any Slate acquired by [Gala] and rights therein.
>
> 8. To provide such other services as may be agreed from time to time between the parties."

35. Under the MSA also:

(1) Invicta reserved the right "to delegate such of the Services as it considers appropriate to a third party, provided always that [Invicta], shall retain responsibility and liability for the performance of all the Services."

(2) It was provided that, without further consent of Gala, Invicta was entitled "to carry out any business of the same nature as and competing with the Business without accounting for and paying over profits made by [Invicta] in such business".

(3) Invicta was to receive a fee for its services calculated under a formula (see Part D).

36. Both the OA and MSA provided that nothing in the relevant agreement "shall be deemed to constitute a partnership between the parties hereto nor constitute any party the agent of another party for any purpose".

37. On the same day, Gala entered into a placing agent agreement whereby it appointed Chiltern to be exclusively responsible for the provision of services relating to the promotion of Gala to investors.

Nature and relevance of contractual relationships under the MA, OA and MSA

38. The parties took different views on the precise nature of the contractual relationships between (1) Gala and Invicta, and (2) Gala and Chiltern. The precise scope of Invicta's and Chiltern's roles is relevant to the parties' arguments on whether Gala carried on a trade and whether it did so "with a view to profit".

Evidence of Mr Yusef

39. In that context it was put to Mr Yusef, in effect, that Chiltern in fact operated Gala under the plain terms of the OA. He disputed that this is correct as a matter of contractual construction and said that is not what happened in practice. He made the following main points:

(1) It is not unusual for such agreements "to be drawn as widely as possible…to avoid the possibility that the document has to be revisited in the future". The OA was drafted before the transaction was entered into and:

> "certainly our understanding was that the operator simply was there to service the obligations and the needs of…the LLP, in terms of compliance. It was a compliance mechanism and compliance requirement."

(2) Whilst there is a general catch-all clause in the OA, Chiltern's role was in fact "very limited and to the point" and was akin to that of a company secretary. There is:

> "no way in which - at no time did they get involved in the actual business, which is to identify assets, negotiate, acquire the assets, and do all of the other things that are within the confines of the services that were rendered by [Invicta]. Chiltern is a non-entity, from the point of view of the business."

(3) So the catch-all provision does not "properly describe or accurately reflect the function of Chiltern in those circumstances"; rather the proper analysis is to look at what Invicta did in the MSA given this is "after all a media business. Chiltern were not equipped to perform that role and they were not asked to perform that role". Nor does the provision which required Chiltern to report to Gala (see [33(2)] reflect what Chiltern were asked to do. It came from a sort of standard form arrangement. At no time did Chiltern, and they were not in a position to, report to Gala on matters referred to in that clause and they were not asked to do so: "They were not qualified or competent to report to the LLP, and those functions are expressly reported and undertaken by Invicta in the [MSA]." In his view, therefore, the OA should not be looked at in isolation but together with the MSA:

> "The real bread and butter operation, media operation as opposed to corporate operation of the business was undertaken by Invicta at all relevant times, before and after the execution of the documents…At no time was Chiltern involved in any of these activities…They were not competent to do that. The members were not looking for them…we have to look at the actual operation as it actually happened. Operationally, Chilterns were nothing more than a…Company Secretary."

(4) There is a contradiction inherent in the documents. It is provided that the operator has *exclusive* operational capacity but the MA contemplates that a third party could be engaged to do other things in relation to Gala's business. So the

situation is "at very best unclear…and ambiguous". As it happens Gala engaged a third party, Invicta, which actually reported to Gala and did all of the things that needed to be done on behalf of Gala, as far as the business was concerned and:

> "I draw a distinction between operating the LLP and conducting the business….Chilterns were at all times responsible for operating the LLP, in much the same way that a company secretarial company is engaged to provide company secretarial services. That's the distinction that was made at the time and that's the distinction which is the reality….The agreement makes this quite clear that it contemplates the possibility that the LLP would engage others. It's quite clear that Chilterns didn't have the competence to do the services that are at the heart of this transaction. Organising the Company Secretarial aspects of the enterprise, though important, it was important for everybody, including the members that the LLP was run in a compliant way, and that was Chiltern's function, the guts of the transaction in terms of the trade was at all times undertaken by Invicta….We were always clear in our minds that we needed Chiltern for the operational aspects and not for the business trading aspects of the business."

(5) Chiltern had no competence in the film business and neither Invicta nor the members looked to them, for an understanding of the film industry:

> "They had no connection with Sony, wouldn't know how to get involved with Sony, and...the true relationship and the business mind of the partnership...is embodied in the [MSA]...When one takes the full menu of services, you see that that's where the proper brains, business brains...or business mind of the partnership resides…"

40. In re-examination, Mr Yusef emphasised again that Chiltern's role was to operate Gala for compliance purposes. That role was subsequently taken over by Invicta, once it had become registered under the Financial Services Act. But the role of operator of the business, which was not a regulated function, was always carried out by Invicta, at all times, as the agent of the partnership:

> "The partnership relied on us to be the face of the partnership in its dealings with the studios and also eventually the licensee or the licensor and our sub-licensee. That was our role at all times."

41. Under normal legal principles of contractual construction, as summarised by the UT in *Ingenious UT*, Mr Yusef's views on how the contracts are intended to operate (and the assertions he later made as to what Sony wanted to achieve), as expressed many years after the contracts were put in place, are not relevant to their construction. Accordingly, we have not taken account of his views in assessing the meaning and effect of the relevant documents in legal terms. We take Mr Yusef's points set out above, and the comments he made on other documents, as set out in Parts B and D, where appropriate, as evidence of how the arrangements were intended to work and did work, in practice, and of his experience of how film transactions are structured and otherwise as his submissions on Gala's case.

Submissions and conclusion

42. As regards the "trade" issue:

(1) Gala's secondary argument as regards its stance that Gala carried on a trade is that, for the purposes of the required multi-factorial assessment, all the acts of Invicta carried out under the MSA must be attributed to Gala (as, so it says, must the acts of both those appointed by Invicta to assist it and of the Sony sub-licensee). Gala submitted that Invicta was appointed as Gala's agent under the terms of the MSA as regards the activities specified in the MSA but considered that this attribution should be made regardless of whether Gala was strictly an agent.

(2) HMRC disputed that Invicta was appointed to act as Gala's agent under the MSA and submitted that no such attribution should be made whatever its precise role was. This issue is dealt with in Part C.

43. As regards the "with a view to profit" test, the issue is whether Chiltern or Mr Yusef/Invicta were the "controlling minds" of Gala:

(1) HMRC said that (a) who are the "controlling minds" of an LLP is generally to be determined according to the contracts governing its operation, and (b) in *Ingenious FTT*, at [493], the tribunal decided the controlling mind was the operator of the relevant LLPs as follows:

> "To the extent a subjective determination of the view of the LLP has to be made the parties were agreed that it would be that of the controlling minds of the LLPs: the LLPs delegated their running to the Operator, so if one asks about the conduct of the business it is the Operator's conduct of it which is relevant, and that in turn is that of its directing minds."

(2) In their view, the controlling mind was Chiltern/those controlling it, given that, pursuant to the MA, it was appointed as operator and was "exclusively responsible" for the provision to Gala of the very broadly framed services listed in the OA. HMRC noted that this accords with the view expressed by solicitors in Instructions to Counsel dated 23 January 2004 produced on behalf of Gala (for a conference which Mr Yusef attended) that: "Day-to-day operation of the LLP would seem to vest in [Chiltern] under the [OA]". HMRC also noted that the provisions in the MSA highlighted above demonstrate that (a) Invicta did not act as Gala's agent but rather was appointed to provide services to Gala, and (b) overall, its role was confined to giving advice only without any ability to bind Gala, and (c) by contrast, under the OA, Chiltern could bind Gala, to the extent necessary, in relation to its services.

44. In HMRC's view, the tribunal should draw an inference adverse to Gala from its failure, as the party with the burden of proof, to call any witness from Chiltern to give evidence and this failure should preclude Gala from inviting the tribunal to make any inferences in its favour. As explained in section 2 of Part B, HMRC took the same stance in relation to Gala's failure to call any witness from Sony. HMRC relied on the comments of:

(1) Brooke LJ in *Wisniewski v Central Manchester Health Authority* [1998] PIQR P324, that:

> "From this line of authority I derive the following principles in the context of the present case:
>
> (1) In certain circumstances a court may be entitled to draw adverse inferences from the absence or silence of a witness who might be expected to have material evidence to give on an issue in an action.
>
> (2) If a court is willing to draw such inferences they may go to strengthen the evidence adduced on that issue by the other party or to weaken the evidence, if any, adduced by the party who might reasonably have been expected to call the witness.
>
> (3) There must, however, have been some evidence, however weak, adduced by the former on the matter in question before the court is entitled to draw the desired inference: in other words, there must be a case to answer on that issue.
>
> (4) If the reason for the witness's absence or silence satisfies the court then no such adverse inference may be drawn. If, on the other hand, there is some credible explanation given, even if it is not wholly satisfactory, the potentially detrimental effect of his/her absence or silence may be reduced or nullified."

(2) Lord Hodge in *Royal Mail Group Ltd v Efobi* [2021] 1 WLR 3863 ("*Efobi*") at [41], that:

> "The question whether an adverse inference may be drawn from the absence of a witness is sometimes treated as a matter governed by legal criteria, for which the decision of the Court of Appeal in *Wisniewski v Central Manchester Health Authority* [1998] PIQR P324 is often cited as authority. Without intending to disparage the sensible statements made in that case, I think there is a risk of making overly legal and technical what really is or ought to be just a matter of ordinary rationality. So far as possible, tribunals should be free to draw, or to decline to draw, inferences from the facts of the case before them using their common sense without the need to consult law books when doing so. Whether any positive significance should be attached to the fact that a person has not given evidence depends entirely on the context and particular circumstances. Relevant considerations will naturally include such matters as whether the witness was available to give evidence, what relevant evidence it is reasonable to expect that the witness would have been able to give, what other relevant evidence there was bearing on the point(s) on which the witness could potentially have given relevant evidence, and the significance of those points in the context of the case as a whole. All these matters are inter-related and how these and any other relevant considerations should be assessed cannot be encapsulated in a set of legal rules."

45. Gala said that the controlling minds were Invicta/those controlling it, in particular, Mr Yusef on the basis that: (1) it is plain from the MA that the Placing Agent Agreement, OA and MSA are to be read together to understand the allocation of responsibilities between Chiltern and Invicta, (2) it is obvious from the MSA that Invicta was charged with doing the activities specified in it for and on behalf of Gala. Whether or not Invicta was strictly a general agent under the MSA does not affect the analysis as, plainly, it did the things provided for under the MSA to allow Gala to enter into and perform the transactions and not for its own benefit, (3) the documents demonstrate that Chiltern was concerned only with compliance and Mr Yusef's evidence on the limitations of its role and scope of Invicta's role is clear, and (4) HMRC's accounting expert said that he did not recall attaching any great relevance to what Chiltern did or not do (see Part F).

46. Gala emphasised that the question is a factual and practical one as to who is responsible for the transactions that are said to amount to trading and what those persons were trying to achieve. In Gala's view, on the evidence, it is incontrovertible that Mr Yusef was the controlling mind. Mr Bamford, who at the relevant time was the managing director of Invicta, may also have been a controlling mind and, whilst there is no evidence from him, there is no suggestion he would have given different evidence. What he said and did, as shown in the contemporaneous documentary evidence, is entirely consistent with Mr Yusef's evidence.

47. As regards the case law, Gala said that (1) the position in *Ingenious* should be treated with caution as the facts in that case are different, (2) it is clear from *Efobi* that the tribunal should not apply a legalistic approach to the evidential issue but should look at the full context. It is not a simple mechanical exercise and is more a matter of common sense, (3) it is not surprising that Chiltern are not available to give evidence so long after the relevant events, and (4) Mr Yusef has explained that Chiltern did not do anything of relevance as accords with the documentary evidence. There is no evidence of Chiltern doing anything relevant to the issues in this case or showing Chiltern did not care about profit. There is no suggestion that Chiltern had a different view or that there is any evidence that would be adverse to Gala in relation to Chiltern which Gala is somehow seeking to exclude.

48. HMRC noted that (1) in *Ingenious FTT*, at [908], the tribunal recorded that the operator in that case "agreed to find and negotiate film deals and to administer the LLP", (2) there was no suggestion that, insofar as the operator carried out its function of administering the LLP, it was not the controlling mind, (3) nor did the tribunal say that the operator was the controlling mind only in so far as it had a role in relation to negotiation or suggest that the operator was subject to the same sort of limitation as regards negotiation as Invicta was under the MSA.

49. As HMRC set out, as a matter of general law, agency is a relationship in which a principal confers authority on another to act on its behalf in some respect, such that acts undertaken by the agent within the scope of the authority are binding on the principal. It is essentially a fiduciary relationship which must involve (1) a fiduciary duty of loyalty on the agent not to compete with the principal and to act solely in the interests of the principal, (2) the principal having an element of control over the agent, including an ability to terminate the agency. As set out in *Eclipse CA*, in determining whether a relationship is one of agency it is essential to examine the nature of the relationship between the parties and not to have regard only to the labels used by the parties.

50. In our view, as a matter of contractual analysis, the provisions of the MSA are not consistent with a fiduciary agency relationship given that (1) Invicta was engaged to provide a range of services to Gala and did not have power to bind Gala in its dealings with third parties, (2) Invicta was permitted to compete with Gala, and (3) it was expressly provided that the MSA did not create an agency and that it comprised the entire agreement between the parties. Moreover, we note that, given that the MA provides that, anything that was not delegated or entrusted to another person, remains the responsibility of the members, it seems that Invicta did not have any power to approve and deal with the marketing plans prepared by Sony, or to authorise payments from the expenditure account. That seems to have been a function of the operator and/or the designated members under the MA.

51. However, our view is that, notwithstanding that it was not formally appointed to act as an agent for Gala, Mr Yusef/Invicta is the party by reference to whose subjective views the "with a view to profit" test is to be assessed. It seems to us that it is inherent in the nature of this test that it must be applied by reference to the views of those who actually, in practice, operate the activities of the relevant LLP which are asserted to amount to a trade. On the basis of Mr Yusef's comments set out above (which we accept so far as it is evidence as regards what happened in practice) and the facts and circumstances set out in Part B, we consider it reasonable to infer that (1) in practice, Invicta acted for Gala as regards setting up and managing the Gala arrangements in all material respects, including, in its dealings with Sony, and (2) as is apparent in particular from the evidence of the Referrers, the members relied on it to do so. In any event, for all the reasons set out in Parts B and C, our view is that Gala did not carry out its activities "with a view to profit" whether Chiltern or Invicta is taken to be its controlling mind.

Section 4 - Overview of the transactions

Terms of the transactions

52. From around March 2003, Invicta set about finding a major film studio which was willing to participate in the arrangements and, from around June 2003, sought to attract investors to participate in the arrangements as members. Gala entered into 2 sets of transactions with Sony on materially the same terms (1) on 2 December 2003, in respect of 4 films ("**the first transaction**"), by which time 35 investors had become members of Gala, and (2) on 3 February 2004, in respect of 2 films ("**the second transaction**"), by which time a further 30 investors had become members of Gala.

53. Mr Yusef said that there were 2 transactions because of (1) cash flow; the investors' contributions to Gala flowed in gradually, and (2) the way the release dates fell for the relevant films: between (a) 12 December 2003 and 13 February 2004, and (b) 12 March 2004 and 14 May 2004, as regards the films which are the subject of the first and second transactions respectively.

First closing

54. The minutes of the meetings record that on 28 November 2003, (a) at 12pm, a meeting of Chiltern and Gala's designated members took place at which the admission of 35 members was approved, and (b) at 12.15pm, a meeting of Gala's members took place at which the documentation for the first transaction was approved. On 29 November 2003, a meeting of one of Gala's designated members took place to authorise any of its directors to execute documents on its behalf.

55. As corresponds with the IM, the first transaction was funded by:

(1) contributions made to Gala by its 35 members on or around 2 December 2003, of which (i) a sum of £62,695,394.25 (comprising 77.54% of the total) was funded by loans from Société Général ("**SG**") and (ii) a sum of £18,160,156.92 (comprising 22.46% of the total), was provided as cash contributions, and

(2) a loan of £10,915,499.38 obtained by Gala from SG equal to 13.5% of the total contributions.

We refer to these

loans together with those obtained in respect of the second transactions as "**the SG loans**" or "**SG borrowings**". The sums borrowed from SG of a total of £73,610,898.64 were paid into Gala's "transaction" bank account on 2 December 2003 and simultaneously an equal amount was paid into the expenditure account.

56. On 2 December 2003, Gala entered into the following documents implementing the "film distribution" side of the transaction:

(1) Gala and Sony Pictures Entertainment Inc ("**SPE**") entered into an option agreement ("**the Option**") which provided that (a) during the period from 2 December 2003 to 27 January 2004 Gala could opt to require SPE to grant licences to it in respect of the right to distribute specified "Pictures", and (ii) Gala had certain rights in relation to "Sequels". The Option also included provisions for Gala:

(a) To review the content of "Marketing Plans" as defined, in respect of each selected "Picture", as:

> "the detailed marketing plan prepared by Gala or, at Gala's request [the Sony sub-licensor]…which includes: (i) a detailed breakdown of the Distribution Expenses including the [Gala Expenses]….to be incurred in connection with that Picture (ii) the final date at which all [Gala Expenses] in respect of the Picture are intended to have been incurred."

"Gala Expenses" are defined as specified types of "print and advertising costs" involved in the marketing and distribution of "Pictures", namely:

> "(1) the duplication costs for theatrical prints, trailer prints, DVDs and videos, (2) the following advertising costs: (i) the cost of buying media time for the purpose of advertising the Pictures; (ii) the cost of print advertising; (iii) the cost of outdoor advertising and (iv) the cost of Internet advertising SAVE THAT where a Picture has been theatrically released in part of the Territory, [Gala Expenses] shall not mean the duplication costs for theatrical and trailer prints in that part of the Territory."

"Distribution Expenses" are defined as a broader description of costs relating to the marketing and distribution of "Pictures". We refer to these plans as "**the**

Initial Plans” and to the Initial Plans together with all other marketing plans prepared by the Sony sub-distributor in respect of the transaction films as “**the Plans**”.

(b) To commission an opinion from Houlihan Lokey Howard and Zukin (“**HL**”) as to the commercial viability of the “Pictures”.

(2) Pursuant to the Option:

(a) Gala and entities related to SPE, Columbia Pictures Industries Inc (“**Columbia**”) and Screen Gems Limited (“**Screen Gems**”), entered into licence agreements with Gala, whereby Gala was granted exclusive licences, each for 21 years, to distribute Something’s Gotta Give, Big Fish, 50 First Dates, and You Got Served (“**the first transaction films**”), and

(b) in return for the grant of the licences, Gala was required to pay SPE licence fees of a total of £10,915,499.38 (a sum corresponding to Gala’s SG borrowings).

We refer to these licence agreements and those entered into under the second transaction as “**the LAs**” and to the rights granted to Gala under those agreements as “**the Rights**”.

(3) Gala entered into a distribution agreement with Sony Pictures Releasing Corporation (“**SPR**”), an affiliate of Columbia, (“**the DA**”) whereby:

(a) Gala granted SPR exclusive licences, for a term of around 8 years, to distribute each of the first transactions films, on essentially the same terms, as regards the main operative provisions, as those set out in the LAs.

(b) Gala agreed to pay the Initial Expenditure in respect of each first transaction film into the expenditure account for the stated purpose of meeting Gala Expenses shown in the Initial Plan for each film. The aggregate Initial Expenditure equals the total SG borrowings of £73,610,898.64. Whilst the DA contemplated that, following closing of the transactions, Gala could pay further sums into the expenditure account to meet additional Gala Expenses, no further sums were paid into it for that purpose.

(c) SPR agreed to pay Gala (i) annual “Minimum Royalty Payments” and, in year 8 of the term, a “Minimum Amount”, which were calculated to be sufficient to meet respectively the interest due on, and the principal of, the SG loans, and to produce a small profit over the term, and (ii) a share of the “Gross Receipts” under the waterfall (as broadly defined to include box office and other receipts arising from the commercial exploitation of the transaction films). We refer to the “Minimum Royalty Payments” and the “Minimum Amount” together as “**the Minimum Sums**” or “**shortfall guarantee**”. It was a condition to Gala’s obligations under the DA taking effect that SPR would procure the issue of a letter of credit to Gala to secure the payment of the Minimum Sums.

The waterfall operates to allocate Gross Receipts between Gala and SPR under eleven provisions which, essentially, apply in order of priority from the first to the eleventh (see section 11).

(d) There were detailed provisions regarding changes to the Plans. Gala asserts that these gave Gala a right of approval over all material aspects of the marketing of the transaction films throughout the relevant territory during the term of the DA (see section 9).

Hence, pursuant to the DA, on closing, Gala paid £73,610,898.64 into the expenditure account plus £572,616.62, as funded by the cash contributions (a total of £74,183,510.26). The additional sum was paid because the amount Sony

had to deposit in support of the letter of credit it was required to procure was issued in Gala's favour (see [61]) was larger than the Initial Expenditure/principal of the SG loans; interest was due on the SG loans at a slightly higher rate than that payable on the deposit.

(3) Gala and SPE entered into a call option agreement ("**the Call Option**") whereby, in return for £1, Gala granted SPE an option to require Gala to sell its "Business" to SPE on specified exercise dates for the higher of (a) the Rights' market value at the exercise date, as calculated under a schedule, and (b) a sum equal to the amount that would have been payable to Gala as the Minimum Amount, if the exercise date for the option were the last day of the term of the DA ("**the option price**"). The pricing was designed to ensure that, if this option was exercised, Gala would receive at least a sum equal to that required to repay the principal of the SG loans. The exercise dates fell 25, 60, 84, 120 and 180 months after the date that Gala acquired the Rights. The first exercise date was initially 31 December 2005 but this was extended to 28 February 2006 ("**the first exercise date**") and later additional exercise dates were added (see [67] and section 15). Further details of the main terms of the Option, LAs and DA are set out in section 9 together with our analysis of the legal effect of the main contractual terms in the documents and the overall effects of the composite transactions embodied in them.

57. The loan agreement made between SG and Gala on 2 December 2003 included statements that (1) the reason for the loan was the acquisition of a portfolio of distribution, sequel and remake rights in relation to various films for a term of 21 years further to purchase agreements between Gala and major film studios, and (2) the loan was to be applied exclusively for that purpose.

58. The loan agreements made between SG and each member on 2 December 2003 included the following provisions:

(1) SG "will take security over the assets of [Gala]…in respect of the Loan. Any security taken by [SG] does not affect your personal liability as borrower under this Agreement. You are and will remain fully liable for all amounts which are or may become payable under this Agreement."

(2) The proceeds "of your capital contribution will be used by [Gala] to pay expenditure in relation to the printing, advertising and other promotional expenditure arising from [Gala's] exploitation of the distribution, sequel and remake rights…in relation to various films…acquired by [Gala] from major film studios…or such other purposes as [SG] may from time to time agree with [Gala]…".

(3) The borrower irrevocably authorised SG to make the loan available for the benefit of Gala and payment was to be made into a designated account held with SG, in the name of Gala, and the loan was to be applied exclusively in accordance with the provisions set out in (2).

(4) The borrower undertook to repay the principal on or before the eighth anniversary of drawdown and the dates for payment of interest and principal were to be agreed by SG with Gala acting on the borrowers' behalf under a power of attorney which SG required the borrower to sign.

(5) The interest rate was to be such that "the aggregate amount of the minimum income receivable annually by [Gala] from any entity to which [Gala] grants distribution rights…in respect of the films on any date is sufficient to make all payments of interest and the repayment of principal" in relevant loans.

59. All of the loan agreements contained provisions that:

(1) "The [Minimum Sums] received by [Gala] and assigned to [SG] in respect of the Films on any date will be used by [SG] to reduce or pay off the amount due from [Gala] on that date".

(2) Gala was to be required to sign various security documents in SG's form, and to comply with various other conditions before SG would provide the relevant loan. Details of the security arrangements are set out in [61].

(3) SG made (a) no warranty or representation as to the commercial viability of the investment for which the loan may be advanced, (b) no assessment of the commercial viability or likely success of any films purchased, or other investments made by Gala, and (c) no recommendation or advice as to suitability of the investment or the likely returns or tax or other financial benefits which may be derived by Gala from it.

60. In side letters, in consideration of SG providing the SG loans, Invicta agreed to pay SG (i) prior to the making of the loans, arrangement fees of £626,953.94, as regards the members' SG loans, and £43,662.00, as regards Gala's SG loan, plus sums to cover SG's legal costs, land registry charges and the costs of bankruptcy searches, (ii) a non-refundable up-front fee of £16,171.11 to cover any loss, liability, cost or expense which SG may incur as a consequence of the early repayment of the SG loans whether as a result of the exercise of the Call Option or otherwise.

61. On 2 December 2003, the following security arrangements were put in place:

(1) As arranged by SPR and, as was required for Gala's obligations under the DA to take effect, Barclays Bank Plc ("**Barclays**") issued a letter of credit under which:

(a) Within specified time limits, Gala could make an "Annual Demand" for payment of a specified "Annual Amount" in respect of each specified "Annual Date", of a sum corresponding to the "Minimum Royalty Payment" due to be paid to Gala on that date under the terms of the DA, if Gala did not otherwise receive such a sum.

(b) At any time on or after the date on which the DA was terminated and prior to 28 August 2011, Gala could make a single demand for a "Termination Drawing" of an amount not exceeding the "Net Balance" as at the date of receipt of the demand by Barclays. The "Net Balance" is the amount that would be standing to the credit of an account with Barclays, broadly, as at the date of the demand, if (i) an amount equal to the Initial Expenditure was deposited in it on closing of the transaction, (ii) interest at the specified rate (namely, the rate corresponding to that due on the SG loans plus a profit element) as calculated up to the demand date was credited to the account, (iii) the account was debited on each "Annual Date" falling on or before the demand date with an amount equal to the "Annual Amount" for that date, (iv) on the demand date, the account was debited with any break costs or credited with any break benefits, and (v) on the demand date, if Gala would have been entitled to make but had not made an "Annual Demand", the account was credited on the relevant "Annual Date" with a sum equal to the amount for which Barclays would have been liable under the LC had such a demand been made.

(c) It was agreed that notwithstanding the termination of the DA Gala would continue to be entitled, subject to the terms of the letter, to make a demand either (a) for the "Annual Amount" in relation to each "Annual Date "which falls on or after the date of termination or, in its absolute discretion, (b) for the

amount available in respect of a "Termination Demand", and Barclays "shall not be concerned to see that the [DA] continues or has been terminated".

We refer to this and the letter of credit issued in respect of the second transaction as "**the LC**".

(2) The initial LC was funded by SPR placing funds of £74,183,510.26 in an account with Barclays pursuant to a deposit agreement and charge. Under this agreement, it was provided that (a) in order to induce Barclays to issue the LC, SPR would deposit a sum equal to the Initial Expenditure in an interest bearing account with Barclays on closing of the first transaction, and (b) Barclays would pay amounts equal to the Minimum Sums/"Annual Amounts" to Gala, provided that the sums placed on deposit with it by SPR were equal to Barclays' actual and contingent liabilities under the LC and SPR irrevocably directed Barclays to pay such sums to Gala's account, and (c) SPR would charge the account in favour of Barclays as security for its obligations in respect of the LC whether under the reimbursement agreement or otherwise. We refer to this sum and that provided in relation to the second transaction as "**the Deposit**". SPR also entered into a reimbursement agreement with Barclays under which it agreed to reimburse Barclays for sums paid by Barclays pursuant to the LC, broadly, on the basis that this obligation would be satisfied from the Deposit.

(3) Gala entered into a debenture with each of SG, SPE, SPR, Screen Gems and Columbia and a deed of priority and subordination to regulate the priority of the debentures:

(a) Under each debenture, assignments and charges were given as security for the obligations owed by Gala to the secured party under the relevant agreement with that party. Hence, (i) the debenture with SG secured the obligations of Gala and its members to SG under the loan agreements made with SG, and (ii) the debentures with Columbia and Screen Gems, SPR and SPE secured Gala's obligations to the relevant party, under the LAs, the DA and the Call Option respectively. The security could not be redeemed, in that the relevant rights could not be reassigned to Gala and the charges released, while the relevant agreements remained in place.

(b) The debentures were each similar in form. Under the debenture in favour of SG, (a) it is recorded that Gala agreed to execute it in consideration of SG agreeing to make available loan facilities to it and to the listed members for the purpose of funding each such member's contribution; all of which was to be applied by Gala for the acquisition of rights in relation to the transaction films and to defray Gala Expenses, (b) Gala covenanted to pay and/or perform the "Secured Obligations" when due, (c) it was provided that all amounts received by SG from SPR at the direction, and for the account, of Gala were to be applied in satisfaction of and deemed to discharge the obligations of Gala under the agreement but subject always to the extent of the amounts received, and (d) Gala gave SG a fixed and floating charge over its assets/rights and assigned absolutely to SG all of Gala's rights under the LAs, the DA, the Call Option, the LC, and all other agreements entered into by Gala in connection with the exploitation of the films.

(c) The deed of priority provided that security granted to SG had priority to the security granted to the various Sony entities.

(4) Further to the debentures, 3 notices of assignment and irrevocable payment instructions were given by Gala and SG to SPR, SPE and Barclays. In each case the relevant party was notified of Gala's absolute assignment to SG of various

rights pursuant to the debenture and irrevocably instructed to pay to Gala's account with SG (a) in SPR's case, sums due under the DA, (b) in SPE's case, sums due under the Call Option, and (c) in Barclays case, sums due under the LC.

(5) Under these arrangements, therefore, in practice, sums due from Gala and the members under the SG loans were to be satisfied by payments made by Barclays under the LC using the funds in the Deposit, and those payments were to be paid direct to SG.

We refer to the arrangements set out in this para, [61], together with those put in place in respect of the second transaction as "**the security arrangements**".

Second closing

62. As regards the second transaction:

(1) The minutes of the meetings record that, on 2 February 2004, (a) at 12pm, a meeting of Chiltern and Gala's designated members took place at which the admission of 30 additional members was approved, and (b) at 12.15pm, a meeting of Gala's members took place at which the documents entered into on closing of the first transaction were ratified and draft documentation for the second transaction was approved.

(2) On 3 February 2004, Gala's additional 30 members made cash contributions of £7,008,097.53 and contributions of £24,194,473.82 funded by SG loans and Gala borrowed a further £4,212,347.13 from SG. The loan agreements made with SG contained the same provisions as set out above in relation to the first transaction.

63. On 3 February 2004, Gala entered into the following documents:

(1) Gala and SPE entered into an agreement to amend the Option (among other things) by extending the option period to 3 February 2004 so that Gala could opt to acquire a licence of Rights in respect of Breakin' All The Rules (previously known as Break-Up Handbook) and Secret Window ("**the second transaction films**").

(2) Pursuant to the amended Option, Gala entered into 2 further LAs with Columbia and Screen Gems, whereby (a) Gala was granted exclusive licences, each for 21 years, to distribute the second transaction films, and (b) in return for the grant of the licences, Gala was required to pay SPE licence fees of a total of £4,212,347.13. Hence, SPE received total licence fees in respect of the first and second transactions of £15,127,846.51.

(3) Gala and SPR entered into agreements under which they agreed amendments to the DA and Call Option, which were necessary to ensure the inclusion of the second transaction films in the arrangements and to increase the Minimum Sums to cover the repayment of the principal of, and interest on, the additional SG loans taken out on the second closing.

(4) The funds obtained under the SG loans of £28,406,820.95 in total were paid into Gala's "transaction" account and an equal sum plus an additional amount of £217,461.03 (a total of £28,624,281.98) was simultaneously paid into the expenditure account. £217,461.03 was deposited in the account from the cash contributions to cover the small increased difference in the interest due on the SG loans and on the Deposit. We refer to this amount plus the £572,616.62, referred to in [56(3)(b)] as "**the Interest Margin**".

(5) Three side letters were entered into with SG by Invicta (two letters) and GDL (one letter), pursuant to which Invicta and GDL agreed to pay various fees and breakage costs to SG in relation to the further SG loans.

(6) A further LC was issued by Barclays in favour of Gala at the request of SPR, in effect to guarantee payment of the increased Minimum Sums. SPR entered into (a) a further reimbursement agreement with Barclays under which it agreed to reimburse Barclays for sums paid by Barclays pursuant to the LC and (b) a further deposit with Barclays under which it placed the sum of £28,624,281.98 into a deposit account at Barclays.

(7) Gala and SG entered into a supplemental deed of debenture which provided or confirmed that the obligations owed to SG by Gala and its members under the new SG loan, and the new LC, were within the scope of the obligations secured by the earlier debenture. Pursuant to this deed, 3 notices of assignment and irrevocable payment instructions were given by Gala and SG to SPR, SPE and Barclays (respectively) on the same basis as those entered into under the first transaction.

Overall effect of the transactions

64. The overall financial and economic effect of the transactions is as follows:

(1) Of the funds it received by way of contributions and SG loans, Gala deposited into the expenditure account, £102,017,714.59 of Initial Expenditure, plus the Interest Margin of an additional £790,077.65, a total of £102,807,792.24.

(2) Sony placed £102,807,792.24 on deposit at Barclays, pursuant to the Deposit. That deposited sum was used (and could only be used) to repay the interest and principal on the SG loans under the security arrangements.

(3) The sum of £25,168,254.45.26, which equals the amount of the cash contributions, corresponds to:

(a) £15,127,846.52 which was paid to Sony as the licence fees under the LAs.

(b) £8,364,237.29 which was paid to Invicta as fees, comprising £6,019,395.06 paid on 2 December 2000 and £2,344,842.23 paid on 3 February 2004 ("**the Invicta Fees**"). Invicta paid various fees from this sum including bank charges to SG in addition to those referred to in (c) (as set out in Part D).

(c) £886,092.82 which was paid to SG as fees, comprising £652,645.68 paid on 2 December 2003 and £233,447.14 paid on 3 February 2004 ("**the SG Fees**").

(d) The Interest Margin of £790,077.65 which was paid into the expenditure account for the purpose of putting Sony in sufficient funds to place on deposit to service the borrowing costs and repayment of the principal of the SG loans.

Overview of the role of Mr Ackerman and HL

65. At the hearing there was much discussion in relation to the role of Mr Justin Ackerman and HL and of certain letters they provided to Gala. In short:

(1) Invicta involved Mr Ackerman and his company, Little Big Picture Company ("**LBPC**"), in activities which it asserts were relevant to Gala's trade. Mr Yusef said in his witness statement that he considered it "essential for Gala to have a US operation to assist both with the setting up of the arrangement and in the day-to-day running" of the film distribution business. To that end, he introduced Mr Ackerman to the venture who he had known for around 30 years, having been introduced to him through mutual friends and connections in the industry. He said that he "knew him to be honest, diligent and well connected in Hollywood", over the years, he had "built up a considerable expertise in film production, distribution, film-financing and film industry technologies" and given he was well connected, he may be able to open certain doors that Mr Yusef could not.

(2) LBPC was formally appointed to provide services under an administration agreement dated 1 December 2003 ("**the LBPC agreement**") initially for a period of 1 year which was extended for a further year (as confirmed by an exchange of letters between LBPC on 28 March 2005 and 7 April 2005). However, Mr Yusef involved Mr Ackerman in discussions on the proposal from around May 2003 onwards. Mr Ackerman/LBPC leased premises in Los Angeles from which to conduct work for Invicta from 1 March 2004 to 28 February 2006.

(3) Initially Mr Ackerman envisaged that he would have a substantial team in Los Angeles to work on Gala matters. On 26 June 2003 in a letter to Mr Bamford he set out that (a) the office would "maintain daily interface with the major Hollywood studios whose "A" list product we will be distributing", (b) this activity would be overseen and managed by 3 "highly qualified motion picture industry executives" and 2 or 3 executive assistants who he would oversee, and (c) he had only just begun the search for skilled staff, but was already talking to a potential recruit. In fact, only 2 office assistants were employed who were responsible for paralegal and administrative tasks including filing, reviewing documents, note taking at meetings, communications, record keeping and reporting to Invicta. Invicta was invoiced by LBPC for services and expenses on a monthly basis. Mr Ackerman said that Invicta put the brakes on his proposal for a larger team as they did not want such high overheads in LA.

(4) Mr Ackerman/LBPC sent Invicta a number of letters relating to the transaction films and the Plans:

(a) A letter of 6 June 2003 in which Mr Ackerman commented on which of Sony's slate of films Gala should consider acquiring rights in ("**the June letter**").

(b) Letters of 1, 3, 4, 7, 6 and 10 November 2003, in which Mr Ackerman stated that the transaction films had excellent chances of commercial success ("**the November letters**").

(c) Letters dated 1, 5, 8, 12, 14, 15 December 2003, in which Mr Ackerman recommended the approval of the Plans for the transaction films ("**the December letters**").

(d) A letter dated 20 January 2004 in relation to the distribution expenditure in respect of the film Secret Window ("t**he Secret Window letter**").

(5) Invicta instructed HL, a specialist media financing firm, to provide an opinion on the expectation of profit from the transactions. HL sent Invicta 2 letters dated 21 November 2003 and 30 January 2004, in which HL stated that the films listed in the letter had "a reasonable expectation of profit" ("t**he 2003 HL letter**" and "**the 2004 HL letter"** respectively and together "**the HL letters**").

66. On 28 January 2005, pursuant to a resolution of Gala, Invicta was appointed as the operator of Gala in place of Chiltern under a new agreement on the basis that Invicta was "now authorised and regulated by the Financial Services Authority".

Exercise of the Call Option

67. At SPE's request, on 9 March 2006, the Call Option was amended to allow SPE to exercise it on the 28th day of any month in the period of 28 February 2006 to 28 February 2007, in addition to on the pre-existing dates. In return for agreeing to this, Gala was paid the sum of £75,000 Mr Yusef said, as "an arbitrary amount to compensate the LLP for the inconvenience caused".

68. On 20 April 2006, SPE gave notice that it wished to exercise the Call Option and, on 28 April 2006, on exercise of the option, the Gala "business" was sold to SPE for £103,910,434.41. This sum was equal to the Minimum Amount which would have been

due under the DA on the assumption that the exercise date was the last day of the term of the DA (as that sum was higher than the market value of Gala's Rights). As regards the movement of funds:

(1) On 27 April 2006, SG gave two notices to Barclays under the LC which required Barclays to pay the "Net Balance" of £103,910,434.41 to SPR's account with SG. This constituted the total Deposit, plus interest accrued on the Deposit, less sums equal to the Minimum Sums which, under the DA, fell due prior to the Call Option exercise date.

(2) On 28 April 2006, SPR instructed SG to pay the sum of £103,910,434.41 into Gala's SG "transaction" account and Gala instructed SG to repay the SG loans in the sum of £103,334,645.57 from that account.

(3) The difference between these two sums of £575,788.84 is essentially what remained of the Interest Margin.

(4) The parties also entered into various other documents in relation to ending the transactions whereby the DA was terminated, and the various security documents were released.

Loss and tax position

69. Gala's accounts for the period ended 5 April 2004 showed Gala as having incurred expenditure of £111,307,630, comprising £98,417,735 of "costs of sales" which Gala claims it spent on Gala Expenses in respect of the transaction films, legal and professional costs of £8,364,237, interest charges of £180,791, an exchange loss of £4,525,657 and bank charges of £533. The majority of the loss is claimed to arise, therefore, on the basis that Gala incurred the Initial Expenditure on Gala Expenses in the tax year 2003/04. In his witness statement, Mr Yusef said that (1) the expenditure was not artificially created in order to generate a tax loss, (2) it is standard industry practice to spend vast sums of money to market and promote a film when first released, as the time-honoured way in which the studio seeks to get the widest exposure of the film to its target audience, and (3) Gala showed an accounting profit in the second and third years and the intention was to make an actual profit within 5 years. It is a key part of HMRC's case that (a) Gala did not *incur* the Initial Expenditure on Gala Expenses, on the basis that it was an integral part of the structure from the outset that (i) Gala would receive a corresponding sum back as the Minimum Amount/option price, and (ii) that would be funded by the Deposit which SPR was able to provide to Barclays without a cost to it, due to Gala providing SPR with the Initial Expenditure for it to use to meet Gala Expenses, and (b) Gala had no interest in making a profit, or a return for members, from Gross Receipts and no realistic prospect of doing so.

70. For tax purposes (1) Gala claimed that it incurred the loss in its first accounting period, (2) the members sought tax relief of a total of around £44 million in respect of their respective shares of the loss, (3) Gala reported the date of cessation of trade in its accounts as 28 April 2006 and a disposal for CGT purposes for disposal proceeds of £103,910,434 in its 2006/07 tax return, and (4) the members were subject to a CGT charge in total of around £7.2 million.

71. On Gala's analysis, the overall effect of the arrangements is that the members realised a cash profit from the arrangements of around £11.8 million. This is the portion of the total tax relief claimed of £44 million in excess of (1) £25 million of the total contributions which was not recouped through Gala's receipt of the option price of £103 million, and (2) the CGT of £7.2 million due on the gain arising on the exercise of the Call Option. On this approach, using the illustrative figures in the IM, an ordinary member who made a cash investment of £224,600, received tax relief of £400,000 and would make a net profit of £102,384 through tax relief alone.

Part B – Facts

Section 1 - Background to the Gala arrangements

72. Mr Yusef described how the Gala transactions came about and what he hoped to achieve with them in his witness statement as set out at [73] to [78].

73. He saw difficulties that the studios were facing as an opportunity for private HNWIs to get involved in film business "higher up the food chain" in terms of where the profits are made and, potentially, to make a return from that involvement rather than just participating in the fixed income stream/tax deferral received pursuant to sale and leaseback arrangements Invicta had previously been involved in:

(1) The studios were coming under increasing pressure to come up with innovative financial models to mitigate their cost exposure due to a number of factors including: (a) a decline in video/DVD sales revenues as a result of the increase in media streaming; (b) the costs of development, production and P&A significantly increasing due to technological advances; and (c) a change in the US accounting treatment of the way in which costs were booked and depreciated, meaning that the major studios had to account for P&A immediately.

(2) This meant (a) the studios, who had previously sought to keep all of the funding, and therefore the "upside" (potential profit), of their films in-house, were looking elsewhere for assistance, and (b) they needed to find innovative ways to mitigate costs and risk and might potentially be more open to joint venture-type arrangements with third parties, or outside financial assistance, than they had been in the past.

74. In his experience, in the past, private film investors primarily found themselves involved in the financing of film production, as studios were traditionally reluctant for them to become involved in the distribution process and an investor's weak bargaining position was invariably reflected in the type of film project which the individuals were invited to participate in. He felt that (a) there was more chance for members of Gala to make a return from involvement in the distribution process, in particular, as distributors are usually "higher up the food chain" as regards the sharing of receipts from the films than those involved in production. He carried out some preliminary research to ascertain whether there was any appetite for that, and (b) there was "a way to involve private participants on a more even playing field" and since "the financing of film distribution is a less volatile and potentially more profitable area," it would offer a better chance of returns, and (c) if Invicta could "put together a knowledgeable and experienced group of HNWIs, there were ways in which they could potentially get themselves closer to the gross profits that could be made from a film by removing one of the expenses that are deducted before net profits are shared".

75. He knew that, where certain conditions are satisfied, tax legislation allowed for individuals who invested in a business to offset up front losses incurred by the business against their income tax liabilities of that year and earlier years. He started to focus on "developing a business that would aim to make profits from film exploitation" but which would be "enticing to participants as a result of tax relief on income". He saw tax relief "as a mitigation element rather than a driver":

(1) "The tax relief was attractive in as far as it would entice or "hook" participants, and therefore encourage them to learn about the business. I hoped that, over time, as they became more comfortable with participating in the film industry, the need for tax relief would gradually diminish and eventually disappear..."

(2) As the film industry is speculative in its nature and, given that Invicta were intending to attract HNWIs as participants, "tax mitigation, necessarily, was to be

an initial feature of the structure, although only as a form of downside protection in the event that Gala was not a commercial success". In his experience HNWIs are not generally willing to part with their money on such a speculative, and therefore high-risk venture, if they could not mitigate that risk. He thought that part of the reason that certain legislation had been implemented (for example ss 42 and 48 of the Finance Act 1992) was to offer "downside protection" to incentivise people to participate in the UK film industry.

(3) He wanted to create an environment and a structure that would enable Gala to participate in "Major Studio quality deals" on a model used by "Silver Screen". "Silver Screen" initially had a tax component, but the pursuit of profit was the primary aim. Once it had done the first couple of deals with the studio, it got to a point of eminence and dominance where it had an almost equal negotiating position with the studio and could increase its profit share whilst at the same time removing the tax aspect to it. He also had in mind that German investors continued to invest in the shipping industry and investors continued to invest in UK windfarms long after the relevant tax incentives to encourage participation in that industry were withdrawn. He attributed that to the fact that the investors had become comfortable with how the relevant industry worked whilst the incentives were in place.

(4) The ultimate aim, therefore, was to provide a low risk yet profitable transaction that participants understood and were comfortable with, which had the capacity to grow organically into a major player in the sector, so that investors would continue to contribute funds even without "downside protection". He calculated that, by around years 4 or 5, "we would have done a number of successful transactions" that made a return for the participants and "the amount of tax relief they required would shrink because, backed by the historic successes, they would be comfortable putting on risk the entire investment to make a profit". He thought that by that time the bargaining position with the major studios would be so good that the amount of return a participant could make would be correlated to the amount of equity and risk at any time.

(5) Invicta was not looking to create a string of LLPs but to do several transactions within the original Gala structure, either through admitting additional members or by incorporating another vehicle owned by Gala. At one stage, Invicta was in advanced negotiations with both Sony and Paramount Pictures Inc ("**Paramount**") but that deal was never concluded.

76. His vision was to grow Gala over 3 primary phases and the intent was: (1) in the first phase, to establish a trading partnership with one of the studios, whereby "we would participate in the distribution of major film releases and make a return on the involvement;" (2) in the second, to acquire more films in subsequent years with finance raised through additional rights issues from existing members and additional subscriptions from new members so that a major studio "was comfortable dealing with us and we could negotiate better profit margins" and "in fact...the only way we could secure a Major Studio was to take a proposal to them which involved a very large sum of funding over a number of years...", and (3) in the third, to convert Gala to a plc and float it on the AIM market but this "did not come to fruition due to a change in legislation".

77. He looked "to ways in which a participant could become involved in films (and share the profits therefrom) which had a genuine prospect of being a commercial success". Invicta wanted:

(1) To place Gala and, therefore, the members in a position whereby they could participate in "gross receipts" from the relevant films, as "adjusted for the recoupment of transparent costs" on the same (or similar) basis as the studio (higher up the "food chain") on the basis that gave a better prospect of securing a return.

(2) Hence, to arrange for Gala to enter into an arrangement in which "we would be involved in the distribution of films released by one of the Major Studios" and would "play an active part in that process...on terms which ensured that [Gala] would have a realistic opportunity to enjoy the benefit of the potentially significant returns that films can make".

78. More specifically:

(1) The thinking was that the studio's ability "to charge unnecessary distribution costs would be reduced by Gala's active participation in the distribution process and "real time" understanding and approval of the distribution plans". Hence, Mr Yusef wanted Gala "to be actively involved in reviewing and approving" the marketing plans for the relevant films and suggesting changes to them and in "the overall distribution process...with appropriate approval rights over the process":

> "we wanted to have an input on final decisions that were made in relation to the P&A marketing strategy...we wanted to be sure that we had some sort of oversight and control as to what was being spent. We knew that if we simply funded the P&A, and the distributing studio knew that money was available regardless, they would spend it, and they knew that if they spent it, the fee would come from a higher level in the food chain....In short, were we not to be involved in the distribution process, they would spend our money and make more money (by virtue of increased Distribution Expenses) at our expense – i.e. the more P&A that was spent, the lower the pot at the end. We wanted to be able to control that to some extent so that we could ensure there was a greater eventual return for us."

(2) However, "we very much had in mind the advantages to be gained by deploying the infrastructure already in place with the studio" and were seeking "to engage with a studio to enjoy all of the groundwork that they have put in and contacts that they have established over many years" so that "by forming a joint venture-type arrangement with one of the Major Studios, Gala would immediately obtain the advantages of scale and market share enjoyed by that studio".

(3) In determining the amount of Gala's share of profit from the film:

> "the studio's recoupment of production cost would be limited to 60% (rather than 100%) of adjusted Distributor's Gross, therefore increasing the potential pot available for distribution and, since the studio would not provide all of the funds for Distribution Expenditure, the members have the chance to reach profitability sooner...by participating in distribution so that the distributing studio does not take 100% of the Distribution Expenditure, the lower the deduction that is made at that stage, the higher the balance that would potentially be available as a profit share."

(4) Gala would participate in the distribution of a range of films to give investors the maximum chance to invest in a project that is likely to succeed at the Box Office, and would be able to choose the films from the studio's entire slate of films for the year; it was important to avoid the studio "cherry picking" only those films they considered potentially less likely to be a commercial success:

(a) The studios field a broad range of films for distribution each season "on the principle that they would have the benefit of a portfolio effect and cross collateralisation" so that "the gains from one asset could mitigate any losses of another. Across a portfolio of films, the [studios] have more successes than failures (which is evidenced by how successful the [studios] are)". A projection for participation in one film often ends in failure whereas participation in a range of films would "increase the likelihood that one or more of those films would be successful enough to mitigate against any lack of success of others".

(b) Also, some films perform better in some territories than others and Invicta considered it important to ensure that members were not simply fed projects that the studio might consider to be "potential duds" which it knew had little prospect of commercial success. Accordingly, Invicta considered it "vital that there be no restriction on our access to the full slate of films" from the relevant studio "so that the members participated in a range of films in order to improve the chances of an overall return."

(c) Gala would have access to films (i) that had not already been released because "we wanted to maximise the revenue exposure from cinemas and down through other media formats", and (ii) for which not more than 30% of the marketing costs had already been incurred by the studio, as:

> "we were not interested in simply reimbursing costs to them...otherwise we would just be acting like a bank and we were not interested in bankers' returns. We wanted to be actively involved in the P&A process and we wanted to have approval rights over the marketing, and so on, so that, over time, the studio would be able to see that Gala's experienced team was able to add value to the distribution process. This would then put us in a better bargaining position with a Major Studio when we were negotiating further deals in the future…."

79. In his witness statement Mr Yusef said that (a) having formed the conclusions set out above, he began to have "informal meetings with film executives, to sound-out the reception that the deal structure we were proposing would get at each studio", and (b) "encouraged by the responses, we began framing out the finer details of our structure". He described the essential features of the arrangements Invicta sought to agree with the major studios as follows:

(1) Under licence agreements, Gala would acquire the rights in the films for 21 years, to take into account, as was industry-standard at the time, the 3 "cycles" or "broad windows of exploitation" of films of around 7 years each:

(a) The first covers the theatrical (cinema) film release window, a DVD release, a subscription-TV window (Sky Box Office, HBO etc) and a terrestrial TV window which typically take between 5 and 7 years: "broadly, you knew what you were in for and, naturally, the vast majority of commercial exploitation of a film takes place in this cycle".

(b) The second is intended to account for commercial exploitation of films from, amongst other things, changing technology.

(c) The third is intended to "sweep up" any other types of possible exploitation in a film such as cinema re-screenings, format re-releases or further terrestrial TV showings and the possibility of new technologies adding some commercial value to the rights of a film for this cycle.

In reality, the purpose of the second cycle (and to a lesser extent the third cycle) is that "you want the ability to be able to exploit a film for a longer period of time in case something happens which results in a film having some commercial value

again, and new technology is what typically drives that. His "understanding was that 3 cycles of 7 years was standard at the time".

(2) Under LAs (a) Gala would have distribution rights in the United States, Canada, and the UK, as these are the 3 key territories for western-society made films which would likely bring in the most revenue and as it was proposed to employ Mr Ackerman whose main expertise was in these territories (together with Germany), (b) Gala would have first-refusal or matching rights on sequels and remakes as, in Mr Yusef's experience, if a film is commercially successful, sequels are often made so as to "ride on the coattails" of the original's success, and (c) Gala would be obliged to incur a maximum of 91.5% of the value of the amount raised on distribution expenditure on the films selected, but Gala could incur more if desired.

(3) As regards the distribution agreement:

(a) "we wanted to align ourselves with the distribution arm of these studios to tap into their expertise and infrastructure" and Invicta intended to enter into a distribution with a studio entity "so that the films would be distributed by an agent on our behalf" which would cover the first cycle. Invicta thought that they would be in a much better negotiating position in year 6 and 7 as regards terms for the further cycles, as they hoped that by then they would have entered into further, valuable, deals with a major studio. Hence, granting the rights for 8 years (rather than 7) would provide room to negotiate in years 6 and 7. They wanted to have some control in the future and to be able to reconsider their position after the first cycle:

> "The transaction we wanted to achieve would not result in a simple pass through of rights from the licensor to our distributor. Gala acquired a license of rights including the right to sequel and remakes for a term of 21 years and licensed distribution rights for a term of 8 years. Whilst agreeing to an arrangement on this basis introduced some risk (for example that agreement could not necessarily be reached with the distributor for the remaining term), at the same time it could also introduce opportunities to agree more favourable terms than might be agreed for the full term at the outset."

(b) As noted, Gala wanted to be involved in the distribution process and have some control over the distribution expenditure (with approval rights), to ensure that it had an expert involved in the process, and to maximise the prospect of it being commercially successful.

(c) The profit from the relevant films (after deductions for certain items) would be split between the parties in the ratio 30/70 in favour of the studio. Mr Yusef considered this would be a figure that would be tempting for the studio to accept. This was an opening position, and he expected this ratio to change over time, "with our share of the profits increasing as the studio became more comfortable with us as partners".

(d) There would be a "shortfall guarantee" in place to secure the obligations of Gala's distributor to make payment of annual royalties and a minimum annual shortfall (if any) equal to the members' full recourse loans.

80. Mr Yusef continued in his statement to state that initially, Invicta worked to the following broad financial positions:

(1) Mr Yusef considered that, assuming that "tax mitigation for participating" was available to members "we could, realistically, obtain a total raise of between approximately £150 million and £250 million". He said:

> "we knew that, for any Major Studio to be interested in what we were proposing, it had to be large enough to make it worth their while getting into

something with us. Accordingly, we were always looking at trying to get to an amount in the hundreds of millions, with a prospect of further raises over subsequent transactions...”

(2) Initially they decided that the participants would each be required to contribute a minimum of £1 million. They saw this as the first of a series of transactions and wanted “people in the partnership that would have the capacity to be involved in further raises down the line; people with substantial income and who were sophisticated, the kind of HNWI who has some experience in evaluating and dealing with these kind of opportunities”. As it turned out, they did not strictly enforce this, usually as a favour or a gesture of goodwill, either for an important existing client, or to an introducer they expected further work from as a result. The smallest sum raised was £454,141.00, although there were not many people that fell at the lower end of the spectrum and very many raised considerably more than the lowest sum.

(3) The participants would be required to contribute around 20% from their own capital, with the balance made up from a full recourse loan. At the time, Mr Yusef was dealing with all of the banks in the media space on a daily basis and had a fairly clear idea before he discussed the proposal with them. He could not now recall why they landed on the 22.46%/77.54% ratio but the amount of equity was determined following a combination of: (a) discussions with the bank on the cost of the loan; typically, the lower the equity, the higher the cost of the loan. Invicta had to ensure that the cost of the loan would ensure that the prospective returns would work; and (b) what Invicta could achieve with the investors; the less equity that investors would have to put in, the more likely it would be attractive to them.

(4) He estimated that the cost of acquiring the rights to distribute the films would be around 10% to 15% of what Invicta hoped to raise and Invicta intended that Gala would fund this by borrowing such a sum pursuant to a non-recourse loan. It was also a function of what Gala would be able to afford and “whether a studio came up with a number that we could not afford. Commercial realities were brought to bear on that situation.” We note that there is no evidence that the price paid by Gala to acquire the Rights was based on negotiation or commercial valuation.

81. Mr Yusef’s intention was that Gala would not be a “retail” mass market investment like the sale and leasebacks that Invicta did. Its principal purpose was to attract members “seeking an introduction to trading in the international film distribution business and trading in film assets and distribution networks, which individuals would not normally have access to”. Invicta sought agreement from a major studio for them to make available a slate of films for Gala to choose from on the basis that:

(1) (a) Invicta would conduct an exercise to analyse which films from the slate had the best prospects of being commercially successful and making a return, (b) Gala would acquire the rights to the selected films once funds had been raised, and (c) the films would be placed with the studio for theatrical exhibition, and exhibition in all other forms of media.

(2) Gala would incur distribution expenditure in the form of “release print acquisition and media buys” which would serve to promote the films to the paying public (as a necessary and customary part of the exploitation process). The trade of Gala would be the distribution and commercial exploitation of the films in all media known or thereafter invented.

82. Mr Vallat placed much reliance on Mr Yusef’s evidence in support of Gala’s case. In particular, he submitted that on the basis of his evidence the tribunal should accept

that (1) Mr Yusef/Invicta had a long-term vision to grow Gala under a model whereby Gala would fund (in part) and actively participate in the distribution process, (2) he/Invicta/Gala aimed to and did negotiate a good deal in that (a) under the waterfall, Gala was higher up the "food chain", and (b) there was no restriction on its access to the full slate of films from the studio so that Gala could choose commercially viable films; hence the deal was made with Sony as the only studio willing to do this, and (3) he, as the Referrers also said, viewed the tax benefit as a form of "downside protection" only.

83. However, for the reasons set out in full below, we do not accept many aspects of Mr Yusef's evidence. At this stage, we note that:

(1) We do not accept that, under the deal agreed with Sony, Gala had meaningful contractual rights in relation to the distribution process or that, in practice, any activities were carried out by it or on its behalf which had any material import or consequence as regards that process whether from Gala's or Sony's perspective. As set out in full in section 9, we consider that, under the terms of the DA, (a) Sony had the right to conduct the distribution process as it chose and was not appointed as, and did not act as, Gala's agent in doing so, and (b) Gala did not have any right to "input on final decisions that were made in relation to the P&A marketing strategy" in respect of the transaction films or "control as to what was being spent" by Sony in distributing the transaction films and, in practice, Gala simply monitored what Sony spent (see section 14).

(2) As set out in section 11, we do not accept that Gala had a realistic prospect of receiving a share of Gross Receipts under the waterfall of anywhere near a sufficient sum for it to recoup from such receipts a sum equal to the full contributions/Gala's full outlay under the transactions. In that context, we note, in particular, that (a) Gala did not have a right to a share of 30% of the Gross Receipts from the transaction films (after deductions), or anything approaching such a proportion, (b) nowhere in his lengthy witness statement did Mr Yusef explain what the actual profit sharing ratio was or why, given what was actually obtained, he thought 30% was achievable or, as he put it, "tempting for the studio" and that that ratio would increase over time, and (c) whilst under the waterfall, Sony's ability to recoup Production Costs was limited to 60% (less a sum equal to the licence fees), any benefit to Gala is illusory given the rest of the terms of the waterfall.

(3) Moreover, Mr Yusef's claim that the aim was for Gala to participate on an equal footing with Sony, to provide valuable input and to prevent Sony spending unnecessary costs is inherently implausible given (a) the discrepancy in the resources Gala chose to devote to its activities (essentially, Mr Ackerman/LBPC who reported to Invicta) and those already available to Sony, as Mr Ackerman essentially accepted (see section 14), and (b) contrary to Mr Yusef's suggestion, Sony had every interest in avoiding "unnecessary costs" on the transaction films on its own account, whether it paid for distribution costs with funds provided by Gala into the expenditure account or otherwise; under the terms of the waterfall, all distribution costs incurred on the transaction films would reduce ultimately the Gross Receipts otherwise available to be divided between Gala and Sony.

(4) Overall, the substantial discrepancy between what Mr Yusef said he sought to achieve and what was actually achieved under the contractual terms agreed with Sony, of itself renders implausible Mr Yusef's statements that the intention was to realise returns from involvement in the distribution of films as part of a long-term vision. Mr Yusef's comments on other projects and scenarios (such as transactions in relation to the production of films and "Silver Screen") do not add

any weight to his evidence in this regard given that (a) the tribunal is not in a position to judge the nature and effect of those transactions and what the aims and intentions were of those involved in them, and (b) the tribunal's task is essentially to assess the nature of *these* transactions on their own terms taking account of all relevant facts and circumstances pertaining to *them.* We have commented on Mr Yusef's assertions as regards Sony's motivations for entering into these transactions in section 2.

(5) We also do not accept that, as was a theme of both Mr Yusef's and the Referrer's evidence, generating the loss and associated tax relief can be described as a form of "downside protection" or "mitigation" in the event that the Gala transactions were not a commercial success and that obtaining that benefit was not the driver for the transaction. As set out in section 4, this is an inaccurate description and our view is that, given how the Gala arrangements were designed and operated, obtaining the tax benefit must have been the driver for the transaction, at least as far as those who devised and operated the scheme were concerned (see, in particular, sections 11 and 15).

84. In early 2003, Mr Yusef instructed lawyers (Denton Wilde Sapte) to prepare instructions to counsel in relation to reviewing the tax efficiencies of the structure. A conference with Mr Jonathan Peacock QC took place on 6 March 2003. Mr Peacock was instructed to consider and advise on the tax treatment of a structure in which an LLP was set up to act as a trading film distribution fund and to address certain "key assumptions" which were necessary for the structure to yield "a tax efficient return to investors".

85. At around the same time, Mr Yusef sent proposal documents to 5 film studios: Disney, Fox, Universal, Paramount and Sony. In a covering email to Paramount, Mr Yusef described his "product" as being in competition with a "structure" offered by Scotts Atlantic. The proposal documents were in similar terms and included statements that:

(1) The minimum fund size would be £150 million and the maximum £250 million. The investment objective was to acquire and commercially exploit all media distribution rights to a portfolio of up to 7 films pursuant to an option.

(2) The IM would state that the studio did not endorse the Gala fund or make any representations or warranties as to income/expense or the tax treatment of the fund's business and every member would be required to indemnify the studio against withholding tax and from any claim relating to any matter in the IM.

(3) The studio would provide Gala with a range of unexploited films which must be available for release prior to 1 August 2004 and all distribution expenditure in respect of those films to be incurred by Gala must be capable of being incurred prior to 5 April 2004. Gala later provided a draft term sheet to Paramount in which it also referred to this requirement. The films were to be evaluated by Gala and it must be clear from the documents that the studio would not have the right to put films to Gala.

(4) The precise price was to be negotiated but may not exceed 13.5% of the "Fund Capital" (the gross funds raised from members), Gala would be obliged to incur a maximum of 91.5% of the "Fund Capital" exclusively to directly meet marketing costs of the selected films, profits were to be allocated as to 30/70 in favour of the studio and Gala was to enter into a distribution agreement with an affiliate of the studio.

(5) The studio would have a call option and a charge/security interest to protect reversionary rights/share of profits and approval rights over sub-distribution arrangements.

(6) The terms of the distribution agreement would include that it would be for 8 years, Gala would not enter into the agreement unless it approved the marketing plans, Gala's representatives must have an active role in monitoring the line item expenditure to be paid from the expenditure account in accordance with the approved plan, and Gross Receipts were to be allocated as follows (and in this order of priority (a) 35% distribution fee to Sony, (b) talent participations to Sony, (c) recoupment of any distributor spending on distribution expenses to Sony, (d) recoupment of expenses paid for from the expenditure account to Gala, and (e) 30% to Gala and 70% to the studio.

(7) Gala would require a "shortfall guarantee" and a letter of credit which the studio must fund from its own resources.

86. It is plain from this, therefore, that (1) the Call Option, shortfall guarantee and LC were all part of the proposal from the outset, (2) the licence fees were determined according to what Invicta came up with and not by extensive negotiation or valuation of the Rights, and (3) generating the loss in the 2003/04 tax year was an important part of the proposal.

87. On 14 May 2003, a second conference was held with Mr Peacock QC, in which he was asked to consider and advise on the tax implications of proposed changes to the structure. A copy of the note of that conference (dated 10 July 2003) was provided to prospective investors. It referred to the key assumptions necessary "for the structure to yield a tax-efficient return to investors" and noted that investors' return "may, in certain circumstances, be derived solely from the accompanying tax benefits".

88. Mr Yusef said the following in his witness statement as regards initial discussions with the major film studios ("**the studios**") on the Gala proposal:

(1) He/Invicta knew that Invicta had to come up with a scale of deal that would be of interest to the studios; mostly they are interested in deals of half a billion or a billion dollars. However, he thought this "would never be achieved by Gala on its own, certainly not in the short term anyway". So, he suggested to the studios that asking for this in the marketplace right from the outset would not be very feasible but that if "we had experience with one successful deal with a moderate fund value, further deals would follow" which would lead to the levels of investment the studios were looking for. He noted again that "we were looking to emulate Silver Screen" and that is how he/Invicta presented their position to the studios as part of the negotiations.

(2) He thought that, "what we were asking for...as a complete set of terms, was challenging to say the least" given, in particular, that they were seeking (a) full access to a studio's slate of films, and (b) a degree of control and participation over their marketing plans, which he thought none of the studios had ever given before. He added that the process was helped by the fact that, in most instances, his discussions were "at the decision influencer level ("influencer" only, since no one person has the sole right to green-light projects in the studio system)".

(3) Invicta had "extensive relationships" with executives at all of the studios who all showed "an initial interest in transacting with us to defray their [distribution] expenditure". He thought that (a) there was an initial conversation with the studios before they were sent term sheets, and (b), if there was interest, there was a subsequent meeting or meetings which were all lined to take place

within the space of a few days in May 2003. He and Mr Bamford took turns to deliver a presentation at these meetings and Mr Ackerman attended some of them.

(4) Disney, Fox and Universal baulked at the idea: they did not want Gala to be involved in the distribution process, to have access to their slate of films (they preferred only to make 1 or 2 films available), or to provide rights to sequels. There were similar issues with Paramount although some progress was made with them, and they were sent an initial draft version of a term sheet. Disney offered a deal on those terms but:

> "as we were only interested in a deal which would maximise the prospect of a successful commercial exploitation of the rights we acquired, we declined the deal as we did not consider it would meet the needs of our intended participants (who we knew would want a genuine prospect of making a return on their investment)."

(5) All of the studios, except Sony, said that they would be willing to transact but only with the effect of giving Gala the right to reimburse the studio for the cost of the Gala Expenses, without any say as to which films Gala would acquire. Sony were prepared at least to consider "what we regarded as a proper "joint venture" type arrangement" where "we would be fully involved in the process and could choose films from their slate that we considered would give us the best possible prospect of making a return".

Section 2 - Negotiations with Sony

89. Mr Yusef said the following in his witness statement as regards the conduct of negotiations with Sony:

(1) (a) In 2002 Columbia had broken the record for biggest "domestic theatrical gross", with a tally of $1.575 billion, (b) however, in 2003 Columbia was "entirely dependent" on its ultimate parent for finance which was "suffering in its key markets and in its stock valuation following an aggressive expansion into new businesses which had proved unrewarding and unprofitable. SPE was, therefore, under increased pressure from Sony Corporation to reduce its dependency on financing from Tokyo, at a time when the cost of making and distributing films was escalating at an alarming rate.

(2) Mr Yusef's contact at Sony was Mr Ken Lemberger who he had known for a long time. He became executive vice chairman of SPE in 1997 and its president in 2001. At the time of the initial contact with Sony, he was working as a consultant (and he retired from SPE in 2003) but he was still there and "put us in front of the right people" (for which he was paid an introducer's fee). Mr Lemberger "saw that it was worth Sony looking at doing a deal with us if we could work up to the scale talked about. He used what little power he had left at the time to suggest to Sony, that they ought to meet with me".

(3) Although Mr Lemberger and his colleague Mr Stefan Litt, "came across as being much more receptive to exploring innovative financing channels than the other major studios" and "were willing to consider" the Gala proposal, it was "still a hard sell":

> "Gala's participation at the distribution level of a Major Studio's key assets was, at the time, a unique proposition and one which Sony had to be convinced would be suitable for them and was just the beginning of a joint venture with Gala that was capable of operating in the future at scale."

(4) He recalled that the initial meetings with Sony were attended by officers who had direct responsibility for the distribution side of things and:

> "they really bought into the idea that this was not a one-off deal. In fact, I recall having a conversation with one of the executives who said to me that, were this

> to be a one-off deal, they would not have considered agreeing to it as it necessitated bringing in external lawyers, accountants, and internal professional advisory to sign everything off and so would not be worthwhile for them."

(5) There were detailed discussions in meetings as to the nature of Gala's participation in the distribution process, the type of films which would fall into the Gala portfolio and the profit ratio that each entity would be entitled to, and "it certainly remained a challenge to convince Sony that our desired key heads of terms would be in their interests (as well as, of course, our own)".

90. Mr Yusef said in his witness statement that there were negotiations with Sony on the key terms as follows:

(1) There was initially great resistance at Sony to Gala being actively involved in the distribution process at all. Mr Yusef sought to overcome this by meeting with the senior marketing people who control that process to explain the proposal. He brought Mr Ackerman along with him, who was able to add his experience. As the discussions progressed:

> "we were able to convince Sony that our objective was not to obstruct the distribution process, rather, that Gala would be able to add value to the process by being involved in it with the common goal of maximising the potential for returns".

(2) It was agreed that "we would use SPR, the distribution arm of SPE, to distribute the films". Invicta did not have an issue with this as (a) it is inconceivable" that a studio would agree to allow a licensee to distribute its films through another studio, as a direct competitor, and (b) "we were looking to tap into the established infrastructure that Sony had".

(3) Sony was initially reluctant to agree to Gala being able to pick which films to acquire rights to from its whole slate but Invicta explained that:

> "we were only looking to set up an arrangement which maximised our chances of successfully exploiting the films and making a return, and therefore that this was a critical aspect for the deal to go through."

Sony saw it was in their interests for Gala to have access to the slate to ensure the deal would not fall through.

(4) There was an initial suggestion from Sony that Gala would acquire films where the expenditure had already been incurred. However, Invicta explained that this was not acceptable as, if Gala just reimbursed Sony in that way:

> "we would have no control over what had been spent...it was vital that Gala was able to participate in new projects across the slate because we were not interested in acting simply as a financing party, analogous to a bank. We wanted to be a business partner, acting alongside the studios."

It was agreed that such films would not be the subject of the transactions.

(5) Invicta were keen to secure rights in any sequels to the films purchased as "we wanted the ability to ride on the coattails of any successes/profit that we made from the original". Sony were quite relaxed about this although they would not allow Gala to have access to sequels of any films that they had already released for similar commercial reasons.

(6) Invicta wanted terms that would create an acceptable risk versus reward ratio for the members whereby Sony would provide a letter of credit to guarantee "minimum royalties" to cover the loan payments. It is not uncommon for a distributor to pay such sums to secure the distribution rights to a film and it was entirely commercial for Gala to insist on a cash backed letter of credit to secure SPR's obligations. Notwithstanding the prudent down-side protection that Gala

negotiated, there was banking risk if, for example, the bank became insolvent and called in their full-recourse loans from the prospective members which, as subsequent events showed (the global financial crisis which resulted in major banks like Lloyds almost failing) was not fanciful.

(7) Detailed discussions took place on the waterfall. As set out above, Invicta were keen "to place ourselves as high up the food chain as possible". Sony wanted to ensure that the deal ensured that their existing obligations were met in that they could pay out those that they had already contracted with and that there was an acceptable profit share. There were a lot of negotiations about this but:

> "we were eventually able to reach an agreement on the basis that would be acceptable to both parties, and which gave us confidence that we would be able to make a return if we selected the right films and they were a commercial hit."

91. Mr Yusef described the conclusion of the negotiations as follows in his witness statement:

(1) As negotiations progressed, Sony "really seemed to buy into" the proposal because they thought that there would be "a conveyor belt of funds" and "that promise helped us to convince them to give us the favourable terms we were after." Invicta also had to convince them that without those favourable terms, they would not be able to seal the deal with investors and, unless Gala had access to the full slate of films, Invicta would not be able to proceed. It was:

> "very much a two-way conversation, with Sony looking to achieve what they wanted (access to regular and large sums of money to outsource their financial outlay) and with us wanting to achieve terms that would maximise the prospect of us making a return on our involvement."

(2) After weeks of discussions the parties agreed heads of terms on 5 November 2003, which encapsulated the outcome of the discussions. Invicta were "extremely pleased to have secured an agreement with Sony because of the success that Columbia had had in the previous year" and felt they had "stolen a march on" competitors, as "the only way that they could overcome barriers to entry was to accept terms or deal structures that were not as favourable as ours and that we had already rejected". For example, the deal rejected with Paramount was later taken up in substantially that form by a UK competitor and:

> "we genuinely considered that we had something better than our competitors could offer, which maximised the prospect of making genuine returns, and which would likely be of real interest to individuals who wanted to participate in the film distribution industry."

(3) Invicta then had meetings with the officers involved with business affairs and who had the responsibility to structure the deals and engaged professionals to document and complete the transactions.

92. We find much of Mr Yusef's evidence on the negotiations he asserted took place with Sony implausible, in particular, in light of the facts that, as we have concluded below, (a) under the contractual terms of the deal concluded with Sony, Gala had no meaningful rights (or obligations) to participate in the distribution process and no realistic prospect of receiving Gross Receipts under the waterfall of a sufficient amount to meet Gala's full outlay under the transactions (and the members' full investment) (see sections 9 to 11), and (b) from the outset, Invicta/Gala expected the Call Option to be exercised by Sony at the first opportunity and the transactions were designed so that it was inevitable that Sony would do so (see section 15). In particular, we find it implausible that:

(1) (a) Sony was convinced that Gala would be able to add value to the process by being involved in it, (b) Invicta wanted to maximise "our chances of

successfully exploiting the films and making a return", (c) Sony saw it was in their interests for Gala to have access to the slate, (d) Sony acknowledged that Gala would have some control over what was spent on the distribution of the selected films, and (e) detailed discussions took place on the waterfall and Invicta reached a deal on this which gave them confidence they would be able to make a return if they selected the right films and "genuinely considered" that they had something "which maximised the prospect of making genuine returns".

The contractual terms which Gala concluded with Sony speak for themselves and do not provide a basis for the assertions made in these comments (see sections 9 and 11 and our comments in section 1). Moreover, we consider that Mr Yusef/Invicta must have been aware from the outset that Sony was highly unlikely to agree to Gala having meaningful rights in respect of the distribution process and to receive a share of Gross Receipts given that (a) as explained below, in economic terms, all that Sony was offered in return for its participation in the arrangements was £15 million (as structured as licence fees paid on day 1), and (b) all Gala had to bring to the table in terms of contributing to the distribution process was a one man company which, as Mr Ackerman himself agreed, was a resource which was not in the same league as those which were already available to Sony (both internally and through the agents it contracted with) (see section 14).

(2) Invicta's desire to secure rights in any sequels to the selected films was as it envisaged being able to ride on the coattails of any successes/profit that were made from the original. It seems highly unlikely that any sequel or remake would be in prospect before the first exercise date and, as noted, we consider that Mr Yusef/Invicta fully expected SPE to exercise that option as soon as it could, as in fact happened (subject to the short extension to the exercise date made at SPE's request). As set out in Part C, in our view, in reality, Invicta/Gala sought such rights so that Invicta/Gala could point to them as demonstrating the commerciality of the arrangements, but they had no real interest in them.

93. Moreover, we do not accept Mr Yusef's evidence that (a) Sony was, as he put it here, interested in a "conveyor belt of funds" because Sony wanted access to regular and large sums of money to outsource their financial outlay on the distribution of its films, and (b) the prospect or "promise" of further funds helped to convince Sony "to give us the favourable terms we were after". On the second point, the limited nature of the contractual terms agreed with Sony speaks for itself; Gala did not have "favourable terms" on any normal commercial meaning of that term (see sections 9 and 11). On the first point:

(1) A repeated feature of Mr Yusef's evidence is his insistence that (a) Sony did not enter into the transactions to receive the "measly" £15 million of licence fees which he asserted Sony would regard as an insignificant sum or "chump change" and, (b) rather, Sony wanted funding for their distribution expenses on an on-going basis under a lasting relationship and had hoped to gain much larger sums from Gala. He said that Sony were "hungry for money" and wanted to find third parties who would fund its distribution expenses, (i) as he said in his statement and at the hearing, due to a change in the accounting treatment of distribution expenses in the US, and (ii) as he said at the hearing, as the Sony group had made a substantial loss in the previous year. He presented this on a number of occasions, as here, in support for his view that Sony were prepared to give Gala meaningful rights in relation to the distribution of the films, and/or that SPE would not have exercised the Call Option when it did had Gala been able to

demonstrate that it could provide further substantial funds to meet further distribution expenses.

(2) We do not accept that Gala has demonstrated that, (a) in fact, a desire for funds to meet Sony's distribution costs was Sony's motivation for entering into the transactions for any of the reasons Mr Yusef gave, whether as a result of a change in US accounting treatment or otherwise, (b) Sony were not interested in the £15 million of licence fees, and/or (c) Sony wanted to have a longer term relationship with Gala for the reasons Mr Yusef gave.

(3) The nature of the transaction speaks for itself. As set out in section 10, there was plainly no economic benefit to Sony in funding terms as a result of Gala paying the Initial Expenditure into the expenditure account under the terms of the DA. As part of the design of the structure, on closing, SPR had to place a sum equal to the Initial Expenditure on deposit with Barclays to fund its obligations under the LC, in order to induce Barclays to issue the LC. Under the terms of the DA, SPR had to procure that the LC was issued to Gala as a condition for Gala's obligations under the DA to take effect. Mr Yusef made no suggestion that, if Gala had obtained more bank funding and put a larger sum into the expenditure account, the structure of the arrangements would have been any different. Indeed, he stressed that such shortfall guarantee and security arrangements to enable the repayment of bank finance are entirely normal and what is to be expected in transactions of this kind. It is reasonable to suppose, therefore, that had Gala/the members obtained more bank funding, the Minimum Sums/amounts due under the LC would have been increased correspondingly and SPR would have been required to make a commensurately larger Deposit to fund them. Hence, however large the sums in the expenditure account, Sony's cash return from the transactions would remain confined to its "benefit" in the form of the licence fees.

(4) Moreover, Sony did not obtain any other material benefit from the involvement of Gala/Invicta/LBPC/Mr Ackerman in the distribution process for which it was prepared to give Gala a realistic entitlement to profit from Gross Receipts (and Gala did not have any such entitlement) (see, in particular, sections 9, 10, 11 and 14).

(5) We note that the Referrers also referred to their understanding that changes in US accounting meant that Sony had a commercial reason for its participation in these transactions although their evidence is not clear or consistent as to what the relevant changes were or what impact they had (see sections 5, 7 and 13). We accept that, at the relevant time, the Referrers had such an understanding; there is evidence that some investors were told this by Mr Yusef/Invicta and some were told it by UBS or Ms Challons (as explained in section 4, both of whom were involved in promoting this structure to potential investors).

(6) However, in light of the lack of credibility of much of Mr Yusef's evidence, we make no finding that this was Mr Yusef's understanding. Moreover, in any event, we do not accept that the fact that the Referrers had this understanding from persons other than Sony combined with Mr Yusef's assertions on this topic suffice for us to conclude that Sony in fact had any such motivation. We consider that, as HMRC submitted, having regard to the case law set out in section 2 of Part A, it is reasonable to expect Gala to produce evidence from Sony if Gala considers that it is important to demonstrate that Sony had the commercial reasons Mr Yusef asserts it had for entering into these arrangements:

(a) For the reasons set out above, the commercial and economic effects resulting from the design and nature of the transactions plainly indicate that Sony entered into them in order to obtain £15 million.

(b) Sony, as the party whose motivations are in issue, is evidently best placed to comment upon them.

(c) Mr Yusef has a considerable interest in these proceedings succeeding given his/Invicta's role as the designer and promoter of these arrangements and that he invested in them.

Mr Yusef said that it is unrealistic to expect Sony to give evidence to this tribunal but it is speculation as to whether or not Sony would have agreed to do so given that Gala did not in fact ask Sony to do so and apparently Mr Yusef did not think to do so.

(7) Therefore, (a) we reject Mr Yusef's assertion that Sony was not interested in £15 million paid in the form of licence fees; Sony must have been interested in that sum as that was all it gained from these arrangements, and (b) we conclude that this sum was, in effect, Sony's fee for participating in these arrangements and, any interest Sony had in a long lasting relationship with Gala, is likely to be due to the prospect of Sony receiving further such fees.

94. We have commented further on the effect of the security arrangements below.

Section 3 - Selection of the transaction films

Mr Yusef's evidence

95. Mr Yusef set out in his witness statement that:

(1) An essential part of the process was for Gala to decide which films of the available slate provided "the best opportunity of commercially exploiting them to provide a return", and the overall size of the deal would be determined by the likely expenditure on the selected films:

> "In short, once we knew what films were available in the slate, we would determine the likely expenditure, and then work out whether or not we would be able to entice prospective members to participate to an amount that equal or exceeds that amount, otherwise we would be wasting everyone's time having discussions with the studios."

We note that it is apparent from the proposals sent to the studios and the terms of the documents entered into with Sony (see section 9) that, as was a feature of the design of the arrangements from the outset, (a) the overall size of the deal was determined by the funds Gala raised from investors, and (b) the Initial Expenditure was simply a specified proportion of the total contributions.

(2) Gala "relied heavily" on Mr Ackerman (and, later, film valuers HL) to analyse the slate of films available and to advise as to their suitability. He felt that Mr Ackerman was, "being in LA, at the coal-face, and was better placed to carry out that analysis".

(3) Once Invicta knew that Sony was willing to make their entire "slate" for the year available, Mr Ackerman was asked to review the films that were to be released by Sony over the summer of 2003 as against those that were to be released during the winter of 2003.

96. In the June 2003 letter to which Mr Yusef referred, Mr Ackerman made the following main points:

(1) He thought one could expect very strong worldwide market performance for one of SPE's films for summer release but was "less bullish about SPE's other mainframe summer releases, notably Bad Boys 2, S.W.A.T. and Once Upon A

Time In Mexico". Having also assessed the other Hollywood studios' summer releases, he believed the market was very crowded with a significant number of big budget, high-profile releases and "competition will be cutthroat for all but the very strongest contenders". For "this and other reasons", he believed it was in Invicta's and Gala's best interests to reject any financing for the 3 films he had doubts about.

(2) He also recommended that Invicta did not consider certain "Revolution pictures" as: "The SPE-Revolution deal would complicate P&A financing from Invicta and Gala's point of view".

(3) His research caused him to be concerned about the commercial viability of SPE's "sub-label Screen Gems' films, whose genres and small budgets will make market profile difficult". However:

> "Screen Gems' You Got Served and Breakin' All The Rules are both commercially oriented low budget films targeting the under-served African-American and youth audiences. These films should be tracked for audience awareness as the summer and fall progress and, if SPE can promote effectively to these niche markets, then both could have some commercial success proportionate to their respective budgets."

(4) He thought it best for Invicta to focus on SPE's Christmas and winter mainframe releases - Something's Gotta Give, Big Fish, 50 First Dates, and Secret Window as:

> "Word of mouth in the local creative community is strong on all these four films, and I believe SPE will have an excellent Christmas 03-04 season heading off with Something's Gotta Give."

97. Mr Yusef said in his statement that:

(1) In light of the June 2003 letter, Invicta decided to focus on the films Mr Ackerman had recommended and began taking steps to obtain further information about them. It was a key part of Invicta's strategy to obtain files from Sony to enable them to analyse the films. They wanted to ensure that Gala, with Mr Ackerman's help, chose only those films which gave it the best possible prospect of making a return and to send those files to the potential investors so that they could assess the Gala opportunity, and make sure that they understood what they would be getting into. However, acquiring the film files was "a major source of discussion and a point of contention that we had to resolve with Sony".

(2) Invicta's aim was to be in the same or at least a very similar position as Sony as regards the documentation available and Invicta had to convince Sony that, for the deal to work, they would have to give Invicta access to their confidential materials: "the fact that our not having the materials could scupper the deal meant they were keen to complete put us in a good position". Invicta advised Sony that Mr Ackerman would analyse the film files on Gala's behalf, and Sony were able to do background checks on him and sound out their connections in LA to obtain an impression of him. Mr Yusef thought that this is "where Mr Ackerman came into his own. Mr Ackerman was a respected figure in the industry" and Mr Yusef is convinced that "only through Mr Ackerman's involvement were Sony willing to send us their film files".

98. Mr Ackerman said in his statement that he needed access to such documents to properly review the films in "the winter slate". He noted that studios are reluctant to give access to these (a leak can damage the film's success) but Mr Yusef was insistent on obtaining this so Gala could make a proper commercial assessment of the films. He and Mr Yusef discussed this extensively with Mr Litt at Sony and they were eventually able to obtain the information because his relationships at the studio meant that Sony

trusted him and they were aware of his experience in the industry and so how he would be able to use the information to advise Gala.

99. Invicta/LBPC obtained screenplays and synopses of the films, the proposed Plans, the summary cost report, project status report; and the cast and above line biographies ("**the film files**") as formally sent by Mr Litt in a letter dated 17 November 2003. Mr Ackerman was then instructed to carry out a full analysis and sent the November letters. We note that some of these letters pre-date Mr Litt's letter. Mr Yusef said he thought Invicta/Mr Ackerman actually received parts of the film files from Sony during earlier meetings. He and Mr Ackerman were questioned about the timing of the letters as set out below.

100. Meetings with SG took place on 2 June, 3 September, 10 October, 5 November and 20 November 2003. Mr Yusef recalled that "what really got SG excited about it was that it was intended to be an evergreen opportunity (ie not just one transaction but a series of them) with a team that they were comfortable with". He said that once SG had advised what the loan would cost, "it would be a case of putting that figure into the financial model to see whether, financially, it was viable and was something from which we could make a return".

101. Mr Yusef said that, given the opinion provided by leading tax counsel, Invicta considered it prudent to obtain advice from a leading accountancy firm to ensure that the Gala arrangement would be compliant with GAAP in place at the time. Invicta instructed Ernst & Young LLP and they issued an opinion letter in which they said that the accounting policies which Gala planned to adopt for the year to 5 April 2004 "are in accordance with [GAAP]".

Mr Ackerman's evidence on his role in May and June 2003

102. Mr Ackerman made the following main points in his witness statement regarding his involvement in the Gala proposal during May and June 2003:

(1) Initially he worked for Gala on a "good-faith basis" on the basis that he would be compensated for time incurred once an agreement was in place with a studio.

(2) He and Mr Yusef had some very preliminary discussions with studio representatives at some of the film events they went to such as the Cannes film festival. Around May or June 2003, Mr Yusef approached him with a draft term sheet that he proposed to take to the studios for him to comment on. Mr Yusef wanted him to use his contacts to get Invicta in front of key decision makers at the studios. Mr Yusef also had his own important contacts; Mr Ackerman thought his own involvement was intended to add gravitas.

(3) In May and June 2003, he attended meetings with the studios. Invicta were looking for "fairly hands on involvement". Mr Yusef generally introduced him as someone who would be locally available in Los Angeles which some studios, like Sony, welcomed and others did not. It was very important to Mr Yusef to have this active involvement, so it was a deal breaker if a studio was unwilling. Discussions did not lead to deals with the other studios (and Mr Ackerman gave essentially the same reasons for that as Mr Yusef gave).

(4) As regards Sony, he said:

(a) "we really had to convince Sony that the proposal was in their interests - the negotiations with Sony were generally positive, and we found a team that bought into the idea, that we could really collaborate with, and that did not dismiss the proposal out of hand..." but they needed convincing to release their confidential information.

(b) He thought that the references Sony obtained for him helped in securing the deal and gave Sony confidence that they could trust him with confidential materials and work with him on a regular basis:

> "Sony could appreciate why we wanted to be fully involved in agreeing changes to the marketing plans....*and they agreed that we could have full control in terms of making key decisions as to how the [distribution] expenditure was spent*." (Emphasis added.)

We do not accept the highlighted statement for all the reasons set out in sections 9 and 14.

(c) He/Invicta felt that (i) the films Gala could acquire from Sony were very good and offered a mixture in terms of budgets and genres, (ii) Sony had deep expertise in the marketplace and strong relationships with McCann Erickson, a major player in pre-buying of media space for studios and advising on allocation in the US and with media buyers in other territories, and (iii) Mr Paul Smith (president of the distribution and marketing division) and his team were really "open to working with us and to providing detailed information for me to provide the studio with feedback and report to Gala."

(5) As Gala had engaged Mr Ackerman, they were already in a strong position in terms of negotiating deals and executing P&A budgets despite the business itself being relatively junior, due to the experience he brought and the contacts he had.

(6) From around May 2003, Mr Yusef regularly started to visit the US for meetings which were broadly bi-monthly until late 2003/early 2004 when he came more regularly to discuss proposed marketing budgets and plans that were being developed – they met almost daily when he was in LA and otherwise had frequent phone calls.

(7) Following a meeting with Sony at Cannes in May 2003, he advised Gala as to which slate of films to acquire:

(a) Before sending the June 2003 letter, he carried out a variety of research which included calling people he knew and considering what "word of mouth views were in various films" so that he could "get a reference point in terms of commercial confidence". He would probably have spent several days making calls and attending meeting with contacts on an informal basis to obtain more information on the available "slates". If the film was in the post production phase he would have seen it. Otherwise, he would have considered the synopsis and/or cast lists and would do some wider research into the talent as regards how well other films they had been involved in had done at the box office.

(b) He recommended against the summer films on the basis that (i) there would have been too much competition as regards some of the big budget release films, (ii) films that were remakes were too generic; remakes need to be original to do well, and (iii) some of the films were too violent.

(c) He suggested Gala should reject Revolution films as he felt that the person running Revolution may block Gala's active involvement in distribution which would have been contrary to Gala's commercial objectives as "we would not have been able to maximise our commercial upside if the marketing plans for the films were already dictated".

(d) He also rejected some of the Screen Gem films due to concerns as to their commercial viability but did recommend You Got Served and Breakin' All the Rules.

(e) After sending the letter he had a number of conversations with Mr Yusef to drill into some of the issues he had discussed which resulted in him seeking more information from the studios.

(8) In order properly to review the films in "the winter slate" he needed access to the documents relating to them, such as the screenplays.

103. At the hearing, Mr Ackerman confirmed that the Cannes Film Festival ran from around 14 to 25 May 2003 that there was a meeting with Sony in late May 2003 and he came back to the US in late May 2003. He said:

> "certainly Mr Yusef and I met multiple times and discussed both in person and by phone the process of entering into an arrangement - agreement with one of the studios...it focused down on Sony based partly on relationships and partly on the result of discussions with Sony's team as compared to other studios…"

104. Mr Ackerman was questioned on what materials he reviewed before sending the June letter:

(1) He agreed that he referred to 23 films in his letter and said initially that he "would have had the screenplays and there would have been maybe some initial conceptual marketing plans...but the detail of the marketing plans would not have been extensive at that point". When it was put to him that he did not have 23 screenplays in late May, he initially said that he did not recall but he thought (a) "we would certainly have looked at this material", (b) his office "probably has several thousand screenplays" and "it would be not uncommon in the least for that volume of screenplays to be sent to my office....we had a large bank of screenplays in the offices", and (c) "in terms of my other business the flow of reviewing and looking at screenplays in considerable volume is part of Hollywood business". He then said that he did not recall the exact number of screenplays he saw but agreed that he did not see them all and whilst he did not recall the details:

> "I would be looking at quite a lot of films given my profession in any given week...but I know I went through a lot of this material with a sense of certain professional diligence and given my reputation I would not be making a recommendation without having done some thorough research on these materials…I do not remember the full list of all the elements, as I said, that I may have or certainly would have seen."

(2) When questioned as to why he said he "would have" done things as opposed that he did do them, he said he thought this is perhaps a difference between British English and American English, but certainly he was implying in his statement that these things did indeed happen and he believed he did these things albeit he could not fully remember in exact detail 19 years later.

(3) When it was put to him that he recommended rejecting Sony Revolution films not on the basis of how he thought the films would do at the cinema but because he thought the producer involved would block Gala's involvement, he said that the two "are not mutually separable actually": (a) the producer's relationship with a studio would have an impact on the commercial terms of the film (in addition to many other factors) and, (b) from knowing him, he thought the producer may block Gala's active involvement. The producer was a former chairman of Disney, who had taken up a producing role for "Revolution" a relatively new company which had a distribution deal through Sony. He added:

> "I probably in this case would not have read all of these screenplays. However, I certainly would have looked at the synopses and the cast. I would also have had a discussion with Sony about the situation. My research and intel at the time led me to believe that Sony was more committed to its own movies than

to Revolution's movies, even though it was a distributor of those movies....[and that] [the producer] would not welcome the level of involvement that we were looking for....in terms of development of the release plans, marketing assessments and again the dynamic day-to-day business of distribution."

(4) He said that his comment about tracking You Got Served and Breakin' All the Rules was made on the basis of his research and intel. He explained that, at the time (a) Screen Gems was a relatively new division of Sony, (b) Sony had had some fairly poor performance in terms of its overall corporate revenue, and (c) the first place that a studio would look to generally shift its activities would be in its more commercial and more expensive productions. The Screen Gems movies he was concerned about initially were those that he thought might not have the full level of support from the studio that he/Invicta were looking for. However, Screen Gems did have some good traction in terms of word of mouth and there was a positive opinion at the studio on the other films; that is why he recommended that they should be tracked.

(5) He said that in his reference to "tracking" he meant his discussions on a very frequent basis with the Sony marketing team and with various agencies and producers, maybe even other distributors, and his "word of mouth" research as to what people were saying about these films, packages and talent. This included tracking "the star rating of the lead talent involved" as "part of assessing commercial potential is to look carefully at the ups and downs of that particular talent and there is a star rating for that". He added that in his recommendations he had "accurately selected in each case stars, although already famous, who were starting a new ascendancy in terms of commercial appeal" such as Diane Keaton and Jack Nicholson, and that was also the case with certain directors like Tim Burton in the case of Big Fish. He continued that while the tracking data may not be in the bundle, the process and exercise involves "many, many factors that you might call a soft science" which "definitely in terms of reputation" it was necessary to take into account before he would recommend these things to the UK.

(6) It was put to him that even if his diary was 100% clear on returning to the US from Cannes, he had a maximum of a week or 10 days before he sent the June letter and, if he worked 5 days a week for 8 hours a day, he would have only 90 minutes to review each of the 23 films. He said:

"...I would have seen some of these elements probably already in Cannes. Somebody would be marketing certain aspects of these films and would have scripts and promotional material with them already in Cannes...I do not recall the exact details, but we would have gone through a significant amount of material to make this assessment on June 6th…I have in my career watched hundreds of movies in the space of several months' time. So to try to divide that all into 90 minutes is something of a curious task."

(7) When pressed again on the point he said again that he did not recall "exactly which elements" but he "would certainly have looked at a great deal of material on titles that are mentioned in this letter".

(8) He did not agree that it is not a surprise that the letter is as thin as it is, because LBPC still had no contract at this time and the thinness of the letter reflects the fact that there was no contractual obligation to produce it.

105. Mr Ackerman gave the following evidence as regards the nature of his relationship with Invicta in this period:

(1) He confirmed that there was no written contractual relationship between him/LBPC and Invicta before the LBPC Agreement was entered into. He thought

that agreement was under negotiation from mid-October 2003 until it was signed. He agreed that it is clear that LBPC's legal relationship was with Invicta not Gala; he was asked by Invicta to assist them in their trade with Sony in connection with their Gala fund and there was no contract with Gala.

(2) He said that the fact that Invicta paid him an advance of $10,000 in July 2003 created "an unwritten contractual relationship, fiduciary responsibility" whereby he assisted Invicta "on an informal basis as we were leading towards a more formal and contractual relationship" in the procedural affairs as they developed with Sony. He added that it was "very customary in Hollywood and in the motion picture industry for quite a lot of work", whatever area it is in, to be undertaken by both executives and talent prior to a final contract being signed, but with the understanding that a contract is being negotiated and completed. He thought that this was not referred to in his statement "may be an omission" but said that certainly proof of payment could be provided (from a bank statement).

(3) He described the "fiduciary obligation" as "an unspoken obligation" and said that, under US law, there is certainly an obligation to return such a payment if no services are provided. He said it "is a moral obligation" and that the payment was made "on an honourable basis by Invicta trusting" him to assist them in that initial period and he therefore had a "moral responsibility" to do so.

(4) It was put to him that in his statement he referred to acting "in good faith" and he was asked whether that or fiduciary responsibility was the correct description. He said both were involved and summarised the position as being: (a) He did a great deal of work from the middle of July until the contract was signed which he thought provided value "well in excess of the initial token payment of $10,000". Had he not done any work whatsoever, he would have felt a moral obligation to return that money and, if he had not done so, he would have been liable under US law to be sued by Invicta for not rendering services on an informal basis, and (b) there was a clear verbal understanding between him and Mr Yusef that during the autumn of 2003 he would be compensated with a contract prior to the end of the year as soon "as we could get to it and as things were shaping up for both [Invicta] and Gala with the Sony studio negotiations…"

Conclusions

106. We accept that (1) Invicta asked Mr Ackerman to identify which of Sony's films that were due for release in 2003 were likely to have the greatest prospects of commercial success and Invicta decided to pursue further transacting with Sony in relation to those films he recommended, (2) Invicta considered it important that Mr Ackerman was able to access Sony's film files for his further investigations (but not for the asserted reasons, as set out in Part C), (3) Mr Ackerman carried out some degree of an investigation into those films with a view to identifying those he thought were more likely to be commercially successful in terms of the Gross Receipts they would generate, and (4) although he/LBPC were not formally engaged by Invicta at the time he carried out this exercise and he had only limited time to provide an assessment, he carried out this task, as he set out, with some diligence given that he received $10,000 and in reliance on his belief that he would be compensated further under a contract in due course albeit (a) he did not review the screenplays for all 23 films he mentioned in the June letter and it is unclear how many he did review, and (b) he could not remember precisely what documents he did review. Mr Ackerman's evidence on the role he had at this time was consistent and we have no reason to doubt that he undertook an exercise in looking at Sony's slate of films, albeit that it appears it was necessarily a relatively limited exercise given that he did so in a limited time period on the basis of limited information. For the reasons set out in Part C, we do not accept that this activity of itself

this demonstrates that Gala carried out a trade and/or that Invicta/Gala acted "commercially" or "with a view to profit".

Section 4 - Marketing the proposal to investors

Investment Memorandum

Overview of the terms

107. The arrangements were described as follows on the introductory page of the IM:

> "The Invicta Gala Film Fund - a new opportunity which combines film distribution with print and advertising expenditure with the potential to earn profits over the medium term, whilst allowing individual partners to mitigate any potential losses by the application of tax reliefs.
>
> The Invicta Gala Film Fund brings together the proven film industry contracts and expertise of [Invicta], the limited liability partnership structure and the tax advisory services of Stellar Financial Partners Ltd."

108. In the first section, the IM set out that "the Partnership provides an opportunity for individuals to participate in a film distribution LLP established and trading in the UK" and gave details of the structure and funding arrangements. On the first page it was stated that:

> "To the extent that the scale of the Partnership's minimum P&A Expenditure generates a loss in the Partnership's first year of trading, the loss may be mitigated by the application of tax reliefs available to Partners under Section 380 and Section 381."

109. On the second page, under a heading "Taxation" the following was set out:

> "Under current tax legislation, the Partnership will be able to write off the expenditure incurred directly in connection with the Partnership's exploitation of any Portfolio, together with the Partnership's operational expenditure (including the fees and expenses paid to Invicta, the Placing Agent and the Operator). In the event that the Partnership incurs a trading loss in relation to a Portfolio in the year of the P&A Expenditure on that Portfolio that trading loss can be set off in a variety of ways by each Partner whose capital contribution has been utilised in the exploitation of that Portfolio in accordance with his or her Partnership share, as described on page…Note that any interest paid on a loan taken out by a Partner to fund any part of his capital contribution to the Partnership can only be relieved against income or gains of the year in which that interest is paid.
>
> Profits may be generated in future years by the Partnership, and each Partner will be responsible for timely payment of tax on his or her share of those profits.
>
> Any trading losses incurred by the Partnership may be mitigated by the reliefs granted under Section 380 and Section 381. Please refer to the risk factors on pages…If you are in any doubt about whether investing in the Partnership is a suitable investment for you, you should contact your Independent financial adviser for advice."

110. The transaction was then set out in detail:

(1) In the detailed description of the structure it was stated that:

> "The Partnership will provide the opportunity for Partners to acquire the Distribution Rights to Films from the Studio and through the Partnership to trade in the exploitation of those Distribution Rights with a view to profit."

(2) The proposed transactions were described in broad terms that accord with the actual terms of the deal with Sony and details were given of the financing arrangements, the shortfall guarantee and related LC and the Call Option. However, no studio was named and it was made clear that the terms of a deal were still to be negotiated and no details were given of the waterfall. It was stated that "the Agent Distributor will receive a distribution fee from profits to be negotiated at arm's length" and "thereafter all profits after the deduction of

participations, for example actor's profit share and third party expenses, will be shared between the Partnership and the Agent Distributor in a ratio to be negotiated with the studio on an arm's length basis". Mr Yusef said that, at this point, Invicta were in advanced negotiations with Sony but had yet to finalise all of the details with them so that Sony was not mentioned in the IM.

(3) The description included that (a) Gala "may determine (such decision requiring a 75% majority of Partners) to acquire further Portfolios in the future" and Gala "will be entitled to "cherry pick" those Films to be included within the Portfolio from the Studio's production slate of Films for the year in question and to choose the Films based on advice received from Invicta under the [MSA]", (b) the licence fees would be funded by Gala's borrowings and the members' contributions would be used to fund "the P&A Expenditure and to pay the advisory and administration fees of the Placing Agent, the Operator and Invicta", and (iii) all income from the distribution of the relevant films "(after deduction of costs and expenses as set out above) will be apportioned among the Partners pro rata to their respective capital contributions applied to the P&A Expenditure" for the relevant films, and (iv) the Minimum Sums would be applied, in the first instance, towards the repayment of a member's loan and the interest accrued thereon.

(4) In the detailed description of the structure there was also reference to the fact that the incurring of "the P&A Expenditure may result in the accounts of the Partnership for the first accounting period showing a loss" which may be mitigated by each member claiming loss relief under s 380 or s 381. It was noted, that Gala "should expect however to show taxable profits in subsequent accounting years" in relation to the relevant films and that those taxable profits in the hands of the individual members may be offset against interest payable on any loan taken out to fund his capital contribution.

111. The next section dealt with the tax consequences of participation in Gala.

(1) It was stated that:

> "…the Partnership will trade in the acquisition and exploitation of Distribution Rights in a number of Films. The Minimum Royalty Payments over the term of the Distribution Agreement should ensure that the Partnership is trading profitably over its lifetime but, given the amount of the Partnership's capital that it is anticipated will be spent on P&A Expenditure…the Partnership is expected to incur a trading loss in its first accounting period to 5th April 2004."

As explained below, the financial illustrations included in the IM make it clear that (a) the Minimum Sums were calculated to produce a small profit for Gala over the 8 year term of the DA, but (b) (i) if Gala received only those sums, a member would make a substantial loss in terms of his own return, and (ii) otherwise, a member would make a positive cash return only if the Call Option was exercised and/or Gala received very substantial Gross Receipts of a level which, as set out in section 11, we consider Gala had no realistic prospect of receiving under the terms of the waterfall.

(2) There was then a detailed description of how any such loss could be relieved by members. It was noted that (a) "After the first accounting period, the Partnership should be making a profit (on a Schedule D/I basis), due to its share of net profits from the exploitation of the Films or from the Minimum Royalty Payments that are due. Partners will be subject to income tax on the profits arising within the Partnership" and a description was given of the tax position, and (b) the price paid by the Studio on exercise of its Call Option would constitute a

capital receipt in the hands of the members and would be taxed at an effective rate of 10%.

112. There was a section setting out details of the terms of the MA, OA, MSA and Placing Agent Agreement. In a section on advisers, (1) details are given of Invicta and the background of Mr Bamford and Mr Yusef, (2) Chiltern is described as having been appointed to act as operator and placing agent, and (3) Stellar Financial Partners Ltd ("**SFP**") is described as "one of the most experienced tax advisers specialising in film sale and lease back schemes" and the scope of its work was stated to include:

> "to identify areas which may make the participation in the Partnership less attractive, *particularly where other tax shelter products may already have been implemented*". (Emphasis added.)

113. The section on risks for members include statements that (1) the Gala opportunity "is more likely to suit higher rate taxpayers with sufficient income and/or capital gains to absorb their share of the initial trading losses, and may not be suitable for other investors", (2) although Gala "will be trading with a view to profit, profits in the film industry are very speculative and there can be no guarantee" that its investment in a portfolio will result in a profit, (3) the studio gives no representation or warranty that profits will be received by Gala or any representation or warranty as to the nature and level of profits that may arise from this transaction, (4) there is a "remote risk that the financial institution" supplying the letter of credit may become insolvent, and (5) a detailed description of the risks relating to the availability and ability of the members to use the losses.

114. Included with the IM were notes of conferences with tax counsel on 6 March 2003 and 14 May 2003.

Scenarios in the IM

115. The IM contained 3 sets of illustrations of the potential financial impact of the Gala arrangements for Gala and its members. These show the net cashflow position for Gala and a member for each specified year ending on 5 April on the main assumptions that (1) the member contributes £1 million to Gala, of which £224,600 is funded from his own resources and the remainder by SG loan, (2) Gala borrows £135,000 from SG which is used to fund a licence fee of that amount, (3) interest is due on the SG loans at a fixed rate of 4.6 % per annum which is paid annually and is deductible from royalty income when computing profits and losses for tax purposes, and (4) the member pays higher rate income tax rate of 40% for each of the years and is fully able to make use of the tax reliefs available.

Scenario 1: This illustrates the position on the basis that the arrangements run their 8-year course and Gala receives only the Minimum Sums. Gala makes a small profit of £42,913 from the guaranteed payments alone (computed as the total distribution income less the total expenditure including interest costs), whereas the member makes a loss of £188,760:

Gala's position	2004	2005	2006 to 2011	2012	2013
Balance b/f	0	0	0	0	0
Capital received	1,000,000				
Bank Loan received	135,000				
Distribution Income		41,764	251,385	931,339	
Repayment of SG Loan				-135,000	
Interest on loan		-6,193	-37,277	-3,105	
Acquisition of [Rights]	-135,000				
[Initial Expenditure]	- 917,522				
Other expenses	- 82,478				

Distribution to Partner		-35,571	-214,108	-793,234	
Net cash c/f	0	0	0	0	0

Partner's Cash flow	2004	2005	2006 to 2011	2012	2013
Balance b/f	0	-224,600	175,400	175,400	175,400
Capital subscribed	-1,000,000				
Partner's Loan	775,400				
Distribution from Gala		35,571	214,108	793,234	
Repayment of Loan				-775,400	
Interest on Partner's Loan		-35,571	-214,108	-17,834	
Tax Relief (payable)		400,000			364,160
Net cash c/f	-224,600	175,400	175,400	175,400	**-188,760**

Scenario 2: This illustrates the position if (i) the Call Option is exercised on 30 November 2005 and (ii) Gala receives the Minimum Sums payable prior to that date and an option price of the same amount as the Minimum Amount. Gala makes a loss in cash terms of £144,863 and the member makes a cash profit of £102,388.

Gala's position	2004	2005	2006	2007
Balance brought forward	0	0	0	0
Capital received	1,000,000			
Bank Loan received	135,000			
Distribution Income		41,764	42,108	
Capital receipt			919,212	
Repayment of SG Loan			-135,000	
Interest on loan		-6,193	-6,754	
Acquisition of [Rights]	-135,000			
[Initial Expenditure]	-917,522			
Other expenses	-82,478			
Distribution to Partner		-35,571	- 819,566	
Net cash carried forward	0	0	0	0

Partner's Cash flow	2004	2005	2006	2007
Balance brought forward	0	-224,600	175,400	180,771
Capital subscribed	-1,000,000			
Partner's Loan	775,400			
Repayment of Loan			-775,400	
Distribution from Gala		35,571	819,566	
Interest on Partner's Loan		-35,571	- 38,795	
Tax Relief(payable)		400,000		1,377
CGT payable				-79,760
Net cash c/f	-224,600	175,400	180,771	**102,388**

Scenario 3: This illustrates the position to 5 April 2007 if Gala receives a Minimum Sum in the year 2004/05 and royalty income of £1.5 million in 2005/06 (32.16% more that the total capital contribution of £1 million and loan to Gala of £135,000). In that case the member makes a cash profit of £139,735.

Gala's position	2004	2005	2006	2007
Balance b/f	0	0	0	0
Capital received	1,000,000			

Bank Loan received	135,000			
Distribution Income		41,764	1,500,000	
Repayment of SG Loan			-135,000	
Interest on loan		-6,193	-6,244	
Acquisition of [Rights]	-135,000			
[Initial Expenditure]	-917,522			
Other expenses	-82,478			
Distribution to Partner		-35,571	- 1,358,756	
Net cash c/f	0	0	0	0

Partner's Cash flow	2004	2005	2006	2007
Balance b/f	0	-224,600	175,400	722,892
Capital subscribed	-1,000,000			
Partner's Loan	775,400			
Repayment of Loan			-775,400	
Distribution from Gala		35,571	1,358,756	
Interest on Partner's Loan		-35,571	-35,864	
Tax Relief (payable)		400,000		- 583,157
Net cash carried forward	-224,600	175,400	722,892	**139,735**

Comments on the IM

116. In our view, a reasonably sophisticated potential investor of the kind who Mr Yusef said the Gala proposal was aimed at (see [125]), on reading the IM, would conclude from its overall tenor and the scenarios, that the arrangements described in it provide an investor with (1) the opportunity to make a return from an investment in selected films due to tax relief alone, subject to the risks associated with obtaining the relief, on the basis that the Call Option would be exercised as shown in scenario 2, combined with (2) the speculative possibility of making a larger return by the time the Call Option was exercised, depending on the success of the films chosen and the terms concluded with the studio, in particular, as regards the share Gala would receive from Gross Receipts from the relevant films. We consider that overall their evidence demonstrates that, broadly, this is how the Referrers viewed the Gala proposal (see sections 5, 7 and 13).

117. Mr Yusef and all of the Referrers referred to the tax benefit as providing "tax mitigation" and "downside protection". The Referrers said that, if their investment in Gala was unsuccessful, the loss would provide a form of tax mitigation. However, as the scenarios demonstrate, this is an over-simplified and inaccurate description of how the structure worked from the perspective of the members in economic and tax terms.

118. In each scenario:

(1) A member who makes a capital contribution to Gala of £1 million, comprising an SG loan of £775,400 and a cash contribution of £224,600, receives a tax repayment of £400,000 roughly within a year of making his investment.

(2) This cash tax repayment arises, so Gala says and as shown in the scenarios, because (a) in the tax year 2003/04 a loss of £1 million arises to Gala comprising £917,522 of Initial Expenditure and £82,478 of other expenses, which it is asserted were incurred by Gala in the course of a trade, and (ii) that loss can be shared amongst the members.

(3) The member is shown as being in a positive cash position from the outset as (a) the amount of the tax refund of £400,000 exceeds the amount of the member's cash contribution of £224,6000 by £175,400, and (b) in effect, as the

scenarios go on to illustrate, arrangements were in place to secure (so far as possible) that both the member's SG loan of £775,400 and Gala's loan of £135,000 and interest on them would be repaid.

119. As the scenarios illustrate, the principal amount of the member's SG loan (of £775,400) and Gala's SG loan (of £135,000) and in each case interest due on those sums are paid from (a) the Minimum Sums or (b) a combination of those sums and the option price, if the Call Option is exercised. Hence, in the scenarios, Gala is shown as (1) meeting its SG loan costs from the Minimum Sums and/or Call Option price (as the case may be) and (ii) making a distribution to the member of the remainder of those sums, which suffices for the member correspondingly to pay his SG loan costs.

120. We note that (1) under the security arrangements, in effect, the Minimum Sums/option price were to be met from the Deposit which SPR made with Barclays in order to ensure that it would issue the LC, and (2) that SPR would procure the issue of the LC to Gala was a condition for Gala's obligations under the DA to take effect. It is readily apparent, therefore, that the Initial Expenditure/principal of the SG loans, plus interest on the loans, was to be repaid from funds which, in effect, SPR was required to deposit with Barclays on closing of the transactions in order for the transactions to proceed (see also section 10).

121. The scenarios show that (1), in economic terms, in each case, the member is in a neutral position as regards the arrangements for the payment of the principal and interest on his SG loan; the distributions received from Gala match or exceed the interest and loan repayment, but (2) the member is subject to a tax charge on the sum paid to meet the principal of his SG loan in the form of (a) a substantial income tax charge, where, in scenario 1, that payment is funded by the Minimum Amount, and (b) a much reduced CGT charge, where, in scenario 2, that payment is funded by the Call Option price.

122. In scenario 1, where the arrangements remain in place for the 8-year term of the DA and Gala receives only the Minimum Sums and Gala makes a small overall profit:

(1) The distributions the member receives from Gala during the term (of an amount equal to the Minimum Sums less interest payable by Gala on its SG loan) match the interest due on the member's SG loan.

(2) The distribution the member receives at the end of the term of £793, 234 (an amount equal to the Minimum Amount less the amount retained by Gala to meet interest and the principal due on its SG loan) matches interest and principal due on the member's SG loan. However, this distribution is subject to income tax of £364,160. The member, therefore, makes an overall loss of £188,760 (£364,160 less £175,400 remaining of the tax refund carried forward).

(3) In effect, therefore, the benefit of the initial tax refund of £175,400 remaining after set-off against the member's cash contribution is wiped out in full and, in fact, there is an excess tax charge for the member of £188,760.

123. In scenario 2, where the Call Option is exercised in year 3 and prior to that Gala receives only the relevant Minimum Sums and Gala makes a loss:

(1) The distribution the member receives from Gala prior to the exercise of the Call Option (of an amount equal to the Minimum Sums paid to Gala less interest payable by Gala on its SG loan) matches the interest due on the member's SG loan.

(2) The distribution of £819,566 which Gala makes to the member when the Call Option is exercised (the price paid on exercise of £919,212 less the amount retained by Gala to meet interest and the principal due on its Gala loan) is more than sufficient to meet the interest and principal due on the member's SG loan.

(3) In this case, this final distribution is subject to a much lower CGT charge than the income tax charge due on the distribution made from the Minimum Amount under scenario 1. The much lower tax charge means that the member retains the benefit of a large portion of the initial tax refund; a sum of £102,388.

124. In scenario 3, where Gala receives additional income from the Gross Receipts from the relevant films of £1.5 million in 2006:

(1) The position is essentially the same as regards the distributions the member receives from the Minimum Sums.

(2) However, due to the receipts under the waterfall, the member receives a distribution from Gala of £1,358,756 (£1.5 million less the sum required to repay Gala's SG loan and interest).

(3) The tax due on the distribution is £583,157 and the member receives an overall cash benefit of £139,735 – around £37,000 more than the return the member receives in scenario 2.

125. It is readily apparent from the scenarios, therefore, that a member would not make an overall positive cash return from his investment in Gala unless (a) the Call Option were to be exercised before the expiry of the term of the DA (with the precise position depending on when that occurred), and/or (b) Gala were to receive very substantial amounts as Gross Receipts under the waterfall. The IM provided a prospective investor with no means of assessing whether Gala had any realistic prospect of receiving a share of Gross Receipts and of the likely level of any such share. Whilst investors are informed that Gala would be able to select the relevant films based on advice from Invicta there are no details of the intended terms of the waterfall which are plainly critical to any such assessment. The term sheet with Sony contains details of the proposed terms of the waterfall and was signed on 5 November 2003 but Invicta/Gala did not provide investors with this and did not provide details of the finalised terms until at most 2 to 2.5 days before the meetings at which investors were admitted as members of Gala and the transactions were approved. This indicates that whether Gala would receive a share of Gross Receipts and the likely level of any such share was a secondary consideration to the availability of the loss and the tax benefit. We note that, as both Mr Yusef and the Referrers emphasised, they/an investor could not "know" that the Call Option would be exercised at an early stage, given whether to exercise was solely within Sony's control. However, as set out in section 15, we consider that it is plain from the design and nature of the arrangements that they were intended to have run their course by the end of the 2003/04 tax year, and it was inevitable that Sony would exercise the Call Option at an early stage. In our view, a reasonable investor, with a serious interest in whether and how he would make a return from his investment in Gala, would realise from the details of the structure provided at least that there was a real likelihood of Sony doing so; indeed, we consider that is inherent in the very existence of the Call Option and the early first exercise date.

Marketing to investors

Evidence of Mr Yusef

126. In June, July and August 2003 Invicta set about finding investors. Mr Yusef said the following in his witness statement about this process:

(1) The aim was to demonstrate that it was possible to make money from film distribution, while at the same providing "downside protection in the form of tax mitigation". It was clear from the market research that "there was appetite in the market for a proper trading opportunity, as opposed to those structures that simply offered a tax advantage such as sale and leaseback".

(2) Invicta pulled together the IM "to provide as much of the high-level information that prospective members (or their financial advisors) would need to consider the proposal and its suitability for them". Invicta looked for HNWIs that could "assess the opportunity on its merits and raise significant sums of money" and who "we thought might be able to take part in more than one transaction in the years that followed, once they were comfortable with what we were seeking to achieve".

(3) Invicta placed the proposal to investors primarily through its own extensive network of contacts in the financial advisory sector but also through SFP who also had such a network. Invicta "went through an extensive due diligence process meeting with the professional advisors to ensure that they understood the product and were only offering it to the right type of individual" and throughout June, July and into August 2003 met with individuals from, amongst others, HSBC, Coutts, UBS and Barclays and with numerous independent financial advisers ("**IFAs**"). Following the meetings, UBS prepared a power point presentation for potential investors based on the IM.

(4) Mr Yusef was very keen "to personally interview prospective members to satisfy myself that they understood the difference between the Gala transaction, which was an active trade taking place with Sony" that "could be profitable within a 2-to-5-year timespan, and the sale and leaseback arrangements that Invicta had promoted in order for clients to achieve a tax deferral". He probably met around 75% of them before they participated, to ascertain their financial objectives and their understanding of the trade. A representative or representatives from SFP was typically in attendance and supported the pitch at these meetings, and at the earlier meetings with IFAs.

(5) Prospective members were asked: (a) to sign and to return to Gala a number of preliminary documents to indicate their intention to participate, and (b) to send a cheque for the level of capital that they wished to invest. The intention was (i) for Gala to hold the forms and funds whilst the finer details of the arrangement were finalised and the film documentation and advice on the likelihood of commercial success was received, and (ii) for this information to be sent to prospective members before closing for them to make an informed final decision on whether to participate.

(6) One of the main reasons he believes that securing a tax advantage was not the only or main motivation of the prospective members of Gala is that they could have achieved this by joining the numerous sale and leaseback LLPs that were promoted by Invicta since 2001. In Mr Yusef's view, from discussions with a significant number of them:

> "the members (including myself), wanted to make money from their participation in Gala, and it is my firm belief that they weren't solely interested in deferring tax. Certainly, that was not my intention with my participation...."

(7) Mr Iain Thacker, Mr Alan Laing and Mr William Cadogan, with their financial advisor Mr Doug Pritchard, "took a very keen interest in wanting to understand the arrangement and to be very much involved in the operation of Gala and guiding its course (which of course we were pleased with as that was precisely the type of individual we wanted on board)":

(a) There were a series of meetings with those individuals during which "we described Gala and its mechanics and the various steps that we were taking so as to satisfy ourselves that the opportunity would be a commercial success".

(b) Given the up-front capital that they were to put in from their own resources and the fully recourse loan they were to take out, the prospective members wanted to test the downside protection aspect of the arrangement to comfort themselves that, if the Gala transaction was not a commercial success, there would be a "tax mitigation element available".

(c) Hence it was agreed that Gala would instruct a different leading tax counsel to provide a third opinion. On 5 September 2003, an initial conference took place with Mr Nicholas Warren QC, which was attended by the relevant individuals and Mr Cadogan's tax advisor, representatives from Denton Wilde Sapte, and Mr Yusef and Mr Bamford. Two further follow up conferences took place on 10 and 22 September 2003 which were attended only by those from Denton Wilde Sapte and Mr Bamford and Mr Yusef. It appears from the note of the conference dated 30 September 2003 that Counsel confirmed that the Gala proposal should satisfy the requirements in ICTA for loss relief claims to be successful.

127. The bundles also contained the presentation prepared and given by UBS, which Mr Yusef referred to:

(1) In the section on "background", it is stated that until recently studios were able to write off distribution expenses over an extended period but accounting standards have changed so that all of these costs are now to be recognised immediately, and as a consequence, studios have been considering ways of outsourcing these costs.

(2) The "key features" are stated in bullet point form to be: opportunity to participate in the acquisition and distribution of major Hollywood films from Sony, ability to shelter current and earlier year's liabilities, not dependent on existing tax breaks offered to filmmakers, predicated on general accounting principles, no 15 year reversal of the tax relief generated on any losses that may be made, and minimum gross investment of £1 million.

(3) Under a heading "structure", the "key" features set out include (a) reference to (i) the split between cash contributions and SG loans, (ii) the fact that profits were to be shared 30/70 between Gala and the studio respectively, (iii) details of the option, (iv) the 91.5 and 13.5 figures, and (v) the shortfall guarantee and LC, and (b) statements that (i) gains arising on the studio exercising its call option would be liable to CGT and should benefit from business asset taper relief, (ii) the distribution spend would generate an initial loss to the LLP, and (iii) the LLP would engage a distribution company and make the films acquired from the studio available for distribution and only those films judged to be commercially viable by the LLP would be included.

(4) UBS also set out (a) the tax planning opportunities as regards ss 380 and 381 ICTA, (b) a member's cashflow, which shows an immediate cash repayment to a member due to tax relief, with a note that cash flows thereafter are dependent upon the studio exercising its call option and the profits generated from the distribution of the films, (c) risks, which are largely tax risks, and (d) under a heading "suitability", reference to clients with significant UK income or gains taxable at 40%, clients with sufficient cash to invest or ability to borrow and non-domiciled clients who do not want to commit to 15 year term of sale and leaseback structures, and (e) scenarios 1 to 3.

128. Mr Mallett and Mr Lewis were both introduced to the Gala arrangement by Ms Challons, who was responsible for Wealth and Tax Advisory within HSBC Republic (UK) Limited (which changed its name to HSBC Private Bank in 2004). The bundles

contained letters from her to Mr Mallett and Mr Lewis dated 4 July 2003 and 12 September 2003 respectively framed in similar terms. Taking the letter to Mr Mallett by way of example, Ms Challons made the following main points:

(1) She gave an overview of the Gala proposal as follows:

> "Under this arrangement print and advertising expenditure and film distribution are combined to generate trading profits over the medium term whilst allowing individual partners to benefit from the same loss reliefs as those afforded by vanilla sale and leaseback arrangements.
>
> When a major studio film is made the costs of production are often matched or exceeded by the costs of distribution which includes printing and advertising costs.
>
> Until recently the major US studios were able-to write these costs off over an extended period. The accounting Standards have now been changed to the extent that all of these costs are now to be recognised immediately. As a consequence US studios have been considering ways of outsourcing these P&A costs in order to remove the Profit & Loss Account hit on their balance sheet."

(2) She set out details of the structure including of (a) the Call Option, which she described as giving Sony "an unfettered right that has no performance criteria or trigger", and (b) the Minimum Sums and security arrangements. She noted the following:

> "…Not all films offered to the LLP will be accepted or necessarily passed on for distribution. Only those films judged to be commercially viable will be included. This decision will be made by a team of analysts employed by the LLP, based in Los Angeles.
>
> As part of the agreement to distribute the films on behalf of the LLP the LLP will make approximately 90% of its working capital available to the distribution company to undertake the printing and advertising of the films that have been chosen. In return for making these funds available the LLP will receive 30% of any profits generated from the distribution of the films and 70% will be paid to the distributor…
>
> The L/C is a bank guarantee, with embedded triggers - so in effect you are relying on a bank guarantee from a bank with an external Credit rating of AA- or better…
>
> The risk therefore of the loans remaining unpaid is that the bank(s) issuing the standby Letter of Credit is unable to meet its obligations…."

(3) She noted that Gala would have the option to select the films to acquire and the intention was to acquire 5 to 7 films amongst which are 2 major blockbusters subject to release dates: Spider Man II and Terminator III.

(4) Under a heading "Taxation" she made the following main points:

(a) It was anticipated that Gala "will make a loss in its first year of trading because of the level of expenditure required to undertake the print and advertising of the chosen films" and Gala was "to be structured and operated in such a way as to allow members…to benefit from the tax relief for losses available" under ss 380 and 381 ICTA (and she described how the loss could be relieved under those provisions). If the studio called for the rights to be sold back "any gains arising on this disposal will benefit from Business Asset taper relief and will therefore be taxed at only 10%".

(b) Scenarios of the cash flow projections are detailed in the IM. She gave a brief description of the assumptions on which each scenario is based and noted that if the studio did not exercise its option as under scenario 1 the distribution would be treated as an income tax liability in year 8 and a loss would be created due to the income tax liability.

(c) Gala is predicated entirely on general accountancy principles and is not dependent on existing tax breaks offered to film makers.

(5) Under a heading "Loss Relief Claim", she set out the following:

(a) Members had to make a minimum contribution of £1 million financed by (a) an initial cash contribution of 22.46% which could either be financed by cash or borrowing. Interest on any loan should qualify for income, tax relief against UK earnings whilst Mr Mallett had an interest in Gala, with (b) the balance (77.54%) of investment to be covered by a loan repayable at the earlier of (i) the date Sony exercised its call option or (ii) the stand by letter of credit being called in to repay the loan in year 8. Gala would raise a non-recourse loan equal to 13.5.% of the contributions to acquire the distribution rights of the films.

(b) An example illustrating the estimated cash flow position in year 1 "assuming that you wish to shelter £1m income in 2003/04" which she said is similar to that of sale and leaseback in year 1. This showed that Mr Mallett's cash contribution of £224,600 would give a "Cash advantage year 1" of £175,400 as a result of a tax refund of £400,000.

(c) At the end of year 2, if Sony exercised its option, the gain should be liable to CGT at 10%, examples of the cash flow position are illustrated in the IM, and if Mr Mallett had capital losses, "such as Mansworth and Jelly losses", he could utilise them to reduce any capital gains that may arise on the disposal. She gave details of when and how a claim for relief for the loss could be claimed.

(6) Under a heading "Risks" she said that the main area of risks are described in the IM and then summarised them as follows:

(a) Trading:

> "This is central to the arrangements if the members are to be able to claim the relief's referred to above. Counsel was of the opinion that the structure, provided it is implemented in full would be regarded as trading since:
>
> Only those films that, after analysis, were expected to be profitable would be acquired by the members, and if, as predicted, the films were successful the members would benefit from a 30% share of any distribution profits made.
>
> - The LLP could top up the fund if required.
> - Members had placed a substantial amount of risk capital into the venture by way of cash and full recourse loan.
> - The acquisition and marketing of the films are acknowledged commercial activities.
> - The infrastructure of the transaction will be such that full business records will be kept and made available for inspection by the Inland Revenue if required."

(b) Ramsay/Furniss v Dawson Risk:

> "This is unlikely since the structure appears to be designed to operate on strict commercial grounds with all commercial activities documented within the business records.
>
> As previously stated the LLP will have the option to cherry pick the films it intends to acquire; the studio has no say in this decision.
>
> There are no artificial steps inserted to create a tax advantage.
>
> There is no pre-arranged exit. The studio may have the right to call for the return of the rights from the LLP but:
>
> - There is no absolute certainty that the studio will exercise the option; and

- It can only do so by paying a commercially computed price."

(c) Security:

"If Sony goes into liquidation and the Bank providing the stand by letter of credit defaults then the full recourse loan (77.54% of the participation) would revert to the partner. This is similar to the arrangement -under Sale & Leaseback."

(d) Other risks were listed as (i) these arrangements may be challenged by HMRC and Invicta had appointed Steve Bold to defend the position, (ii) it is an illiquid investment and anyone moving abroad prior to the disposal of their interest in Gala would need to check the tax position in the new jurisdiction as it may be less favourable than the UK's, (iii) the taxation treatment described is based on current tax legislation and if the rules change this may affect the tax treatment of a partner's participation, and (iv) if Sony did not exercise the option in year 8 the repayment of the loan would, under current legislation, trigger an income tax charge. She also set out details of a member's liability as a member of Gala, as an LLP and according to the terms of the MA.

(7) HSBC Republic Bank (UK) Ltd will be remunerated by an introducer's fee and Mr Mallett will therefore not be asked to pay any fees.

(8) A loss arising from The Gala Film Fund could be set against Mr Mallett's income from 2000/01 to 2002/03 but his income in 2001/02 "has been largely utilised by the losses arising from your participation in the Castle Film Partnership" and given the level of his income in 2000/01 "it would be more beneficial for any loss claim to be offset against your income in 2002/03 as we could relieve the income which is subject to higher rate tax". She asked for confirmation of his earnings in 2002/3 and estimated earnings for 2003/04. Based on a partnership contribution of £1,000,0.00 which would be relievable at 40%:

"Estimated initial refund £400,000

Initial cash or loan contribution at 22:46% £224,600

Estimated cash advantage in year £175,400"

(9) She concluded that:

"The Gala Fund is a tax efficient product that offers additional benefits over and above: those provided by sale and leaseback film partnerships. Unlike other products in the market it carries no production risk."

(10) She enclosed an IM, the MA, an Instruction and Application pack, a loan agreement, an admission form, a copy of the "robust" counsel's opinion, a letter from SG regarding the standby letter of credit and the CV of Mr Bold, tax adviser to Gala.

129. We consider that an investor of reasonable sophistication of the type who Mr Yusef said the Gala proposal was aimed at would interpret the UBS document and the letters from Ms Challons in much the same way as such an investor would interpret the IM (see [125]). We note that, whilst the investor is informed in these documents that there will be a 30/70 profit split, the investor is not given sufficient information to work out if that would be likely to generate a positive return for him/Gala. As set out in section 11, this was not in fact the profit split under the waterfall.

130. By the end of October 2003, 23 individuals had signed up to invest in Gala and had paid contributions of approximately £13.8 million. Mr Yusef noted that they were not committed at this point. He said that by the time the IM was issued, "he was fairly well advanced and quite confident of doing the deal with Sony"; it would be illogical to have done this unless he thought that there was a 90% chance of doing the deal with Sony. He agreed that the IM was a key document to attracting members and that it does

not contain details of the studio, the films or the profit share. He said all of that would have been dealt with at the meetings of Gala when prospective investors became members. They were then asked to consider the films that were available, the terms of the DA and profitability by virtue of the HL letters. In his view, that was the appropriate time for people to determine whether they wanted to move forward, once Invicta had established which studio Gala was to deal with and the terms of the deal. He agreed that when the term sheet was signed on 5 November 2003 no investor would have had it and all they would have had to go on is the IM. We note our comments at [125] (and see sections 7 and 13 as regards the evidence of the Referrers).

131. As regards the UBS presentation:

(1) Mr Yusef did not agree that this shows that it was inevitable that the Call Option would be exercised. He thought that UBS were setting out the tax position *if* the option was exercised and noted that "we were never in position to call for the option to be exercised".

(2) He agreed that in fact there was no 30/70 split of profits and said that he explained to UBS at the time, "that was a structure that we were aiming for but it turned out that in the negotiations that's not what we got". We note that it appears that Mr Yusef/Invicta did not expressly inform investors of the actual ratio for sharing Gross Receipts. They were provided with the means to find that out at most only 2 to 2.5 days before the transactions were approved, when they received the transaction documents.

(3) He said:

> "we were not looking for someone with significant income or gains, taxable at 40%, who wished to have the ability to shelter current and earlier year tax liabilities. This is UBS' targeting of people who they thought would find the downside protection that we were offering useful. What we were looking for were people who had the wealth and the appetite to get involved with the film trade, other than something that they were probably used to, which is sale and leaseback…UBS has been approached to invite their customer base to look at our structure. I didn't prepare this [presentation]. Nobody in our office prepared this document. They then went out there and harvested their database, and then in many instances we then met with these people to explain what was happening in terms of the actual trade, the actual business of Gala. This doesn't even deal with the business of Gala."

(4) He added that this was a client gathering exercise, but it would not begin and end with this presentation. After this process was finished, Invicta would meet with the vast majority of suitable individuals (at Invicta's or UBS's offices) and would explain:

> "not just this is all about tax and downside protection. There is more to this structure...as is reflected in my witness statement, and that would be what we would be looking to ensure that the prospective members understood."

(5) It was put to him that UBS put tax at the centre of their marketing material. He said they had to do that, because they had to explain to their customers what the tax consequences of the transactions would be. However:

> "At the presentations I was certainly involved in UBS and other institutions, my emphasis was more on what the transactions involved and what we would be doing in terms of participating in the film trade. Obviously, it did in turn also involve me having to explain the tax consequences, but I did in every single instance explain to people that the tax treatment was not the driver. They obviously had to qualify for that in order to get the downside protection, but that shouldn't be the driver. There were other ways for these people to get involved in tax mitigation or tax deferral…as I say their objective was to

explain to their clients what the consequences of the transaction would be. It wasn't their job, nor were they qualified to talk about the film side of the business, which was the trade that these people were entered into. That was my job."

(6) In re-examination, he emphasised that the UBS analysis was not prepared by Invicta and did not represent "the way in which we pitch or try to explain the way the transaction worked". Invicta would talk about the tax element of it, but in terms of downside protection rather than "this is the reason why you should do this deal". He was quite certain Invicta would not have pitched it in that way:

> "We would have explained in detail how, because it was relevant to the concern that some people would have at the time. It was important to distinguish what we were trying to do here from what they were used to, which is sale and leaseback type of transactions. It was, therefore, important to explain to them that this was intended as a trade. There was a profit motive. There was an element of risk but that the risk would be mitigated in this way."

132. He later reiterated that Invicta and the members were interested in profit and the members could have achieved the tax mitigation in a variety of different ways. Rather the "desire to get involved in a trade of film distribution was a guiding factor...I believe that we were in pursuit of a commercial transaction". He added that he was interested in the slate and the slate making a profit and otherwise he would not have engaged HL or gone through many of the other steps. He emphasised again that he thought this had "the potential to go way beyond this situation and get to a position where investors could invest in the film industry, with a level of comfort and familiarity" so they did not need a downside protection. That was his own personal aim. It was not just to do a tax deal:

> "We could have done that elsewhere, in a different way. I wanted to build a company similar to the Silver Screen project...This was the beginning of what I hoped would be that case. So, my ambitions on a personal level went way beyond this phase of the transaction."

133. Mr Yusef was taken to the scenarios:

(1) It was put to him that scenario 2 demonstrates that a member makes a significant positive return (and Invicta, Sony and SG, also all get all of their fees) without the need for a single cinema ticket to be sold and for Gala to receive anything under the waterfall. He agreed that everybody would have been paid and that an inherent and significant element of the model from the outset was that a member would receive a guaranteed positive return come what may. He said that he did not believe the members went into this transaction for that purpose as they "could have achieved that a different way without as much bother":

> "…they could have achieved somewhere close to that by doing a deferred tax arrangement, for example, or some other tax things that were available at the time. They didn't need to do this to achieve that. That wasn't the sole driver. That was a mitigant to what they would otherwise consider to be a high-risk transaction."

(2) When it was put it to him that this just sounds too good to be true, he said that he thought that:

> "if it was too good to be true in terms of the overall…objective, I don't think 65 people would put their money into it…If this was credible, the objective of entering into the film business at a high level was also credible and I think this set of people were minded to enter into the film business in a sensible way. I have already said what my motivations or what everybody else's motivations were in the witness statement. It wasn't simply to make tax work. That wasn't the primary objective. We achieved that differently."

(3) It was put to him that this is an absolutely whopping return and it was all about the tax. He said:

> "I intended to participate in this so that we could be involved, as I say, in a sensible position, in a sensible way in film distribution. I had visions that...this phase would be one of many phases. Each time the phases would be slightly different, but essentially the idea is to be involved in film distribution for quite some time. That's why I did it…No, it wasn't all about the tax. We could have achieved that without going through all the bits and pieces at various stages in the transaction…if it was just all about tax, we could have achieved that without doing this."

134. Mr Yusef agreed that, for scenario 3 to come to pass in the real world, one would need over 115 million to come into Gala in Gross Receipts in 2 years. It was put to him that what scenario 3 envisages is totally fantastical and in fact not a penny came into Gala. He said monies did come in; the receipts that came at the end when the "minimum expenditure payment came up" (meaning the Minimum Amount) were receipts of Gala from an accounting perspective, and they were allocated to the members and then the members repaid their respective SG loans. He seemed to accept, therefore, that Gala received nothing under these transactions in excess of a sum equal to the Minimum Amount.

135. It was put to him that the members are only £37,000 better off in scenario 3 compared with scenario 2 and that further demonstrates that the Gala business model did not rely on the members making a profit from Gross Receipts. He did not agree. He said that he thought that Gala was aiming for profit in excess of this amount:

> "That was the thing that drove me as the instigator of the scheme and what drove the members that did come in I believe. Had we performed, that's what would have happened in my opinion. That's what we certainly were projecting to have happen at the outset."

As set out in section 11, (1) Mr Yusef later said that, at the outset, Invicta/Gala estimated likely total Gross Receipts of $1.2 to $1.5 billion, and (2) HMRC produced illustrations which demonstrate that, as the waterfall operates, such receipts would have been nowhere near enough for Gala to make a profit or for the members to make a return from Gala's share of them by the time of the first exercise date.

136. He was taken to the following statement in some instructions to Mr Andrew Thornhill QC who was asked to advise on "the overall chances of success of participation in the LLP in achieving the tax planning objectives of ... clients":

> "*It is essential for the success of the scheme that the payment of the [Initial Expenditure] is allowed in full as a revenue expense of the LLP in the year in which it was paid…*The existence of the [call] option potentially chokes off any upside…As a result the members' commercial interest in contributing to the LLP will be focused on the tax saving that can be achieved coupled with the potential for limited upside versus capped downside." (Emphasis added.)

137. When it was put to him that the highlighted wording shows that tax was the driver for the transactions, he said that (1) these instructions were not prepared by or on behalf of Invicta but for Dominion Fiduciary Services Group and the first time he came across them was when he got the hearing bundle. No-one at Invicta had anything to do with this, it is a mystery as to why this only emerged at this stage but this is not something that Invicta or anybody in the Gala organisation sought, prepared or was aware of. So, the relevant words are those of Dominion and not his, and (2) Dominion are a financial services firm that at the time was based in Jersey who put a couple of clients into Gala who he never met; he had no direct dealings with Dominion or their clients.

138. He agreed that it is clear from the documents that he attended the follow up conference with counsel but reiterated that he did not prepare the instructions and Gala was not involved in doing so. He agreed that this is not about some tax mitigation at the edges, but that tax relief is an absolutely essential component. He said:

> "Well, it has to be, yes. If it's meant to be there in order to entice people to deal with the risk that otherwise would be there, it is essential that it does succeed. It would be curious if it said it would be nice or we would desire it or it would be welcome. No, it has to say that it is essential. My objection was not to that. My objection was to the suggestion or the inference that I prepared, or Gala or Gala's agents prepared those instructions. We never instructed Mr Thornhill."

Conclusions

139. Mr Vallat submitted that the tribunal should essentially accept all of Mr Yusef's evidence as set out above. We accept that, as accords with the evidence of some of the Referrers, Mr Yusef had discussions with investors about the Gala structure and this may have included him presenting it to them as something which could generate a return for investors in excess of the amount produced by the tax benefit. However, we do not accept that this demonstrates that, in fact, Mr Yusef/Invicta/Gala were concerned with whether Gala would make a profit, or the members would make a return through Gala receiving a share of Gross Receipts from the transaction films and/or that the members were primarily concerned with that:

(1) We do not accord any weight or significance to Mr Yusef's repeated asserted belief that investors were not motivated solely by tax considerations because they could have achieved essentially the same, or close to the same, tax effects in other ways such as by investing in a sale and leaseback transaction. On his own evidence, it is not correct that a sale and leaseback transaction offered the same tax advantage as investors could obtain (if Gala's analysis is correct) under the Gala arrangements. He said that such sale and leaseback transactions involve only a deferral of tax. We take him to mean that any initial tax advantage would be clawed back in its entirety over time. However, under the Gala arrangements, members could achieve a return solely due to tax relief, if the Call Option was exercised, as in fact happened (albeit that they would achieve only a tax deferral in other scenarios). The fact that members could achieve this result was spelt out in scenario 2 in the IM, in the UBS document, which also highlighted that there would be no reversal of the tax relief, and in the letters from Ms Challons.

(2) We also do not accept Mr Yusef's suggestion at times in his evidence that (a) Mr Yusef/Invicta were somehow at a distance from the approach taken by UBS in its presentation, and (b) he/Invicta were not looking to find investors with significant income/gains taxable at 40% who wanted to shelter income. UBS based their presentation on the IM and so, in effect, on information provided by Invicta. Moreover, Mr Yusef was plainly fully aware of how UBS was presenting the structure to investors on a repeated basis given he spoke of attending presentations to investors at UBS. Mr Yusef's assertion in (b) conflicts with his other evidence that clearly investors had to have a use for their share of the loss (albeit he said that was "downside protection").

(3) Mr Yusef also initially sought to distance himself and Invicta from the comments in the instructions to Mr Thornhill but (a), it transpired, as he later accepted, that he in fact attended one of the conferences which followed these instructions, and (b) he accepted that it was *essential* to obtain the loss/tax relief although he maintained that "it had to be there to entice people to deal with the risk that otherwise would be there" rather than that it was a goal in itself.

(4) In our view, Mr Yusef's evidence in this section on his/the members concern with Gala's prospects of receiving a share of Gross Receipts is undermined by (a) the terms of the waterfall, which gave Gala a share of Gross Receipts very far removed from the 30/70 split which Mr Yusef said he sought and which UBS and Ms Challons told investors would be the split (see section 11), (b) the fact that no-one involved in these transactions obtained a meaningful appraisal of Gala's and/or the members prospects of realising a profit (see, in particular, sections 5, 6, 7 and 13), and (c) he/Invicta did not provide the term sheet agreed with Sony to investors and left it until at the very most 2 to 2.5 days before the closing of the transactions, to provide investors with information from which they could find out what films had been selected and what the terms of the waterfall were and, at that time, did not provide any overview of the terms of the waterfall. The question arises as to why persons who it is claimed were seriously concerned with Gala's and/or the members' prospects of making a profit from Gross Receipts left it to such a late stage to provide the investors with the information they would need in order to be able to engage with and, if they wished, evaluate or obtain further advice on that issue.

Section 5 - Evidence of the Referrers

Evidence of Mr Cadogan

140. We consider it reasonable to infer from the evidence set out below and in section 7 that (1) Mr Cadogan's primary focus was on obtaining the tax relief, and the prospect of him receiving any return from Gross Receipts received by Gala under the waterfall was a secondary consideration, and (2) his interest in the transaction films' prospects of success emanated from him wanting to make sure that the Gala arrangements would satisfy the requirements for him to obtain tax relief for his share of the loss.

141. Mr Cadogan contributed £449,200 in cash on 24 October 2003, took out a loan from SG of £1.55 million and received a cash repayment of £789,176 in June 2004. He described how he became involved in Gala in his witness statement as follows:

(1) He was introduced to Gala in 2003 by his financial adviser, Mr Pritchard, who knew that he was looking for "something exciting and interesting which could give a substantial return". Initially Mr Pritchard provided a number of documents which they discussed in detail, in particular, the IM and counsel's opinion and he "explained this was an opportunity to potentially earn decent returns on the investment in the medium term and that it was tax efficient" as supported by counsel's opinion.

(2) This was the first film investment he made and he was very engaged with assessing the opportunity on its merits and trying to judge the likelihood of making a return on his investment. He took the documents away with him to consider in his own time. As regards the IM:

(a) He noticed that it (i) confirmed "the positive tax treatment with references to losses being mitigated by tax reliefs" and (ii) highlighted the ability to make a profit from investing in film distribution.

(b) He went through the scenarios with Mr Pritchard and thought they showed he could "make a profit from Gala but the tax arrangements were quite positive in case there was a loss".

(c) It seemed to him that "the success of the Gala investment stood or fell based on the distribution revenue side (whether the revenue obtained would exceed the costs of the expenditure and other partnership costs)".

(3) Having considered the documentation and after attending various meetings with the team behind Gala, where he critically reviewed the opportunity, he

concluded that Gala was a good investment opportunity for him and that there was a reasonable prospect of making a profit from it within a reasonable period of time.

(4) His understanding was that:

(a) The Gala opportunity had arisen as a result of a change in the accounting standards in the US, which caused cashflow issues for the film studios such that they were looking to third parties to contribute to their financial outlay in distributing films and, in return, the studio were willing to share any profits resulting from the films: "This fact alone confirmed to me that there was a real sense of commerciality behind the Gala proposal". Due to the commercial pressure on the studios, they were much more willing to engage in negotiations and there was perhaps some leverage over the studios which could be used to negotiate favourable commercial terms for Gala.

(b) In an attempt to encourage investment in films, the tax environment created by the Government was very positive towards businesses like Gala such that he could mitigate his tax position if the investment was unsuccessful and would be required to pay tax on any income the investment generated.

142. At the hearing Mr Cadogan was taken through the scenarios and, when questioned on the above statements:

(1) He agreed that (a) what came through the waterfall was not guaranteed and drepended on what was agreed, (b) when the IM was published, no terms for a profit share had been agreed, and in contrast to scenarios 1 and 2, scenario 3 is entirely hypothetical, in that it deals with income from a source that was still to be negotiated.

(2) He said that his reference to earning a return in the medium term was not to months but years and, subsequently, it became clear to him that "there was a very great possibility of making a significant return within 2 years". As set out in section 7, he later said this view was due in part to the Call Option.

(3) He said that he spent a great deal of time talking to Mr Yusef and Mr Bamford and he became satisfied that, whilst the scenarios in the IM are illustrations, they do not represent the likely outcome, "once we knew what we were investing in, in terms of films".

(4) He agreed his focus in 2003 was on the likelihood of him making a return on his investment, as distinct from Gala making a return, and said that is "as it would be with any investment".

(5) He was asked whether his reference to "positive tax treatment" is to the almost immediate substantial tax refund shown in the scenarios. He said that the IM suggested that "the statute allowed us to mitigate our losses", and he had also had discussions about that and the fact that "the tax regime as set out by the statute and to encourage investment in the film trade suggested that this would be favourable…to mitigate our losses". He was not sure whether he relied totally on the IM but there was a positive tax treatment explained in the IM and he was aware of it. He then confirmed that he did mean the tax refund. It was put to him that this is not just mitigation. He said that the purpose was to invest in films which would deliver a significant profit and there is no doubt that the way that the legislation had been formed creates that situation. When this was put again, he agreed.

(6) It was put to him that his view that the arrangements were quite positive in case there was a loss does not make sense as the scenarios show that (i) if Gala made a loss, a member would make a profit (as in scenario 2), and (ii) if Gala

made a small profit, a member would make a loss (as in scenario 1). He did not answer this but said that the main driving force of the investment was "are we going to be able to make substantial returns from the distribution of films which are successful" and the tax aspect was not the driving force or the focus of the discussions with Gala; it was "much more important to be sure that the films we were investing in were likely to be very, very successful." When pressed, he said he looked upon the scenarios as being the worst case and did not look at it in the way that counsel did until now. There is no doubt the tax arrangements surrounding film investments were very favourable to the investor and that the intention of Parliament was to encourage the injection of capital into the film industry. He agreed that he was saying that scenario 2 is the worst case even though it shows a member making a very significant profit from tax relief alone after a period of around 2 years, without Gala receiving any income from the distribution of the films.

In giving the evidence set out above, Mr Cadogan seemed more focused on giving a view in support of his/Gala's case than on answering the questions put to him. This undermines the credibility of his evidence. Moreover, we do not accept that he thought that scenario 2 is the worst case given that (a) he plainly considered the availability of "tax mitigation" to be important, (b) he accepted that the prospect that the Call Option would be exercised at year 2 had some bearing on his expectation of making a return on his investment, and (c) it is plain from the scenarios, which he was taken through, that the so called "tax mitigation" would not produce a positive return for a member in the longer term unless the Call Option was exercised and/or Gala received very substantial sums as its share of Gross Receipts.

(7) He agreed that (a) the success of his investment did not stand or fall based on Gala's own profit position (in terms of whether its revenue exceeded its expenditure) because a member could make a profit if Gala made a loss, and (b) the IM did not give him anything to go on in terms of assessing the chances of Gala making a profit, because it contains no detail of the studio or of the films involved, and as nothing had been agreed with the studio as regards the terms of the waterfall.

(8) He said that it is probably right that there is nothing in the IM about a change in accounting policy but there were other conversations at the same time with Mr Yusef and Mr Bamford who he met several times. He also met with Mr Thacker and Mr Laing, who he worked with at Oracle and who were also advised by Mr Pritchard. He thought he became aware of the US accounting issue quite early on and he did some research on it and so did Mr Thacker. So he did not depend upon just the information provided by Gala. He did not consider it curious that what he considered to be key is not mentioned in the IM.

(9) He agreed that by "profits arising from the film" essentially he meant whatever is left after the studio has recouped its expenditure and that he did not specify what sort of share of profit because at this time he only had the IM and it did not have any deal terms.

(10) It was put to him there is nothing in the IM or in counsel's opinion about Gala taking advantage of any tax relief specific to film investments and, in fact, the arrangements did not rely on any such relief but on accounting principles. He said he did not remember all of counsel's opinion, but at the time he did a lot of personal research and that was not his understanding. When it was put to him that it makes no sense that the UK Government wished to incentivise investment in relation to US film studios, he said he had no way of knowing, that is speculation

and: "My understanding at the time was the statute allowed for favourable tax treatment of investments in films, period. I did not have an understanding, nor did I ever come across anything which said otherwise". When pressed he said he was only interested in the statute as it stood (and was not aware of the processes leading to it) and there are large parts of the tax law which do not make sense. Counsel's point did not occur to him at the time.

It appears from this that Mr Cadogan had no understanding of what tax rules were relied on to produce the loss he considered was "tax mitigation" albeit that he knew it was important that there was a "trade" carried on "with a view to profit".

143. In his statement, Mr Cadogan said the following as regards the period following his initial meeting with Mr Pritchard:

(1) As well as research on the change in accounting standards (whereby he satisfied himself that what he had been told in that regard was accurate) he did some internet research on film profitability which partly influenced his early considerations. This research suggested that, because of the enormous appetite of satellite television for films, very few films would fail to make money over 5 years.

(2) In discussions with Mr Thacker and Mr Laing, they quickly came to realise the proposal was relatively complex and wanted to understand the law and to be sure that Gala was conducting a trade that had a prospect of making a profit. They decided it would be sensible to meet the team behind Gala.

(3) Mr Prichard arranged a meeting with Mr Yusef and Mr Bamford in late summer 2003 to get some clarification on the information presented and to gain some comfort that there really was a substantial reason to believe that this could be a profitable investment that was not simply a made-up tax evasion scheme. He recalled being very impressed with what was being proposed and with the team, particularly Mr Yusef. Mr Yusef said that:

(a) it was a golden moment to invest as the studios were under a lot of pressure to engage with others to help solve their cash flow problems arising from the accounting change and, due to that, investors had a certain amount of leverage over studios which he was attempting to use to negotiate advantageous terms,

(b) he was confident of securing terms that would maximise the prospect of Gala making a return on its investment,

(c) the intention was that Gala would be able to select certain films from an entire slate of films and to hire experts to review the films and to select only those considered to have the best prospect of success and to procure certain documents to assist in that process.

As regards "the tax mitigation aspect", he recalled discussions that, for the tax planning to succeed, Gala had to be trading but he found the tax side of things to be a bit difficult to follow and so had to consider that aspect in more detail.

(4) Although he was impressed by what he heard at the meeting and thought that, if they could secure the deal as described, there was a real opportunity to make some money, he still wanted to satisfy himself that the tax arrangements were genuine in case the investment did not make the returns anticipated. He mentioned this to his colleagues, who expressed similar uncertainties, and they agreed to press Gala for a second counsel's opinion to verify the tax mitigation aspect of the arrangements. They asked to be involved in instructing counsel and to attend the conference with him. The conference with counsel went on for 2 to 3 hours during which Mr Thacker and he led a lot of the discussion to clarify their doubts and concerns. The conference identified some issues, and 2 further

conferences were then held to iron these out. He did not attend these; they were content to leave it to Gala to deal with.

(5) At the end of this process, he was very confident with the Gala opportunity especially after seeing the note of conference dated September 2003 which supported the earlier opinion and felt satisfied that Gala would be trading within the meaning of the legislation such that "if a return was not made we could at least mitigate the tax position" and:

> "I considered that profitability would be dependent upon the films that were going to be made available to us. Given that the intention was to be able to choose the films, not just take any slate that the studio wanted to dump on us, I viewed our chances of making profit to be decent. It was a major advantage to be able to select the films we wanted to buy. It seemed to me that we just needed to pick the right films. Accordingly, I reached a firm decision that, assuming that I was satisfied that the films that were being offered had a reasonable prospect of being successful, I would invest in Gala."

(6) There were meetings in the summer and into the autumn of 2003 with a mixture of Invicta and his colleagues and Mr Pritchard; he was keen to understand the Gala opportunity to be notified of developments as they occurred and to have a genuine involvement in guiding the business. He recalled (a) Gala rejected a deal with Paramount because they would not let Gala pick the films to acquire and that Gala concluded a deal with Sony which enabled selection of films from their entire slate, and (b) Gala rejected an earlier slate of films offered by Sony and, when the next slate was presented, he was pretty confident in the films made available. Something's Gotta Give featuring Jack Nicholson, a film starring Adam Sandler, and Big Fish starring Ewan McGregor and Albert Finney, stood out to him. At some stage during this period, he became aware that Gala was setting up an office in LA and employing Mr Ackerman and thought he saw his CV and credentials, all of which emphasised to him that considerable due diligence was being put in place by Gala to maximise the prospect of Gala making a profit.

144. Mr Cadogan emphasised repeatedly the importance of Gala having the ability to choose films which were likely to be successful and so to generate Gross Receipts. However, it is notable that, when considering whether to invest, he appears to have had no concern or interest in the other matter on which Gala's prospects of actually receiving Gross Receipts (and the level of any such receipts) depended, namely, the terms of the waterfall. He made no mention of this as a matter of concern or importance in his witness statement. As set out below, he also did not mention this at the hearing until he was specifically questioned on the significance of the deal terms. By contrast, Mr Cadogan plainly was very concerned with the tax benefit given that he, together with certain other investors, insisted on further conferences with tax counsel and he attended the main one.

145. Mr Cadogan confirmed that, in his reference to making money, he meant generating revenue in excess of the members' investment and said he was looking at the overall profitability of film making at that time and the way in which demand was exploding. He agreed that, when he carried out his research, he did not have any details about Gala's share of any Gross Receipts and he could not assess the prospects of Gala making a profit and added that his purpose was to assess whether this was an industry which was in a period of growth or a period of decline.

146. As regards consulting counsel:

(1) He agreed that his concern was to do with the fact that in all of the scenarios an investor could get back a substantial repayment of tax almost immediately.

When it was put to him that presumably this sounded too good to be true, he said his focus was on whether this was a commercially viable business that would provide a substantial return due to the success of the films, but he did not want to be involved in a business which was purely arranged to provide a tax advantage. He agreed it was very favourable, and said he just wanted to check it out.

(2) He thought that the meeting with Invicta took place no earlier than late August 2003 and agreed that, by then, no specific studio had signed up and no terms were agreed. He said, in effect, that he felt very positive about Mr Yusef and Mr Bamford when he met them, but he certainly wanted to check this was not some sort of made-up tax evasion scheme and his colleagues had similar uncertainties. He said 90% of the issues were dealt with at the initial conference but there were 1 or 2 small issues, which he did not recall and, when counsel's opinion was published, he was quite happy with that as an affirmation of the positive nature of "what we were doing, that we would be trading, it was a commercial prospect and we had a good chance of making a profit".

(3) He said he and his colleagues did not attend the further conferences because, having discussed the remaining issues, with Mr Yusef and Mr Bamford they were "perfectly satisfied" that they would deal with them because "we had great faith in them, as experts in their field". He could not recall the issues, but they were not major - only minor issues of verification - which it was subsequently confirmed were resolved. He confirmed that by early September neither he nor counsel had seen the transaction documents and deal terms were not agreed.

147. We note that (1) Mr Cadogan was plainly highly aware that the structure produced a very favourable tax result for members, (2) whilst he did not understand the legislative basis on which Invicta relied to produce the loss/tax relief, he was aware that obtaining that depended on Gala carrying on a trade on a commercial basis with a view to a profit, (3) he apparently formed the view these requirements would be satisfied following the conferences with counsel, notwithstanding that neither he nor counsel knew what the terms of the deal with Sony would be, and (4) he did not seek any further or updated opinion once the deal terms were agreed. His concern with the tax treatment chimes with the fact that, at the time, he was focussed on his own return rather than Gala's position and thought that "there was a very great possibility of making a significant return within 2 years" at least in part due to the Call Option.

148. When questioned on his ability to assess Gala's prospects of making a profit in September 2003:

(1) Mr Cadogan initially suggested that this depended solely upon the films being successful and generating a substantial amount of revenue. He then agreed, however, that it also depended on what terms were agreed with the studio and, in September 2003, he did not know the terms but added that "we did have a general idea about what we were going to try to negotiate from the discussions".

(2) When it was put to him that he was not in a position to assess Gala's prospect of making a profit given he did not know the deal terms, he said he trusted Mr Bamford and Mr Yusef particularly, who was leading negotiations "to have met his objectives of providing a favourable environment", which in his view Mr Yusef subsequently did. In other words, he had confidence in Mr Yusef and expected Gala to get favourable terms from the studio and he noted that "we had been given an outline of the potential bargain we were going to get" and of what Invicta were trying to achieve, although he did not know the outcome.

(3) It was put to him that he made a firm decision to invest at a time when he could not know Gala's chances of making a profit. He said:

> "Except that I had already…formed the view that Mr Yusef would be successful in negotiating terms which would provide us with a favourable environment…The terms of the agreement he would get from the studio would provide us with a strong basis for making a substantial profit, over a reasonable period of time."

(4) He did not agree it was a case of having blind faith in Mr Yusef but said it is a judgment. He said, in effect, that he should have added in his statement that his decision was subject to agreeing reasonable terms with the studio and confirmed that he knew, at that time, that Gala's prospects of profitability depended on all on the agreed terms and they had not been agreed yet.

149. We note that (1) Mr Cadogan evidently appreciated that whether he could make a return from Gross Receipts from the transaction films depended on the terms of the deal with Sony but (2) he was happy to proceed with his investment in Gala on the basis of only a general idea or outline of what may be agreed and, as is apparent from the rest of his evidence in section 7, did not try to find out what had actually been agreed.

Evidence of Mr Summers

150. At the time of the transactions, Mr Summers worked for Goldman Sachs' convertible bond business in London. He invested at the time of the second transaction and (a) made a cash contribution of £224,600, (b) claimed loss relief of £993,296.42 and received a repayment of £377,448.12, and (c) so recovered £152,000 in addition to his cash contribution. He made the following main comments in his statement:

(1) In general, his decisions to invest are centred on his "motivation to make money out of that investment when everything is taken into account". He views "tax efficiency" as just part and parcel of the evaluation of each investment.

(2) In 2003 his accountant introduced him to Mr Andrew Straszewski, of the John Lamb Partnership, who recommended Gala to him. He had no particular interest in films and considered this as he would any other investment opportunity on a cost-benefit analysis. Although he did not have much knowledge of the film industry, especially in relation to distribution, he was interested and willing to learn.

(3) He was informed that film-related investments initially arose out of a government incentive to build up the UK film industry. Such investments struck him as "something that was generally accepted and widespread as being a smart investment where you can potentially generate great returns if things go really well and get a sort of "tax break" if they did not go well. This provided a degree of certainty to the investment and cushioned the risk somewhat. He recalled that "smart tax efficient types of investments such as film investments were common currency at the time" and Mr Straszewski's advice on Gala was that "it was a non-aggressive type of film investment that had the potential to make a decent profit" and, "in his eyes, the entire opportunity had been very thoroughly thought through".

(4) Mr Straszewski summarised the IM and the risks involved. He advised that Gala was very much at the safer end of the spectrum and that the Gala documents were very well put together by a smart team. Mr Summers' understanding was that:

(a) Involvement in Gala would carry with it some risk that his investment might be lost owing to a fully recourse loan, but the investment and loan

payments ought to be paid back by income generated by exploiting films, and anything over and above that would constitute a return on his investment.

(b) There was a risk that the loan might not be paid back, for example, in an insolvency scenario, but that risk would be mitigated by the strong financial standing of the parties involved, and with the tax break providing a degree of certainty, everything combined to predict a fairly decent upside if things went well. He found the thought of being involved in the film industry alluring and exciting.

(c) If the investment went well, he would make a not-insignificant return (based on the various projections) and, if it did not go well, then the downsides were not going to be enormous for him.

(d) It is inevitable that some films are a success, and some are not but he thought that (i) given the involvement of a major player in the industry, Sony, it felt like a large-scale production, (ii) Gala would invest in well-known films, and (iii) it seemed unlikely that Sony would be involved with something that was in any way questionable.

(5) All in all, he thought that the Gala scheme seemed cleverly put together, however, the attraction was not just the bit of clever financial engineering, but the relative excitement of being involved in the film industry.

(6) On-going through the IM:

(a) He found that the introduction provided an attractive initial summary for an investment, stating the potential to earn profits.

(b) He understood that there was a real financial purpose behind the Gala film investment. As a result of the change in accounting standards in the US, where film studios were no longer able to write off their print and advertising expenditure all upfront, investments such as Gala arose to help studios deal with that up-front cost. We note that he said the change in accounting had the opposite effect to that set out by Mr Yusef.

(c) He recalled Gala's aim to make a profit was mentioned many times and the IM illustrated that there was opportunity to make a gain that would be taxable.

(d) The ability to mitigate loss under the application of tax relief was specifically outlined very early on in the introduction and was presented very much as a given element, and not up for debate. He found the risk factors to be quite standard.

(7) He did not recall in detail looking at the scenarios in the IM but is able to understand them and expected that he could do so at the time. Looking at them now:

(a) He thought that the most likely outcome would be either scenario 2 or 3 but that, even if scenario 2 was the outcome, it was worth investing because there was enough of a return.

(b) He can now see that, by 2007, it was projecting that he would have made a 50% return with the potential to make considerably more, factoring in the tax relief included. In short, "I expect that I was thinking that there was a high potential to make a profit given the various financial projections and information given through the [IM]..."

(c) He expected to make an overall profit after 3 to 4 years of his initial investment. He understood at the time that the members' interests were entirely illiquid and, on that basis, it was entirely standard and normal to expect profits after 3 years. This seemed a reasonable period of time within which he

could make a return and the transaction also seemed to be something which was pretty commonly entered into and which other individuals found relatively attractive also. In short, "the Gala scheme was not one where I expected an immediate and stunning return on my investment, and it was never sold to me that way."

(8) He decided to invest in Gala because he saw that the net cash flows over the life of the investment could be "quite positive" even allowing for some of the risks that the structure might not work. He, therefore, wanted to invest to make an overall profit within what he considered to be a reasonable period of time given the illiquidity of the investment. He understood this to be a relatively safe investment, owing largely to the up-front tax relief, but with the potential to make a relatively decent return if it were to succeed. He spent enough time on Gala to understand the outline elements, but not dozens of hours working through all the intricate details.

(9) He gave consideration to the tax mitigation because that formed an inherent part of the investment and was one of the upsides to it, but it was all part and parcel of the opportunity. The tax consequences formed part of the entire investment package which he evaluated all together as part of the projections prior to entering into the investment. Ultimately, if he were back in 2003/2004 (when there was no negative press surrounding film investments) he would invest in Gala again because "it is a reasonable and credible opportunity. It did not at the time at all feel like this was later going to be stigmatised and challenged" and:

> "Essentially, I understood that if things go particularly badly I would lose money, just like any normal investment scenario, and if it goes well, I would make a return and it would be something fun to do."

151. Although Mr Summers said in his witness statement that he imagined that, when he invested, he would have thought scenario 2 or 3 was the likely outcome, the overall tenor of the totality of his evidence in this section (taken together with that in section 7) indicates that his primary motivation for deciding to invest in Gala was an expectation that scenario 2 would occur so that he would make a return from the tax relief alone and that he considered that anything additional would be a bonus. We note in particular that, as set out below, (1) he was very clear that his focus was solely on his own ability to make a return as opposed to whether Gala would make a profit, (2) he took a very broad overview of the arrangements and had no concern with or knowledge of the waterfall or how likely scenario 3 was to occur and decided to invest despite this lack of understanding and information. Any belief that Gala would receive Gross Receipts was based simply on (a) the expectation that transaction films would be chosen by experts as economically attractive films, (b) that the experts would try to achieve something akin to scenario 3, and (c) the involvement of Sony, as a major studio (and he thought there was a rationale for their involvement due to the accounting treatment), (3) he acknowledged that the loss was a key part of the transaction (albeit he thought it would have to occur as part of something generally credible) which was a "given element" or expected outcome and that the transaction provided a tax shelter, and (4) he agreed that if the Call Option was exercised and he obtained the tax benefit, that would suffice for him to view the Gala arrangements as successful and anything else would be a bonus.

152. Mr Summers was taken through the scenarios. It was put to him, in effect, that, when he decided to invest, he was not in a position to assess what profits Gala would make, the expectation was that the Call Option would be exercised at the earliest opportunity as in scenario 2 and, in fact, obtaining the tax benefit was the central aim of this scheme:

(1) He said he had heard the term waterfall but he did not know what it was. He was aware that there were guaranteed Minimum Sums and a possible further share of film revenues depending on how well the films performed but that is as far as his knowledge goes. He understood that there is a distinction between Gala's profit position and whether he made a return on his cash contribution and he would honestly genuinely say then and now his interest was much more concerned around his financial outcome.

(2) It was put to him that in scenario 3 there is no certainty that Gala would receive £1.5 million and that scenario had no practical utility for a serious investor. He said such illustrations are only ever financial projections and there is obviously no certainty. He confirmed that he personally did not know (a) what level of Gross Receipts would be needed for Gala to receive £1.5 million and would not have sought to know that as he was much more concerned about his personal cashflow, or (b) how likely it was that Gala would receive £1.5 million. He said he made his decision much more on what he might potentially receive from this process and here he was presented with a range of projections. He did not presume to understand waterfalls and he thought, in all such situations, probably an investor is always looking at a scenario somewhere in the middle as the most likely. At the time he did not spend a huge amount of time debating whether scenario 2 or 3 was the most likely, he had not re-read the IM in exorbitant detail in recent times and his recollection of exactly what it said is not perfect. When he invested he assumed that "the people that manage the process will be able to be competent enough, given their experience, to be able to generate something similar to the projections".

(3) He said if the member expected to be in the cashflow position shown in scenario 1, he should not invest and obviously that scenario is an illustration of a bad outcome which a member would hope would not happen. Hence, why he had said he thought the most likely outcome was scenario 2 or 3.

(4) He agreed that now he could see that the IM does not state how likely the outcome in scenario 3 is and could not do so, as the split of Gross Receipts was still under negotiation, but he genuinely could not say whether that is what he thought at the time. He thought he did not spend an inordinate amount of time going through and trying to prove all of the financial projections.

(5) It was put to him that in scenario 2 a member makes a 45% return even if the films were flops and Gala received nothing under the waterfall and, as a serious investor, he expected that those setting up the structure would arrange for that to occur. He said that looking at the figures in scenario 2 now, a "large portion" of the return is made up of tax relief and, when pressed, agreed the return is entirely due to tax relief.

(6) He agreed that from the IM he could not understand with any precision what film income would come to Gala. He thought he did not want to know that at the time, as he was hiring people to do this for him. It was put to him that given this lack of information and that the IM did not contain details of the films involved and how much money they may make, he could not have known there was the potential to make considerably more based on the IM. He said that he could see the point, but "there was an expectation that there would be films chosen by experts in their field that would be attractive economic propositions" and that was "the whole basis of the procedure" albeit that he was not in a position to estimate the exact nature of the waterfall himself.

(7) He agreed that, in principle, whether Gala and Sony each made a profit depended on the expenditure they each incurred and the receipts they each obtained, and their positions may be different and he had no idea what that split was.

(8) He did not recall any familiarity in depth at the time with what the expectations were as regards the exercise of the Call Option. He noted that the scenarios are merely projections and, whilst it was impossible to check the validity of scenario 3, he imagined all the scenarios were feasible. With his "banker hat" on, any IM has scenarios in it and he did not think an investor would view scenario 3 as impossible; it would be taken as an example of what could happen which is not designed to be concrete and the investor would not think he needed to understand every single financial movement.

(9) He was certainly hoping scenario 1 would not come about. Scenario 3 or something similar would be very pleasant and the best outcome, which an investor always hopes for, but these projections in the IM came before some of the information provided on the people who were setting up the vehicle, who have the expertise in the films. He thought scenario 3 is not impossible to understand as an illustration, albeit it is impossible to understand in terms of exactly how you arrive at the projection, but inherently by investing in the structure and the experts that were hired there is an implication that they would try to achieve scenario 3 or something similar.

(10) It was put to him that (a) it would be reasonable to assume those setting up the structure were driving at scenario 2 if they had agreed a deal under which scenario 3 is impossible or fanciful, and (b) it is fanciful to suggest £1.5 million would come to Gala under the waterfall given that, on the illustrative figures after roughly £2,000 comes in, receipts are split in the ratio of 1 to Gala for every 334 to Sony. He said:

(a) He could not comment on the motivations of those who set the structure up. However, he noted that (i) there could be a scenario 4 where there is further income and the Call Option is exercised, (ii) in his experience as a banker, you never put your best-case in an IM, because it would look like you were over selling, (iii) it certainly is not unusual to have a scenario showing incrementally higher returns, and (iv) he imagined, 18 years later, that his thought process was "merely worst, middle, best case thereabouts with no degree of precision".

(b) He is not familiar with the numbers counsel cited and cannot comment on what is usual in the industry; this is outside his area of competence quite substantially. The terms impossible and fanciful are not maybe ones he would use.

(c) When pressed, he commented that he certainly did not hope for scenario 1 and concluded that:

> "at the time I would have been under the impression that blockbuster films could generate very substantial revenues, some of which would come back to the LLP. That was probably the limit of my knowledge".

153. He confirmed that he invested in the Cobalt Data 2 LLP scheme and used relatively aggressive forms of tax avoidance to protect his financial position including an investment in two films sale and leaseback arrangement and that he was portrayed by HMRC as a serial avoider.

154. He was pressed on whether his expectation at the time was that he would make a return from the tax relief and that was what the arrangements were about:

(1) He said that all he was concerned with was his overall outcome and agreed that, looking at scenario 2 now, it appeared that his return came entirely from tax relief. He said, in effect, that his expectation at the time was to make a profit. He seemed to agree his expectation was to obtain a tax refund and said:

> "but by the process of having the tax as part of the structure that you invested in, you are part of an LLP, which is carrying on a business which exists as an entity...there is a lifetime to this business when it's carrying on a trade, it is carrying on an activity. It wasn't I put my money in. There's my tax. There is no involvement. There's a business and there's a process. The fact that we are here representing [Gala] should illustrate that I am still fully involved as a minor partner."

(2) It was put to him that in his statement he said he did not think he would have an active role. He said he was still a member of an LLP and whilst he was not claiming to be actively involved, his point is "you don't cease to be a member of the LLP when you achieve the tax".

(3) He agreed that (a) he hoped personally to make a return on his money, (b) he was not familiar with the terms of the waterfall and so could not have known, when he went into this, how much income, if any, was going to come into Gala but thought that "whenever you invest in any business you never know the outcome", and (c) he did know about the projected tax relief and he noted that tax relief is part of very many IMs. He said the tax relief was a key part of what this was about, but he thought there was a suggestion that it would have to occur as part of something generally credible and it was not as if there was an immediate repayment although he was certainly hoping for it within a year. He added that tax efficient investing is certainly not unusual and more recently he had invested in EIS and SEIS related business and a "very large part of my willingness to do that is for the associated tax benefits, because they insulate me from the fact that it's a very risky process". When pressed, he said he thought that the tax relief is "a key part of what this was about".

(4) He seemed to agree that the wording in the IM relating to SFP is a candid recognition that the arrangements constitute a tax shelter. He said that he thought that is an incredibly sensible point to have, because "as an investor... at least part of your process is to try to achieve some tax relief.." and he imagined that is in pretty much everything a tax adviser would write.

(5) It was put to him that given that the sums Gala put into the expenditure account were guaranteed to come back to Gala, in economic terms, Sony still bore the relevant expenditure on distribution costs. He said that this was not an element of the structure he would have considered at the time; he would not have spent "50 hours reading the [IM] and trying to understand every single metric" and he had not subsequently made himself incredibly familiar with the IM. He agreed that the fact that, as he understood it, the studio entered into the arrangement for accounting reasons is not incompatible with Gala and its investors entering into them for the tax relief. He noted that a lot of corporations "do a lot of different things to achieve tax benefits" and "look to do things which are part of the tax code" and this did not strike him as in any way unusual or out of the ordinary.

(6) He agreed that, as in scenario 2 tax relief alone would result in a return for a member, fundamentally it did not matter whether Gala generated any revenues from the films. He added that he thought his comment in his statement summed up his beliefs "in terms of the benefits that would accrue to taking the risk of investing in what was a volatile industry" in that it may potentially generate great returns if things go really well and provide a tax break if they do not go well. He

just felt a little bit nervous about committing to specific questions about payments here and there to certain groups or banks when this was not part of the diligence he did on the structure.

(7) He confirmed that he did not look at the waterfall at the time and still had not but said he thought that, as by the time he was involved other people had already done the transaction, he had the security of knowing that other people had proceeded with it. He agreed that at the time he was not in a position to know what Gala's share of revenues under the waterfall would be or how likely it was to receive anything.

(8) He confirmed that in referring to him making a decent profit he meant a return on his cash and a profit for him and also that is what his financial adviser would have been concerned about.

(9) He seemed to agree that, in this case, the tax relief was not simply mitigation of a loss in the sense that it reduced the economic burden of a loss but gave a positive return and the tax relief was a given or the expected outcome.

(10) He seemed to agree that the films could be flops but that tax still gives a member a return. He said, in effect, that was only in scenario 2 and his witness statement correctly reflected his perhaps naive thoughts about this opportunity at the time and even now. He said it would be disingenuous for him to say that the associated tax benefits of the Gala investment did not cross his mind or were not part of his investment process. Any investor who goes into this would be aware of the potential tax benefits, and obviously he was aware and it was part of his thought process. However, he absolutely did not sit there and rationalise to himself that the only way he would make money out of this is because of the tax because he was investing in a partnership and:

> "If you are investing in a partnership, you are part a partnership that can have a business that carries on for many years...investing in a partnership potentially has a long tail of consequences and it's not something that you go into lightly."

(11) It was put to him that, subject to the tax analysis being correct, the scheme would succeed due to the tax relief and anything else would be a bonus. He noted that under scenario 1, which he hoped would not occur, a partner's cashflow is a negative number, even though the tax relief is factored in. He added that this was not viewed by him as a riskless investment; nothing in life is riskless. He then agreed it is true that, if the Call Option was exercised and he obtained the tax relief (as he would, if the tax analysis is correct), that would suffice for him to view these arrangements as successful and anything else would be a bonus. He noted there is a lot of "ifs" involved (although that is what in fact happened.)

(12) He did not accept that the fact that a number of the risks in the IM were all to do with the availability of tax relief demonstrates that tax relief was central or of key importance. He said that he did not spend a huge amount of time on these factors; he probably read or skimmed through them and:

(a) Promoters of any scheme put in as many of these risk factor as they can because it is their insurance against "a Black Swan event" and any investment structure which has a tax element, would have all of these risk factors in them as a matter of standard course.

(b) Absolutely they demonstrate the importance of the tax relief but there is also "a degree of real world reality" in that any promoter would have included this in the IM - otherwise he would potentially be guaranteeing the existence of these reliefs and it is "very, very standard in all [IMs] to have a large number

of risk factors" and none of those here are probably unusual or not standard. Anything having a tax element would have all of this in it.

155. It was put to him that in scenario 2 the tax relief is not just one of the upsides but the key upside and the central benefit. He said that is true "but obviously at the time we made the investment, we didn't know that scenario 2 was going to be the outcome".

156. As regards the nature of the return he envisaged:

(1) He confirmed that where in his statement he spoke of making a return, he meant him personally making a return on his cash contribution.

(2) It was put to him that whilst the exercise of the Call Option generated a gain for tax purposes there is no economic, real world commercial gain. He said that all he was looking at was his net cash carried forward.

(3) He seemed to agree that when he spoke in his statement of making a return over 3 to 4 years he had in mind the sort of time frame in scenario 2. He said obviously he was saying he did not expect scenario 1 to come about or he hoped it would not come about.

(4) It was put to him that, in reality, he would lose money only if the tax analysis turned out to be wrong. He said that is not true because in scenario 1 that was not the case and whilst that is correct in scenarios 2 (and 3) that was only one of several scenarios. Essentially, his thinking was driven by what he said in his statement; if things went badly, he would lose money just like in any normal investment scenario, and if they went well, he would make a return. He agreed that scenario 2 is not really a normal investment scenario but said that he had no way of knowing for certain that scenario 2 would come about and he noted again the outcome in scenario 1. He said scenario 1 is a normal investment scenario, "because you can lose money... this was never presented to me as riskless... any investment has a worst case, average case".

157. We note that (1) whilst Mr Summers' emphasised scenario 1 at various points, his focus was on it as an entirely theoretical possibility which he did not expect to happen, and (2) whilst he emphasised he did not *know* scenario 2 would occur, he accepted he expected it to occur.

Evidence of Mr Mallett

158. Mr Mallett made a cash contribution of £134,760 and claimed tax relief in year 1 in the region of £236,752. At the time of the transactions he was employed by Commerzbank as a corporate financier.

159. He said the following in his witness statement:

(1) Around 2002 Ms Challons advised him (a) that a popular investment opportunity related to films, (b) the government was looking to promote such investment, and (c) whilst investing in films was more speculative than "safer" investments, the legislation in place at the time provided an element of "downside protection" of tax mitigation should the investment be unsuccessful.

(2) He then invested in 2 film sale and leaseback structures, which Ms Challons explained had the sole benefit of providing an effective means of deferring tax. She later referred him to a number of different types of film investment opportunities and explained the mechanics of film partnerships. In summary:

(a) His broad understanding was that the partnership would acquire rights in films which it would seek to commercially exploit to generate a profit, and (a) if the investment was successful, he would make a return on which he would pay tax; and (b) if it was unsuccessful, tax mitigation was available so that he could offset any losses from it against his income tax liability.

(b) Ms Challons said that these opportunities were "non-aggressive". His understanding was that, whilst HMRC might review the tax mitigation, if it applied, it was considered uncontroversial and would be unlikely to be challenged, and if the investments were successful, he would end up paying more tax on his profits.

(c) He did not have any background experience in film but was sufficiently interested to take note of box office successes and which actors were considered to be "high-profile". Otherwise, his understanding of the film industry was (and remains) that (i) it is a particularly unpredictable industry, but (ii) it is not uncommon for films to be "Box Office hits" which generate a very significant amount of revenue. Clearly film studios must overall make money on their films otherwise they would not be in business.

(d) He considered that (i) were he to invest in a particularly successful roster of films, his return could be significant. His aim was to get a decent spread of risk across several film investments, in the hope that one or more of them would be very successful which would cover those that were less successful and still provide an overall profit, and (ii) given his understanding that the investments were developed around a government incentive and the tax mitigation offered some downside protection, they fitted his investment requirements at the time and were worth investing in. Accordingly, he invested in a number of different film partnerships that were more profit driven and commercial than his previous sale and leaseback investments; Gala, "Inside Track" in 2003, "Ingenious Film Partners LLP" in 2005 and "Ingenious Film Partners 2 LLP" in 2006. At the hearing he confirmed that he was aware that the other films partnerships he invested in were the subject of litigation but did not accept that they were tax avoidance schemes and was not aware they were described as such by the Court of Appeal in July 2021. He said he entered into what he understood to be film investments and, at the time, the thought behind it was as set out in his statement and he was introduced to it by a leading global bank.

(3) He had an initial meeting with Ms Challons at which she provided him with various papers relating to Gala, which he took away to review. He then met with Ms Challons a couple of times and she explained that:

(a) Gala related to investing in distribution of films with the intention to make a return from the investment rather than to defer tax,

(b) film studios were looking to defray or postpone the cost of distribution expenditure following a change in legislation in the US,

(c) Gala intended to purchase rights in several films actively selected by its industry-specialist team with local presence in Hollywood, which it would be able to commercially exploit, and

(d) Gala would fund distribution costs and be actively involved in the distribution of the films for a share of the profits - which would reduce the amount of risk in upfront studio investment quantum, and thereby benefit both the studios and Gala.

(4) He did not know for certain whether he would make a return on his investment but, as long as his risk was spread, he considered there to be a reasonable prospect that he might do so and, given that Gala was intending to invest in several films, the prospect might be enhanced.

(5) He received a letter from Ms Challons dated 4 July 2003 ("**the July letter**") (see section 4 as regards the content of the letter). He carried out an initial review

of the letter and the IM with Ms Challons but thought he needed to read into the proposal in more detail. The IM was the primary document that he reviewed parts of which stick in his mind:

(a) There were several references to Gala's intention to make a profit.

(b) If his investment was unsuccessful, in certain scenarios, he should be able to mitigate any losses by offsetting them against his income tax liability.

(c) Gala intended to purchase the rights to several films, picked from a larger slate of films of a major studio and the studio would have a Call Option for the greater of a Minimum Amount payable to cover the loan or the market value of the rights. He thought it likely but not definitive that the studio would probably exercise the option, but that it would want to sort out its cash flow and costs first, given the change to the accounting treatment in the US (which meant that the film studio had to bear the entirety of the costs in the first year) before exercising the option; so the potential for an upside looked pretty good.

(d) He considered the scenarios but found them a little difficult to follow and considered them to be purely illustrative. In his experience, anybody can produce illustrative figures to show what they want to show. To him, they were academic as, whether he made a return, depended very much on how successful the films were. It was important to him that the arrangements had commercial sense to them and provided an opportunity that could result in a profit. He felt that the IM provided "highly speculative and hypothetical scenarios and outcomes" and it provided the standard "health warnings" that are normally found in such documents.

(6) The July letter also made reference (unlike the IM) to Sony. He was encouraged by the fact that Gala intended to transact with a major studio and this added weight to his view that there was a reasonable prospect that he might be able to make a return on his investment.

(7) On reviewing the IM and the July letter and based on his own (albeit limited) understanding of the film industry, it seemed to him that (a) there was a genuine commercial rationale behind Gala, (b) the potential upsides of investing in Gala could be significant, and (c) by purchasing the rights to several films rather than one, his risk was spread. The amount of his personal contribution in Gala was relatively low. He knew there was an element of "downside protection" in that if his investment was unsuccessful, he would be able to offset any losses against his income tax liability - that was simply part of the package offered, which he took into account in deciding whether to invest. Accordingly, when considering all of the factors, he decided to invest as he thought that he could earn some decent profits from his investment if the right films were purchased.

(8) Having decided that he probably would invest in Gala, on 17 July 2003, he signed the various documents for Ms Challons to send to Gala for them to retain on file for completion when appropriate. He understood that he would hear further from Gala in due course with further information regarding the choice of films and studio.

(9) Ms Challons suggested the amount he ought to invest in the various film schemes as based on capital available to him, investment requirements and his income tax liabilities for earlier years.

160. He agreed that (1) he was aware in July 2003 from the IM that no studio had yet been selected or signed up and the first time he had seen Sony specified was in the July letter, (2) whilst in the July letter Ms Challons referred to a 30/70 share of Gross Receipts, the IM stated that the profit share was yet to be negotiated, (3) Ms Challons

set out the security arrangements in the July letter and the IM referred to the loan and Minimum Sums arrangements as a required element, (4) the blockbuster films Ms Challons referred to in the July letter were not in fact involved in the Gala arrangements, and (5) in light of her comments in the July letter, it is not correct that Gala involved relying on legislation specific to films which was designed to encourage investment in films.

161. He was taken through the description of the loan and security arrangements in the IM and the letter. He was reluctant to accept the description of these arrangements as artificial and circular but had no satisfactory response as to why that description is not apt.

(1) He initially said that this was part of the wider agreement which was a "commercial agreement which had a genuine and compelling purpose" as a result of the change in US accounting principles:

> "So we were looking at what the upside would be from this arrangement. Part of the transaction was that there would be some interim coverage of borrowings....because it might take some time for the royalty payments to come through….[it] seemed to me to be a perfectly sensible commercial arrangement, and part of it was that there was some certainty in respect of the repayment of certain borrowings. It did not deal with the remainder, what we would expect to earn in the event of a successful slate."

(2) When pressed, he said that the LC provided a sort of floor for the arrangement, and was a "standby" facility, in that it only applied if there was insufficient income from the distribution rights (as he thought was supported by Ms Challons description in her letter). He agreed that if A borrows £1,000 from a bank and pays it to B who agrees to cover A's interest costs and repay the £1,000, that is an artificial and circular arrangement but did not seem to accept that is what happened here. He said the LC is a "a standby, and it is only on the basis that there is insufficient income coming from the distribution rights…Which I would say is a slightly different point."

(3) It was put to him that if the bank borrowing was not taken out in the first place, the need for the LC would not have arisen. He said he was doubtful and would like to reflect on and verify that as he was obviously not fully au fait with everything that was agreed in relation to the transaction. He only has what he was given to read.

162. It was put to him that, given that the scenarios show that the exercise of the Call Option makes the difference between whether a member makes a six-figure loss (as in scenario 1) or a six-figure profit (as in scenario 2), he must have regarded it as important for it to be exercised:

(1) He initially said he did not regard it as important because he looked at it in a different way: There was a 21-year agreement and a Call Option with its last exercise date 15 years later and he obviously did not know whether or when it would be exercised. That was entirely a matter for Sony who would only do what is in their best interests.

(2) When pressed, he said that it was not important or rather definitive for him, and Sony had negotiated different dates for exercise, and he assumed that Sony would not have gone into this sort of detail if they had not thought that they might exercise. He said that the significance of the fact that, as set out in the July letter, there would be a substantial income tax liability if the option was not exercised, is partly dependent on what revenues came from the distribution rights. He agreed that the possible revenues were entirely speculative but said that counsel was missing a trick:

> "That's the tax treatment. What we were anticipating was income which would go on for many years if the option was not exercised. So whether it was exercised or not was, as I say, entirely a matter for Sony and not for us, but we went into this on the basis that there would be profits - we had a reasonable expectation of profit and that's what would have come out of that."

163. He was taken to a letter from Smith & Williamson to HMRC and asked why, in the light of the comments made in this letter on his behalf, he now suggested that he did not expect the Call Option to be exercised:

(1) In the letter it was stated that:

> "At the time our client believed he had Mansworth v Jelley losses and subscribed to participate in the LLP in August 2003, *anticipating that Sony would exercise its option, which it did. The availability of capital losses were the factor that influenced our client's decision to invest.* Our client accepts that it was not the only factor that was taken into account, but considers this was a key factor and one that tipped the balance in favour of proceeding" (Emphasis added.)

(2) He agreed that this letter was written on his behalf and the firm would have taken instructions from him before writing it. He said (a) he viewed the comment as dealing with "a due diligence point," as to what would happen *if* the option was exercised, (b) that is what anybody going into this should have looked at, to do so is perfectly sensible; it is the sort of question that any taxpayer and any professional would ask themselves, and (c) and that is why he talked about the commercial sense of the transaction. It was intended to be "a win-win" for both the studio and for Gala and, therefore, the Call Option may or may not have been exercised and, as he had no influence or no knowledge whether Sony would exercise it or not, he had to assess what would happen in each case.

(3) He added that he was told there was potential for *Mansworth v Jelley* losses to be applied and that ticked his final due diligence point and settled it for him that he would proceed:

> "It was a question of that's the last...sort of stone that tips in favour of proceeding, because I had already felt through my reading of the information and a number of items...that there was…a reasonable prospect of profit out of this in both - initially and in the longer term, to quote the [HL] analysis. So I was already convinced that there was a compelling commercial reason for Sony to do this, and it would have delivered us a stream of revenues over many years, or…What happens if it is capitalised? That is my tax situation. That's what I expect my tax adviser would write. I thought "In that case I will go into this". That is the sort of due diligence point as opposed to looking at the arrangement as a commercial prospect."

(4) He said that he would not have used the word "anticipate" but he thought it was used in the sense of looking at what would happen *if* Sony did exercise the Call Option and "anticipating" the consequence of that. His belief was Sony:

> "probably would exercise at some point, but since they had 4 possible dates to do so, I didn't know when and necessarily what the implications would be. It rather depended on how the films performed. That's what we went in for."

(5) When pressed by reference to the wording of the letter, he initially said that the point is that, *if* Sony exercised, then the issue arises as to what the consequences are, and the letter is about the consequences. He then said that he had a belief that Sony would exercise the Call Option because otherwise they would not have negotiated the option terms. However, he did not know that as it was a *call* option.

164. In our view, Mr Mallett's evidence on the meaning of the Smith & Williamson letter is counter to its plain meaning, namely, that he regarded it as probable, or he expected or predicted, that Sony would exercise the Call Option. His reluctance to accept the plain meaning, as with some other aspects of his evidence, indicates that he was influenced by the desire for his/Gala's case to succeed and so gave answers to the questions he was asked which suited that case. However, as he accepted that the letter was written on his behalf and on his instructions, it is reasonable to suppose that he had the view expressed in it. In any event, he accepted that he believed it would be exercised and later (as set out below) that he did expect that albeit that he said he could not *know* that definitively or know precisely when that would occur – as it was a call and not a put option. In our view, a reasonable investor who had read the IM and the July letter could not fail to be aware at least that it was likely that Sony would exercise the Call Option.

165. It was put to him that in the July letter Ms Challons set out an illustration based on scenario 2 and noted that CGT would be due on the gain arising on the exercise of the Call Option at only 10%. Mr Mallett said, in effect, that the tax loss was what one would expect in these circumstances, but a member would in due course pay more tax. It was put to him that Ms Challons recommended a scheme explicitly premised on a desire to shelter income from tax, which gives a member an upfront net return within a matter of months. He said that he would not use the word "shelter" because this was a secondary point to the whole purpose of going into this transaction, namely, that:

> "we thought we... had the potential to earn a substantial amount of money through film, and just perhaps as an example, you mentioned a bit earlier the Spiderman and Terminator films. Obviously, we didn't know how they would turn out and we didn't go into them. However, that was what most interested me and I did do some initial research into what their predecessors were and look at sort of precedents. The predecessors of those two films made...1.4 billion. On that basis that was the sort of transaction we were looking at. That was the potential for our upside..."

166. It was put to him that in the July letter Ms Challons did not emphasise the prospect of making money from Gross Receipts but emphasised tax relief, guaranteed payments, and sheltering income from tax. He seemed to accept that but said, in effect, that she did not mention that aspect more because, whilst the tax position is clear, the performance of the films is not in that, as they all understood, the film business is not predictable. His assumption, as an amateur, was that there was a reasonable chance that the sequels would raise similar revenue to the original films (seemingly meaning the original Terminator and Spiderman films) and that there would be a large amount of money coming through to the members. It was put to him that these points are not in his statement. He said this was just to give an illustration of the points he was making in his statement, and they were not included as how much you earn out of a film is extremely difficult to predict.

167. It was put to him that (a) his statement that if his investment was unsuccessful, tax mitigation was available misstates the position as the tax relief was paid upfront and made the investment successful by itself, and (b) given the tax relief was upfront and guaranteed, regardless of whether a single ticket to a film was sold, it is at the heart of the Gala proposition. He said that:

(1) Success depends on the films over essentially a 21-year period unless cut short by the exercise of the Call Option. Part of the proposition is that there "will be money thrown off through the distribution of profits and the profits shared through the distribution of these films" which cannot be calculated, in that all one can do is show illustrations as in scenario 3, but "one can do considerably better

than that" and, if so, at the end of the day, the members would pay more tax and HMRC would benefit.

(2) He accepted that in fact Gala's "business" was phenomenally unsuccessful, but his investment in Gala was successful through tax relief alone. However, he said that was not the intention of those going into the arrangement. Rather the intention was that:

> "we would be earning significantly greater sums from being in a slate of successful films owned by - produced by Sony and distributed by them with our investment going towards the P&A. That was what the whole purpose of the arrangement..."

(3) When pressed he said again that the members went into this for a very different reason - "the arrangement was to put us in a position whereby we could earn significant amounts of money from it" as supported by the expert opinion of HL and one could have put a series of other illustrations of how much would come out of it. That is why they went into this transaction and at that point it is quite clear that the members, HMRC and Gala would have benefited. He said counsel was looking at the position with hindsight and when "we entered into this the proposition was very different....the option might not have been exercised on the first or any of the 4 anniversaries. It might not have been exercised at all."

(4) He agreed that a return was guaranteed due to tax relief in scenario 2 but added that there was no certainty that the Call Option would be exercised. He agreed that, in each scenario, the member obtains upfront tax relief. He said the expectation was that in that first-year money would be invested and that it would come back over a period of years. There was the potential for the transaction to go on for many years. He agreed that the upfront tax repayment was not wiped out by tax due on the gain arising on exercise of the Call Option, so that a member made money overall through tax relief alone. He said this is 20/20 hindsight by looking at what happened:

> "When we went into this the expectation was that we would be earning a significant amount of money either because the call was exercised at some point during that period or not. The first year that is the correct accounting treatment but over the period we would have made…considerably more."

168. He seemed to agree that it is not correct that the scheme was unlikely to be challenged given that Ms Challons had noted that the arrangements may be challenged by HMRC and Invicta had appointed Mr Bold to defend the position if that was the case. He said he put that down to good preparation and that the investors would expect to see that. It was put to him that the arrangements were not about spreading risk as he made a return on his investment regardless of the position in relation to the films. He said that the reasonable prospect to make a proper return on investment depended on the revenues from the films. He confirmed that he could not recall reading all of the IM. He agreed that the fact that Gala intended to purchase rights to several films from a major studio was of interest because such studios make money, and their films might have better prospects than those released by smaller studios.

169. He agreed that the scenarios show that the profit or loss position of Gala does not necessarily tally with the profit and loss position of the individual investors. It was put to him that scenario 3 can be described as "speculative", given it contains a figure of £1.5 million seemingly plucked from the air, but that description is not apt for scenario 2, which reflects only the Minimum Sums and the exercise of the Call Option. He said scenario 2 was "speculative" in that, at the time, the investors did not know that the Call Option would be exercised or that exercise would occur in year 2.

170. It was put to him that, in July 2003, his assessment of his prospects of making a return on his investment must have been based solely on the tax relief:

(1) He said, in effect, that, at that time, the Gala concept had been explained to him and finding out the identity of the studio out gave him additional comfort, because clearly Sony and Columbia were the leading studios with a well-known track record. He agreed, however, that, at that time, Sony had not been signed up, the films were not known, and no deal terms were agreed. He said (a) there was a clear statement of intent that Sony would be the type of studio or the studio that would be signed up, and (b) he clearly was not deeply in the negotiation of the terms, because that was for Gala itself to do and he relied on them. They are very experienced.

(2) When it was put to him that without that information he could not form a view on his or Gala's prospects of receiving money from the films, he said, as far as he understood, and he was relatively amateur, the nature of the film business is that negotiations go on behind the scenes and Gala would negotiate the best terms it could get. That is entirely consistent with trying to put together an answer to the issue that studios had, namely, that a change in accounting treatment meant that they had to take all of the distribution costs in year one rather than spreading them out:

> "So it was a statement of intent backed by an organisation which was putting it together, and a team in Los Angeles, and on that basis you would anticipate that there would be an attractive slate which would lead to profits being generated.....in the medium term."

(3) When pressed, he said that clearly he could not individually calculate exactly what the numbers were going to be but a framework was being put in place whereby "we would enter into a sensible commercial agreement which should be a win-win for both ourselves and the studio". So on that basis he would not have expected there to be the absolute detail to be able to do a detailed calculation, but this was "a framework for what was... going to be offered to us and clearly was going to be rolled out and put in place". He was presented with what was being put together and asked if he was interested (and he was) but clearly, he could not actually calculate exactly how much investors would get out of it - but no-one could. That is what he expected then to happen as the first part of putting this transaction together:

> "You have to take a view that it is going to be a commercially sensible transaction and on that basis no, you can't come up with the precise numbers, but can you answer to your own satisfaction the key question, which is given a studio such as this one with a slate of films, including two blockbusters, is there a decent prospect that you are going to make some money out of this arrangement, which is for the benefit of both the studio and ourselves? Yes, is the answer."

(4) When pressed on the point that his view was based on the tax relief alone, he said (a) this was a commercial transaction and was entirely typical of a commercial transaction, and (b) the taxation is very secondary here. The point is that in these circumstances there was a very strong reason for a studio to have some of their cashflow effectively provided by a third party for reasons of their accounting treatment. He said, in effect, he believed Sony would not do this without believing that they would make a profit, and in turn that Gala would not do so without terms and analysis that was to come, as it did in November.

(5) He agreed that his expectation was that the Call Option would be exercised but said he we did not *know* when it would be or whether. He did not agree that

his view was that the only risk associated with this transaction was the Call Option not being exercised. He seemed to agree that given the lack of information on the films and deal terms, there was no basis for committing to the transaction in July 2003. He said, however, that he did not commit then and noted that, from the July letter, he had the names of 2 films which were sequels and, as he had already said, they may not have been signed up, but the indication in the letter was that they would be on the slate and the previous success of the earlier films suggested that there were significant amounts of money that could be made.

(6) He agreed that whether Sony and Gala made a profit from the films depended on the deal terms and the fact that a film might be successful and might make a lot of money does not necessarily tell you anything about their prospect of making money from the films, because it all depends on their position in the waterfall and the deal terms that have been negotiated. We note that, as set out in section 7, Mr Mallett did not know the terms of the deal when he signed his acknowledgement and so became committed to the Gala transactions.

171. On the basis of the evidence set out above (and that set out in section 7) we consider that at least one of the attractions, if not the main attraction, of the Gala arrangements for Mr Mallett was the prospect of obtaining a return from the expected tax relief alone albeit that he may have had a speculative hope that Gala would receive sufficient Gross Receipts for him to obtain an additional return. We note that:

(1) Albeit with some reluctance, Mr Mallett accepted that in fact he obtained a return from the Gala arrangements purely from the tax benefit. He maintained that this was the position with hindsight, this was not what investors went into the arrangements for and that he did not *know* that the Call Option would be exercised, in effect, in support of his stated view that obtaining the tax benefit was secondary.

(2) However, whilst he plainly could not *know* definitively that the Call Option would be exercised at the earliest opportunity, his asserted view that the tax benefit was a secondary consideration lacks credibility in light of the facts that (a) he said in his witness statement that he believed it was likely but not definitive that the studio would probably exercise the option, ultimately he accepted that he believed and expected the Call Option to be exercised, and this accords with the plain statement in the Smith & Williamson letter that he anticipated that it would be exercised, (b) he signed the admission documents only 2 weeks after receipt of the July letter, when he only had the IM and the information Ms Challons set out in that letter and related documents, and (c) at that time, he had no basis for his view that there could be a profit from Gross Receipts and that is why investors went into this, other than his reliance on Invicta/Gala (whom he did not meet with) negotiating a good deal, the mention of the 2 blockbusters (which ultimately were not part of the transaction) and that Sony would not do this without thinking they could make a profit. He accepted, that whether Gala would make a profit depended on the terms of the deal and he did not know what those terms would actually be. He showed no concern with the actual terms; he made no mention of the waterfall as an important aspect of the transaction in his witness statement or of any discussion with Ms Challons on that. He was prepared to sign up to the arrangements (albeit he was not committed at this point) on the basis of Gala possibly investing in 2 blockbusters and in the apparent belief that Gala/Invicta would negotiate a good deal, and (d) moreover, the evidence set out in section 7, demonstrates further Mr Mallett's lack of interest in the terms of the waterfall and what share of Gross Receipts Gala was likely to receive.

Evidence of Mr Lewis

172. Mr Lewis contributed £2.3 million to Gala of which £516,580 was financed from his personal resources and £1,783,420 was borrowed from SG. He received tax relief of around £906,000 and a cash advantage in year one of around £389,000. At the time of the transactions, he was employed by Credit Suisse as Head of European Operations of its investment banking arm. In his statement he made the following main points:

(1) He was informed of the Gala proposal by Ms Challons who he was introduced to in 2003 by a contact at HSBC. His initial response was that he was not interested in investing in films, given he had previously invested in sale and leasebacks, which he had clearly understood to be a legitimate and accepted way to defer tax, only for HMRC to open investigations into them. Ms Challons explained that, although there were some "dodgy" film investments that he may have unwittingly been exposed to, there were other better options. He asked her for further information and she sent him the letter of 12 September 2003 (see section 4).

At the hearing he said he did not at the time realise the sale and lease backs he invested in were tax avoidance schemes; he was advised by his local financial adviser that they were encouraged as schemes to help mitigate tax. When he then found out that that was not the case, he paid everything back to HMRC and suggested that he would never invest in anything that sounds like it is not completely legitimate again. He confirmed that Ms Challons introduced him to Ingenious Film Partners 2 LLP which he invested in and that he has settled his liabilities to HMRC on that.

(2) Mr Lewis highlighted that Ms Challons set out in the letter that: (a) Gala was different from "vanilla sale and leaseback arrangements", in that it intended to generate trading profits from distribution in the medium term, (b) Gala intended to acquire the rights to 3 to 7 films from Sony, and to fund part of the distribution expenditure of only those films it judged to be commercially viable, (c) the opportunity had arisen due to a change in US accounting standards, (d) details of the structure and risks, which centred around trading, commerciality and security provided by SG and Sony (although Mr Lewis understood that these risks were relatively low) together with a worked example, (e) details of the taxation of the investment, and (f) the financial outcome for him.

(3) Following this, he started to reconsider investments in films on the basis that (a) the Gala proposal came from HSBC, whose reputation and expertise he had no reason to doubt, (b) he realised that his 2000 film investment had originated from a local financial advisor, who was clearly not as sophisticated as HSBC, (c) the Gala proposal sounded commercial and stemmed from what appeared to be a genuine need for studios to source funding as a solution to the change in accounting standards, and (d) it was backed by a major US film studio (unlike his earlier investments which were in small, independent film producers and studios).

(4) He did not have a background in film and, in order to evaluate the commercial case for Gala, he tried to rely on common sense and logic. Given his initial reservations, he met with Ms Challons on 2 further occasions, and they discussed most, if not all, of the contents of the letter. They also discussed the IM but focussed mainly on her letter, which summarised its contents. Ms Challons seemed to be well connected in the media industry and was very persuasive in explaining how it functioned.

(5) Ms Challons explained (a) how distribution costs compare to a film's production budget, and how the different parts of the film "food chain" can be

separately funded, and (b) the US accounting standards changes in more detail. Given his experience with balance sheets, he could understand why a film studio would want to outsource distribution and give up some of their profits in return for doing so.

(6) They discussed the suggested 30/70 split with the studio of the profit generated by the distribution as described in the letter. That certainly pricked his interest as it seemed to him to be a decent split, bearing in mind the fact that the films were backed by a major US studio.

(7) Ms Challons walked him through the scenarios in some detail and it seemed to him that, if the films did well, there was a reasonable prospect for him to make some money on any investment in Gala. He thought he understood that this was irrespective of whether Sony exercised their option or not. His understanding was that the intention was that Gala would endeavour to make commercial gains and returns for the members over the years that followed the initial investment, from exploiting the films.

(8) They discussed the fact that the Gala opportunity was different to his earlier film investments because Gala would be able to be proactively involved in selecting the relevant films, through a team of analysts based in Los Angeles employed by Gala, and there would be an involvement in the distribution:

> "This really impressed me as it wasn't a case of Gala simply signing a document and letting the studio do what it wanted - there seemed to be genuine participation in trying to pick the right films and being involved in how they were distributed. Even the example films provided on the third page of the 12 September 2003 Letter were Spider Man II and Terminator III, which demonstrated to me the high standard of films that would be involved, and led me to believe that the films Gala would purchase would have every opportunity of being successful and, hopefully, turning a profit."

A significant part of their discussion centred on the "tax mitigation" side of the investment, and he understood that, due to the large up-front costs, Gala would incur significant losses which the members would be allowed to offset against their income pursuant to existing tax and accounting rules.

(9) All in all, he left his second meeting with Ms Challons thinking that the Gala opportunity was an attractive opportunity which might make a return, but which was tax efficient even if it did not. With that in mind, he went away to consider the papers further and to discuss matters with his wife before reaching a final decision. As regards the risks:

(a) Ms Challons repeatedly assured him that Gala was a low-risk investment from both an outright return perspective and from an acceptable tax-efficient angle. He tends not to be interested in high-risk investments.

(b) Although the letter referred to a number of potential risks, with the exception of the tax mitigation side of things, based on what he had seen and been provided with, he considered all those other risks to be low. For example, he considered it unlikely that either Sony or SG, with their reputable respective standings, would default and he did not really even give that any second thought.

(c) Following on from his previous experience of film investments, he asked many questions around the tax risks and got comfortable with the Gala proposal from what Ms Challons told him, and as it had the support of a senior tax barrister and of a former HMRC officer, Mr Bold. The standing and experience of these individuals gave him comfort that Gala was compliant with

HMRC rules as they stood. In fact, he recalls receiving letters from Mr Bold over the years, which reassured him that this continued to be the case.

(10) Although he understood that it was by no means guaranteed, he expected a return of 10-20%, which was higher than the interest rates available and that it would be realised within 3 to 5 years if the option was not triggered earlier and in addition to this, the investment was tax-efficient, which meant that it was even more financially attractive. He reached the conclusion that the whole Gala package was attractive; there was a sound commercial rationale for Gala, it was recommended by one of the largest financial institutions in the world, it could provide him with a return on his investment and it was tax-efficient.

(11) The amount he invested was the amount that Ms Challons recommended he invest and was based on his taxable income in the 3 prior tax years. As he perceived this to be a good investment in the round, and he could afford the contribution, he was comfortable investing that amount.

(12) As it was important to him that he gained a real understanding of this particular film investment given his earlier film investments, he believes that he read all the documents enclosed with Ms Challons' letter.

(13) He signed the loan agreement with SG and the other documents on 1 October 2003, he thought at the end of his third meeting with Ms Challons. He has noted now that there is wording to the effect that SG makes no warranty or representation as regards the structure and the likely returns (see section 3 of Part A). With hindsight, he thought he probably should have asked more questions about this, but he gained comfort from the recommendation of HSBC.

(14) He only dealt with Ms Challons and did not meet with any of the people involved in Gala. He thought that Ms Challons offered the opportunity for him to meet the individuals involved, but he trusted her and did not take up the offer.

173. We consider it apparent from the overall tenor of Mr Lewis's evidence in this section, taken together with that in section 7, that, when he decided to invest (1) a key attraction for him of the Gala arrangements was the prospect of obtaining a return from the expected tax benefit, (2) his view was that Gala may realise sufficient Gross Receipts for him to make an additional return as based, in particular, on (a) his belief that Gross Receipts would be split 30/70, as he was informed by Ms Challons, and (b) his trust in her opinion, and (3) that belief may have been a factor in his decision whether to invest albeit that it is very difficult to assess how significant a factor that was. He had 3 conversations with Ms Challons before he signed the admission documents and said that he discussed this 30/70 split with her as part of this and mentioned this as a matter of importance in his witness statement. However, as set out in [177] and section 7, he did not check whether there was in fact a 30/70 split in the DA or where in the waterfall that split appeared or seek any other information which would have enabled him to assess how the waterfall would operate.

174. When questioned by reference to the scenarios, whilst he did not accept that the expected outcome was that Sony would exercise the Call Option after 2 years, he did accept that tax was part of his consideration and that it was an important part of the transactions:

(1) He confirmed that he was aware of the waterfall and there is a distinction between (a) whether Gala made a profit and whether he made a return on his cash contribution, and (b) whether Gala and Sony made a profit.

(2) He confirmed that he was aware of the Call Option but noted that (a) there is also scenario 3 and scenario 2 was not expected in the beginning, (b) scenario 2 would be the expected outcome rather than scenario 1 if the only conversation

was about those two examples but, when he was convinced to go into this transaction, it was not simply based on the Call Option but on the performance of the films.

(3) He agreed that in scenario 3, £1.5 million was not a guaranteed amount and he did not know from the IM what level of Gross Receipts would be needed for Gala to receive £1.5 million or how likely their receipt was or what films were involved. He said, however, that he based his decision on the quality of the films under discussion and the fact that there was a notification from some external experts that they thought these films should deliver those sorts of margins. It was put to him that, in light of this lack of information, scenario 3 is of no practical utility to a serious investor; a serious investor's intention and hope would be that scenario 2 would happen as it provided a guaranteed return based on the tax benefit and any other cash return would be a bonus. He said he found scenario 3 as beneficial as the other 2 scenarios after listening to Ms Challons, who seemed to be well versed in media positions and the opportunities that should be available.

(4) He said that scenario 2 was not his expectation.:

> "I saw these as 3 scenarios. There could have been 53 scenarios. I saw the first one would result in a loss. That could have just been as likely to happen if Sony decided not to exercise their option. It was their call option. I saw.. scenario 2 as being a way of almost putting a footing on to the conversation, but the reason I was interested in this opportunity was the quality of the films and therefore the likes of 1.5 million would be achievable."

(5) When it was put to him there was no information on the films in the IM, he said when he saw the IM he said he was interested and it was only later when he saw the quality of the films that he was ready to sign up.

(6) It was put to him that Ms Challons set out an illustration of the outcome for him of investing in Gala based only on scenario 2 and specifically drew his attention only to that, because that was what was expected to happen. He said: "That's not the way I recall the conversation or my expectation."

(7) He agreed that (a) in year 1 he recovered his cash contribution plus £376,593.20, and (b) the tax relief of around £893,000 does not simply reduce the burden of a loss but resulted in him making a positive return, and (c) he was still in a positive position, even taking account of the tax on the capital gain which arose on exercise of the Call Option. He added, however, that in each of the scenarios, any of which could have happened, there would be a subsequent tax liability, which offset the year 1 positive cashflow.

(8) It was put to him that a serious investor would view the tax benefit as the fundamental and real attraction, because there is no risk involved other than the risk of the tax analysis being faulty and anything else is simply a bonus. He said: The tax relief was part of it but there was also the profitability part of it which he was happy with. He emphasised again that there would be subsequent tax liabilities that would reduce the initial benefit of the tax relief and that if the option was not exercised, then under scenario 1 he would make a loss. He accepted, however, it is correct that the tax relief alone would result in a profit for a member even after CGT. When pressed he emphasised that he had no control over whether Sony exercised the option and, if it did not, he did not get the tax benefit.

(9) It was put to him that the only risk of not making a huge return just based on the tax relief arose if Sony did not exercise the Call Option. He said in that case, there is a capital gain and that would then return in a profit and if Sony did not exercise the option, there is scenario 1 or 3. When pressed, he said: "Subject

to what I said before in terms of the option, correct, the figures shown, that's correct."

(10) He agreed that the vast majority of the risk factors Ms Challons set out in her letter relate to tax and said that there is "no doubt that tax is an important part of this transaction". He took issue with counsel describing as one of the tax risks Ms Challons' statement regarding the income tax liability that would arise if the option was not exercised before the end of the term of the DA. He did not consider that she was putting the non-exercise of the option as a risk in the sense of something that might go wrong; she was alerting him to be aware that Sony may not exercise it but not necessarily saying that, if that occurred, something had gone wrong. It was put to him that Ms Challons highlighted Sony not exercising the option as a risk as it is an example of matters not going to plan. He said that is not the way he reads it even now. In our view, it is plain from the terms of the letter that Ms Challons viewed the situation where Sony did not exercise the option as a disadvantageous circumstance (see section 4).

(11) It was put to him that the statements in the IM regarding the role of SFP constitutes a candid recognition that Gala was a tax shelter product. He did not seem to dispute this but said that he was not sure that tax shelter means tax avoidance and, recognising his previous investment in films, he took comfort from the fact that SFP were involved. He said he could understand the translation that the IM was saying that investing in Gala is less attractive for those who have done other tax shelter products, because they would not then need this tax shelter product.

175. He was questioned on his comments in his witness statement on the commerciality of the Gala proposal. It is apparent from his responses that he did not know the actual terms of the deal and assumed that Ms Challons was correct that there would be a 30/70 split of Gross Receipts and that Sony required funding due to a change in US accounting:

(1) He agreed that when he considered this in 2003, he did not have the documents and did not know the terms of the waterfall. He said that he meant in his statement that Gala sounded like a commercial proposition after he had heard from Ms Challons about the change in tax laws in the US and that Sony would need to either write off all their distribution costs upfront or find an alternative way.

(2) He confirmed that he was aware that an amount equal to the sums put in the expenditure account was transferred by Sony to Barclays to back up the LCs. When it was put to him that at least in economic terms, in the real world, the funds in the expenditure account were not genuinely available to Sony he said that:

> "Economically yes, but the reality is from my background in banking operations with structural transactions you expect cash to flow through different entities for different reasons. So economically the cash ends up in the same place I guess, but that doesn't mean it hasn't happened."

(3) He seemed to agree that, as a matter of principle, there is no inconsistency between Sony entering into the arrangements because of a change in accounting standards, and Gala and its investors doing so for tax reasons. He said that is the way the world works and: "There's a need and there's sources of financing, and if those sources of financing could be done in a legitimate, tax-optimised way, I think that's what is happening all the time."

(4) He agreed that he did not have the DA when he had his discussions with Ms Challons. He said that his understanding about film selection was based upon

the IM which suggested there would be a team of experts employed by Gala in Los Angeles who would work with the studios. He did not have any more facts than that. He agreed that Sony is a major well-known film studio and it is reasonable to think that they would be better placed than Gala or any experts hired by Gala to work out how to exploit and distribute its films but he thought Sony were not necessarily looking for Gala to help with their distribution: "They were looking to Gala to help them finance their films - the printing and distribution." We note that Mr Lewis was given this impression by Ms Challons in her July letter.

176. It was put to him that he invested because he wanted to generate sufficient losses based on his income in the last 3 years. He replied that he invested as much as he could and this was where he could optimise his previous earnings; that was the reason for the relief, namely, to optimise his tax position on his previous earnings. When it was put to him that he meant that he wanted not to pay tax on his previous earnings, he said that is no different to if he decided "to enter into a...venture capital transaction, based on my last year's earnings I would do it legitimately up to a limit to my earnings" and "I can optimise my tax position to get that year one tax benefit and then have a liability subsequently, not just not pay tax and walk away". He agreed that actually he ended up in a positive position by virtue of tax relief.

177. It is apparent that (a) when he decided to invest, to the extent he considered that there was a prospect of him making a return through Gala's share of Gross Receipts, Mr Lewis relied only on Ms Challons' comments on the 30/70 split, her assurances and the quality of the films she mentioned in the July letter (which, were not in fact included in the deal as Mr Lewis did not check). He did not have the information required to assess Gala's prospects of receiving Gross Receipts, whether on the incorrect 30/70 basis or otherwise, and did not seek to obtain that information, (b) he did not know the actual ratio for the sharing of Gross Receipts between Gala and Sony until it was put to him at the hearing (and see section 7), and (c) he was interested in his own return and not whether Gala would make a profit:

(1) He agreed that in scenario 2, as the tax relief alone gives a profit for a member, it would not matter to a member whether Gala generates any profits itself.

(2) It was put to him that based on the IM he was not in a position to know what Gala's share of any film revenues would be or how likely those revenues were to arise. He said that he certainly was not aware of the details of the expenses and the "expectation again after the input from Ms Challons was that that would still result in figures such as scenario 3" although he agreed that there were unknowns as regards the expenses and matters such as the level of distribution fee and the split of revenues between Gala and Sony.

(3) He agreed that, when he discussed this with Ms Challons he could not verify the 30/70 split as he did not have the details of the waterfall "but again I trusted my adviser and it sounded appropriate". He accepted what she said on this as a fact and did not ask her for any evidence to support it. It was put to him that he did not ask her for evidence because he knew that he would make a return based on the tax relief so that the split did not matter. He said that was not his assumption at the time. He confirmed that he was not aware that there is not a single step in the waterfall where revenues are divided 30:70. He assumed from what Ms Challons said that that was an agreed split, and as a member, he would expect therefore to be able to generate profits and that was why he was interested in the transaction. He added that he expected there would be profits because of the quality of the films, which are mentioned in her letter, such as Spiderman and

Terminator and with a 30% profit distribution of those films, that sounded like a reasonable transaction to him. When it was put to him that Gala did not acquire rights in relation to those films, he noted that the letter says "the likes of" and that he did not know is the honest answer. He did not appear to know, therefore, what films were subject to the Gala arrangements.

(4) It was put to him that he could not know what would come out of a 30:70 split until he knew what came out of the Gross Receipts under the earlier steps in the waterfall. He said that, in hindsight that is obvious but he was focused on the assurance that he was getting from the quality of the films that were discussed at the time and the quality of transaction compared to what he had invested in before and therefore his expectation that a 30% profit would be a significant return figure for him.

(5) It was put to him that if he really expected to make a profit based on a 30:70 split, given that he invested half a million pounds of his own money, he would have done something to verify if that was correct and, he did not do so, as it did not matter as he would make money just from the tax relief. He said:

> "I trusted my financial adviser to give me the right guidance. I didn't think she would come and tell me lies…my concern was that I would end up having the same situation as I had previously. I would enter into a transaction that I was perfectly happy with, but then HMRC would come after me. I didn't want that to happen at all and hence my questions were much more around how legitimate is this…I trusted she wouldn't be coming and telling me untruths."

(6) He was asked if, in his references in his statement to making money on the investment in Gala, he meant he would make money on his cash contribution, he said that he saw it as making money on his whole investment as he regarded the loan as his obligation as well. He confirmed that he was aware that there were arrangements in place for his SG loan to be guaranteed to be repaid but said that:

> "as we have subsequently seen over the last decade or so, nothing is really guaranteed. Banks do fold. So there was still some liability, some potential risk there…I just saw the total amount as the amount I was putting in, even though some of it was funded and some of it guaranteed, but rather than go through that loop again, yes, I expected to make a return on the amount I put in."

(7) He agreed that, in scenario 2, a member makes money irrespective of how the films perform but noted that he had understood that there was a reasonable prospect of making money irrespective of whether Sony exercised their option or not. He agreed, in effect, that the difference in outcome in scenarios 1 and 2 results from Sony exercising the Call Option but noted that scenario 1 applies if the films did not do well whereas scenario 3 applies if they did do well. He agreed that he did not know how well the films would have to do for anything to come to Gala under the waterfall:

> "but reading the [IM] which had the 3 scenarios, my assumption was that if the films did well there was a reasonable prospect for me to make some money, irrespective of Sony exercising their option. That was my statement, because that was the fact. That was how I felt at the time."

(8) It was put to him that his comment that Gala would endeavour to make commercial gains and returns for members over the coming years cannot be right, because the intention was that the structure would be wound up after a couple of years when Sony exercised its option. He said that was never his intention or expectation.

(9) When it was put to him that he was not in a position to evaluate whether realistically Gala could generate any revenues, as he did not know its position in

the waterfall or how the waterfall worked or how likely it was that revenues would arise, he said the quality of the films led him to believe that there was a likelihood that there was a profit to be made in the exploitation of these films and he therefore expected, particularly based on the 30:70 split, that there would be a positive commercial outcome for the members. It was put to him that a 30:70 split was not agreed but, in any event, he was not in a position to know how many Gross Receipts would be needed before that split kicked in or how likely that level of receipts was. He said that he did not have the detail, but he based his understanding on the conversations he had with Ms Challons, who convinced him that the detail and expectation of the return on these films would be commercially attractive.

(10) He was asked if he was surprised to hear that under the waterfall there is a split of 334:1 and was taken through the transcript where Mr Yusef agreed with that. He said: "Of course but without understanding the context of what all the figures mean, they are just a list of numbers, but "I was surprised if I thought it was 30:70 and you are suggesting it is 99.7 to 0.30". He agreed that on the basis of that split of revenues, is it fair to say that, in fact, those running Gala cannot have been aiming to make a return from exploitation of the films, because the revenue position under the waterfall was so weak. He added that, accepting the 30:70 and the scenarios, he was under the clear impression that this should be a profitable investment. If the figures were more like as was just described to him, then he struggled to understand how it can be profitable.

(11) He said that when he prepared his statement, he was thinking of a return of 10 to 20% per annum but he certainly did not tie it back to the scenarios and it was based on his understanding that there would be a 30:70 split.

178. In re-examination, he was taken to Mr Yusef's comments on the benefits of the waterfall he had negotiated. He noted that Mr Yusef spoke of reducing the Production Cost and said, without seeing the numbers he did not know how that results in a net profit for Gala, but "that feels like a very different calculation and outcome to what was described previously". We note that the reduction in the Production Cost does not affect the profit-sharing ratio put to Mr Lewis.

179. Mr Lewis agreed that when he signed the admission form and other documents on 1 October 2003 he did not know how many revenues would need to come in before the supposed split of 30/70 would kick in under the waterfall and that he did not have the 2003 HL letter. His assumption that there would be a positive return was based upon Ms Challons' advice and the quality of the films and the film studio.

180. In his statement he said that the intention was "always to reclaim the loss very early, to allow the investment to continue as planned and to pay tax on the profits as and when they were received". It was put to him that he was not actually in a position to know whether or what amount of profits would come in or whether there would be enough profits to undo his tax relief. He said he had an expectation based upon the scenarios that profit would be made. At some stage he would have to pay tax on those profits. He did not understand the quantum of tax that he would have to pay out in due course, but in every scenario tax would be paid. He confirmed that he was aware that in scenario 2 CGT would be at an effective rate of 10%.

Section 6 - November letters and 2003 HL letter

November letters

181. The November letters from Mr Ackerman to Invicta all pre-date the letter from Mr Litt of 17 November 2003 with which he enclosed the film files. The letters read as follows:

> "I have read the final draft screenplay for SPE's upcoming theatrical motion picture [name] directed by [name], produced by [name], and starring [names]. Given this film's storyline, the high quality of the final draft script, and the committed talent, I believe this film has excellent chances of commercial success in the US and international theatrical and home entertainment markets. I recommend this film for the Gala Partners P&A fund."

Evidence of Mr Yusef

182. At the hearing, Mr Yusef was questioned about how Mr Ackerman wrote the November letters without the films files and why in his witness statement he suggested Mr Ackerman had reviewed the files:

(1) He initially said that the important point was that these documents were received prior to the point at which Gala committed to the films; "these were the projects that we wanted, we selected, and then we had to go through a verification process". So it made sense to him that the film files "dealing with the production schedules, the detailed budgets and everything else would follow in order for us to then take....to our friends at [HL], who then provided us with the final decision as to whether or not to move forward" and noted that was presented to the members at the meetings when the transactions were approved. He pointed out that Mr Ackerman said he had reviewed the scripts before he sent the letters. His recollection was that "we got a whole bundle of documents, which we then sent out to each of the members who had...provisionally committed money".

(2) When pressed, he said he did not know what information came prior to Mr Litt's letter and he thought Mr Ackerman is the proper person to answer. He agreed that there are no further letters from Mr Ackerman updating his advice once he had received the files and that the November letters were sent before there was a contractual relationship with LBPC (although he pointed out there was an understanding with Mr Ackerman).

Evidence of Mr Ackerman

183. Mr Ackerman said the following in relation to the November letters, in his witness statement:

(1) Before sending the November letters, he would have reviewed the screenplays for the films and would have discussed the results of his reviews in the build-up to writing them with Mr Yusef and Mr Bamford. They:

> "would ask about the storyline, strength of the dialogue, proposed cast etc and were keen to get my opinions on whether I thought the film would be a success in light of my experience in the industry."

(2) He would have tailored his review to the requirement of the film but did not include this granular level of detail in the letters as ultimately all they needed to know was whether he considered the screenplay could result in a commercially successful film.

(3) Whilst Mr Litt did not formally send the film files until after he sent these letters, he recalled that some of the documents, such as the screenplays for the relevant films had already been provided to him at meetings with Sony. He thought Mr Litt sent his letter to ensure that Mr Yusef had a complete record of documents.

184. In examination in chief:

(1) Mr Ackerman was asked to amplify what documents he received before Mr Litt's letter was received. He said he had had several meetings on his own with Sony and they had begun to share some initial documents on some of the films with him, and:

> "that would have been very, very initial documents in terms of what we ultimately received, but notably a screenplay. It may have been in certain cases a production budget recording the cost or anticipated final cost of the movie and very possibly some initial campaign release information…of the most general kind to begin with."

(2) When also asked, in effect to expand on what happened at this stage he said, "we simply commented in initial form on the screenplays and the general release concept that Sony had". He explained that a unit that involves production, finance and distribution makes the decision about whether to make a film and the head of distribution is always consulted on whether "this subject matter is something you can make money with and you can release" and his opinion is taken into account in the studio's final decision.

(3) He also explained that in negotiations with studios other than Sony he and Mr Yusef felt it would be difficult to convince the studio to share the critical information they sought and they went forward ultimately with Sony because Sony became comfortable with Mr Ackerman, with the relationships he had in Hollywood and with the concept of sharing the data and involving them in the process.

(4) When asked if he had any insight into Sony's approach to Gala's position in the deal, he said this that Sony was very concerned that "this deal transaction come together in the right way" and:

> "It was not a matter simply of our reaching agreement with their studio attorneys and head of business affairs, notably Mr Stefan Litt, but the deal went all the way to headquarters in New York and to Tokyo…because there was a tax component in the structure of the investment with the UK, they were concerned that the deal not be done in any improper way that would impact Sony's overall business in the UK…and for that reason they were instructed by New York, the people in Los Angeles, to ensure that the relationship with us was built on a fully transactional basis and that our needs were met to the best of their ability."

185. In cross examination Mr Ackerman said the following:

(1) He agreed that LBPC still did not have a contractual relationship with Invicta when he sent the November letters and any money received from Mr Yusef would have long since been used up, so that he was not getting paid for sending any of these letters at that time. When it was put to him that the absence of remuneration is reflected in the thinness of the letters, he said

> "You could infer that, yes, but again I would add that a great deal of work was occurring here on the strength of my relationship with Mr Yusef, which went back quite a few years, and also on the strength of my own reputation. Again, it is quite common in the industry in the preparation of various different stages of business in the film industry is that people will undertake work before being remunerated or before being formally engaged by a contract."

(2) He said he "had already received quite a lot of documentation from Sony" before he wrote the letters and he suggested its provision began very shortly after the initial meetings with Sony, where it appeared that "we should certainly explore the possibility of concluding an agreement for Gala" and "part of that general consensus was that Mr Litt authorised the release of certain elements involving these films". He described Mr Litt's letter as a "bureaucratic and formal approval formalising a document which we would have filed showing that we were now in formal receipt as opposed to informal receipt of elements". However, he did not appear to recall what documents he actually had when he issued the letters and his evidence on this is unclear.

(3) When it was put to him that Mr Litt's letter contained relevant documentation which he did not have when he wrote the November letters, he said that was not necessarily the case and whilst he did not recall, he thought the letter looks "like a formalisation and recording of elements that we needed and had either already received or were receiving".

(4) When his comments in examination in chief were put to him, he said that he stood by what he said in his witness statement but:

> "When I speak about the most general elements and so forth, I am speaking also with a knowledge of the massive amount of material that my office received as these films went into distribution. So a screenplay and number of preliminary marketing plans and different expenditure strategies, production budgets would definitely have been already with me. However, I would consider that, while critical in making a commercial assessment and offering an opinion, essential elements, I would also consider that a small amount of material in comparison to the voluminous amount of data that we would receive on a weekly basis as the movies went into commercial release. Again because of the dynamic nature of the trade or trading, this was coming from Sony. It was being double checked with data coming from McCann Erickson and there is a tremendous amount of data in that process. So that for me is the full body of data from Sony over the lifetime of my involvement advising Invicta on behalf of Gala".

(5) He then seemed to accept that he had received only some of the relevant documents before he sent the earlier November letters but could not recall which particular documents he received. He said that, however, he would have had all the information he needed to make the assessment he made: "Otherwise I would not have issued the letter, however brief it is. I would not have issued the letter". He said again that Mr Litt's letter looks like part of a formal procedure on behalf of Mr Litt's office in papering whatever internal needs Sony had, but:

> "we had already received a lot of the elements that are referred to in this letter...I had spoken to the elements that I was assessing to make an opinion. That is different from the elements I would receive subsequently leading up to commercial release, again because of the dynamic nature of the market and the voluminous amount of data coming from multiple sources, both Mr Litt's office, Paul Smith's office and the McCann Erickson team and other people as well. So this was material that would be added in as part of a process. This process that we are discussing here is a very fluid one, and information is flowing in, not just one documented legal definition of that flow. It is flowing sometimes on an informal basis, certainly leading up to the relationship, as the relationship with Sony was being built, developed and managed, both by Sony personnel, not just Mr Litt. In fact, other people were quite more involved than Mr Litt once the relationship proceeded."

(6) He did not agree that he advised in the November letters without having some of the relevant documents: "I am advising on documents needed to provide a commercial opinion at that time". He seemed to agree that he did not send any further letters once he had all the documents but added:

> "However, there are many further letters and written exchanges between myself, Mr Yusef and Mr Bamford in which I am updating them on changes that Sony is wanting to make in distribution plans, and as being discussed between myself, Paul Smith and the distribution teams. Those meetings were happening 2…3 times a week...and I would very frequently update by phone both Mr Bamford and Mr Yusef immediately after meetings or the day following as well as provide written analysis of some of the changes which would often be based on changes within a given city according to how a film

was performing in its opening week or two, and the changes that we agreed in consultation with the Sony team should be made in order to increase or endeavour to enhance the commercial performance".

Conclusions

186. Mr Ackerman gave inconsistent evidence on whether he reviewed all of the screenplays relating to the transaction films in order to produce the November letters and what information he had at that time, much of his evidence in this respect appeared to be based on what he thought he would have done in such circumstances rather than on any actual recollection and, at times, he focussed on the process after the letters were produced which was not what he was being questioned on. On the basis of all the evidence on this, we consider that (a) it is clear that Mr Ackerman had not received the full set of film files when he produced the November letters, and (b) it is unlikely that he had anything other than the screenplays and possibly, as he said when initially asked about this in examination in chief "a production budget recording the cost or anticipated final cost of the movie and very possibly some initial campaign release information… of the most general kind" . We note that:

(1) We accept that (a) Mr Ackerman was prepared to do work in anticipation of LBPC's formal appointment and that he was mindful of his professional reputation, and (b) therefore, that he is unlikely to have issued letters which explicitly state that he reviewed the screenplays without having done so.

(2) The opinion he gave in the November letters is very limited in that (a) on the terms of the letter, he based his view solely on a review of the draft screenplay for the relevant film and the talent involved; he mentions no other documents or analysis so it seems unlikely he took anything else into account even if he had other materials, and (b) he stated that the relevant film had excellent chances of commercial success but did not provide any quantification of what sums the film may generate. He did not produce any updated letters once the film files were received to take into account the fuller information he would then have had.

(3) We consider that a reasonable business/investor who is seriously interested in conducting a film distribution trade, or investing in it, with a view to receiving a profit/return from Gross Receipts from the selected films would not be satisfied with such cursory letters, written in such limited terms, as the sole basis of the recommendation of which films the business should acquire distribution rights in. Mr Ackerman said he would have discussed the results of his reviews in the build-up to writing them with Mr Yusef and Mr Bamford but any such discussions, on his own evidence, were only about "the storyline, strength of the dialogue, proposed cast etc" and whether he thought the film would be a success in light of his experience in the industry. Whilst no doubt these are important and relevant matters, they are only part of the picture in assessing what Gala may actually receive under the waterfall. Mr Ackerman produced nothing further in writing until he produced the December letters in which he described the Plans then in place in respect of the transaction films as "optimal".

(4) As set out below, Mr Yusef emphasised that Invicta/Gala and the members relied on the HL letters for the further analysis required to demonstrate that Gala had a reasonable prospect of making a profit from the transactions. However, as explained in section 13, we do not consider that a reasonable business/investor would place this degree of reliance on the HL letters. Mr Yusef also suggested in his witness statement that Mr Ackerman provided input into assessing the likely outcome for Gala under the waterfall but, as set out in this section below and in section 13, Mr Ackerman was clear that this was not his role and Mr Yusef eventually accepted that.

187. Mr Vallat placed reliance on Mr Ackerman's comments in examination in chief as demonstrating the commerciality of the arrangements. However, that Sony may have been concerned not to do anything improper and that the transaction was considered at a high level in the organisation does not of itself tell us anything material about the nature of the arrangements. We have commented in our conclusions in Part C on Mr Ackerman's and Mr Yusef's comments as regards the importance of Mr Ackerman having access to Sony's data in respect of the transaction films.

2003 HL Letter

188. In the HL November letter dated 21 November 2003, HL made the following statements of relevance:

(1) HL stated that the purpose of this analysis was:

> "to express an opinion on the likelihood of the Slate, as of 21st November 2003, to achieve profitability by virtue of economic performance in the Slate, along with the guaranteed loan payments due under the Term Sheet [the term sheet dated 5 November 2003]. It is our understanding that the minimum partners' capital will be 85 million sterling and the maximum partners' capital will be 250 million in the partnership."

(2) They said that they had made "such reviews, analyses and enquiries as we have deemed necessary and appropriate" and "among other things" (a) reviewed the Licence Agreement and the Term Sheet and met with certain senior members of the management of Gala to discuss those documents, (b) discussed those documents with certain employees of SPE, (c) reviewed the "Schedule of Theatrical Films to Be Released between 24 October 2003 and 15 February 2004" and the "Schedule of Films Post Theatrical Release Pre Video/DVD Release" and (d) conducted such "other studies, analysis and enquiries as we have deemed appropriate".

(3) They summarised their process as follows:

> "We have relied upon and assumed, without independent verification, that the information provided to us had been reasonably prepared and reflected the best currently available estimates of such information.
>
> In conducting our analysis we utilised data regarding the financial performance over time from a number of feature films, all produced and distributed by a major studio. In addition, each motion picture we examined was a significant major studio release, with similar cost structures and talent.
>
> We have not independently verified the accuracy of bits of information supplied to us with respect to the Slate and don't assume any responsibility with respect to it."

(4) They set out that they understood that the films which "may be included in the Slate" (a) that have yet to be released theatrically include but are not limited to: Something's Gotta Give, Mona Lisa Smile, You Got Served, Fifty First Kisses, and (b) that are post theatrical release but pre video and DVD release include but are not limited to: Bad Boys II, S.W.A.T., The Medallion, Once Upon A Time in Mexico and Underworld.

(5) They concluded that:

> "It is the assessment of [HL] that in order to determine the profitability of studio released feature films, the appropriate time-frame to which reference should be made is typically the first cycle of exploitation of the feature film in question.
>
> Based upon the investigation, premises, provisos and analyses outlined above it is our opinion there is a reasonable expectation of profit from the capital introduced by Gala by virtue of economic performance of the Slate, along with the guaranteed payments due under the Term Sheet, during the first cycle of

exploitation of the Slate and the reasonable expectation of further profits during the first cycle of exploitation of the Slate and a reasonable expectation of further profits after the expiration of the term under the Term Sheet."

189. We note that of the 9 films which HL list as films which they understood "may" be included in the Slate, only 3 were actually involved in Gala's arrangements. Big Fish, Breakin' All the Rules and Secret Window were not included in this letter.

190. Mr Yusef said the following as regards the HL letters in his witness statement:

(1) As regards the decision to instruct HL:

(a) Invicta wanted to obtain further comfort - in addition to that which Mr Ackerman subsequently provided in early November 2003. HL was one of the 3 top media valuation and appraisal companies in the industry, and it was used extensively by all of the main investment companies and media buyers in the sector. Mr Yusef was aware that HL had previously acted in a number of big-ticket transactions which involved Sony, and, following discussions between the two, it was agreed that they would be given access to key Sony executives as well as key data relating to the films, the release plans and budget estimates. In addition to this data, HL had "its own proprietary models which used performance figures for films of a similar genre and films by similar directors and actors".

(b) Mr Yusef had a preliminary conversation with Mr Davis of HL on 1 August 2003 which his diary entry indicates was of around 30 minutes duration. On 12 August 2003, Mr Yusef's PA sent an email on his behalf to Mr Davis with a list of films that had been made available by Sony, (and names of a few cast members) and a call was arranged with him the following day to discuss Gala's requirements. Mr Yusef could not specifically recall either of these conversations but thought that "the purpose of them were to provide him with Gala's instruction of [HL] to carry out some in-depth analysis of [the first transaction films] from the various resources that a prominent film valuer has available to them and to provide an expert opinion on whether the Films had a reasonable prospect of being profitable for Gala".

(2) HL's conclusion, coupled with the very positive analysis that the films had an excellent prospect of being a commercial success provided by Mr Ackerman 2 weeks earlier, gave Mr Yusef "all the more reason to think that the Gala opportunity did have every chance of being a financial success for its investors".

(3) Mr Yusef noted that Big Fish was not referred to in the 2003 HL letter, and instead reference is made to Mona Lisa Smile. He did not know why that happened but recalls that (a) Big Fish was considered a stronger asset than Mona Lisa Smile in any event and so was acquired notwithstanding that it had not been referred to in the HL letter, and (b) Invicta explained to members at the adherence meeting on 28 November 2003 that the view formed was that Big Fish enhanced the profit profile when compared with Mona Lisa Smile and the members agreed to proceed on that basis.

(4) The conclusion that:

"[HL] *(and Mr Ackerman)* reached in relation to Gala, namely that there was a reasonable prospect that a profit could be achieved, was based on the extensive set of data that it received from Sony and its own propriety methodology. I can confidently say that none of the members of Gala would have proceeded with the transaction had [HL] concluded that a profit in that transaction was not achievable in light of the terms and waterfall that were agreed after negotiating with…Sony." (Emphasis added.)

We note that Mr Yusef eventually accepted that Mr Ackerman did not have the role Mr Yusef attributes to him in this extract from his witness statement.

191. Mr Yusef gave the following evidence about the 2003 HL letter when cross-examined at the hearing:

(1) It was put to him that HL had the term sheet which did not refer to the films and a LA which does not contain substantive information about the film. He seemed to agree but said that was not the end of the point and he hoped to have a chance to explain.

(2) It was put to him that HL did not even have the film files. He said that the film files would have also gone to them much earlier and they would, by this stage, have had the same information Invicta had. When it was put to him that HL do not refer to the files, he said they did not need to, because they have got all the details of the films and HL is not a fly-by-night company who would not have gone into this without getting the kind of information you would expect to have at this point prior to entering into this document.

(3) It was put to him that HL did not carry out some rigorous third party stress test as they state they had not verified the information they had. He seemed to agree.

(4) It was put to him that HL referred to 9 films none of which at that stage had been signed up and only some of them were signed up eventually. He said that this was the entire slate of films that Sony had at the time and:

> "it was an essential part of the transaction that we had the right to pick which ones. It was never the intention that we would take all of them. It was only those that we wanted. We cherry-picked.."

He then accepted that it was not the entire slate as it did not include Big Fish and in fact only 3 films of those listed were signed up.

(5) It was put to him that HL does not even say how much profit is going to be generated and how much might be expected from the waterfall, as opposed to as the Minimum Sums. He said that they did not need to:

> "The waterfall is actually reviewed by them. It is important that people understand that. They have looked at the waterfall. We had discussions at the time about what it would mean to get to profitability under that specific waterfall…I am sure there were discussions that took place between me, Sony, [HL], Justin Ackerman. There was a flurry of activity at the relevant time."

(6) It was put to him that the likelihood of profitability of the slate was simply not a concern given that, despite the resources devoted to these arrangements, the only formal appraisal regarding slate profitability is a single sentence which it seems was obtained as an afterthought at the last minute, only a few days before the closing of the first transaction, on the basis that HL did not independently verify matters. He did not agree:

(a) He said HL was one of 3 companies that are in the regular business of making such appraisals, they would not make a statement like that unless they believed that they could justify it, and the document does not properly reflect the amount of work that Mr Davis and his team at HL would have done in order to reach that short, concise statement:

> "it doesn't reflect the flow of work that would have taken place internally and within their own organisation to reach that point…It isn't extraordinary…Gala was very interested. It was very interested in the profit…"

He added it "boils down" to the fact that:

> "we ended up with a waterfall where we were guaranteed the minimum payments coming back for the distribution expenses that we incurred, and we were concerned to ensure that the profitability in excess of that was a reasonable proposition. Both Mr Ackerman and I talked to the people at [HL] and various other people. The number that we would need to reach was discussed in order to achieve profitability, which is a sum in excess of the 100% of partner capitalisation, and based on that, including the [HL] report, we concluded that we had a reasonable prospect of achieving sums from the waterfall in excess of what we put into the project. That's the work that we did."

(b) He said that the independent verification point relates to the accuracy of the documents provided by Sony and not the verification of the work that HL did. They were saying that in terms of the documents supplied by Sony, or even by Invicta, they are relying on the accuracy of those documents, and they have not independently verified, which is perfectly standard and normal:

> "I have seen that caveat in both valuation appraisals, on countless occasions. It's perfectly recognisable wording. They are not going to stand behind and verify documents that they don't control."

(c) As for counsel's assertion this was a last-minute job, the timetable flow he had set out does not "accurately reflect the fact that there were simultaneous things happening at the same time" and:

> "So the first time we looked at this before the conclusion. It was a lengthy process that went throughout the whole period that you've been reviewing. So…for a transaction of this complexity and size, I do not find it surprising that this should fall into place at the last moment. That's not because it was an afterthought that occurred a day or two before the transaction. It was always contemplated that we would get a [HL] report."

(d) He said that the likelihood of profitability of the slate was a concern to those who signed up and to him:

> "I wouldn't have closed the completion. If [HL], at that point, had said, "There is no possibility of achieving profitability based on the documents that we have", then we wouldn't have done the transaction, or we would have looked at other films or we would have re-examined the whole proposition. There is no way that a report without [HL] would have led to completion."

(7) It was put to him at length that HL was not in a position to say whether Gala would be able to make a profit from the slate as it did not have knowledge of expenditure, deductions and of receipts and that he knew HL was not in a position to opine on profitability. He said that was absolutely not the case and he strongly rejected that.

(8) He agreed that HL could not have known what the Initial Expenditure would be when they sent the letter because by then not all members who participated in the first transaction had joined Gala and no licences had been signed. He said, however, that (a) the amount needed in order for Gala to take up the licences was known and HL would have known that from the information that they had from Sony, and (b) the extent to which "Gala actually did put into the thing was not necessary in order to arrive at a profitability figure....it is not necessary for [HL] to know how much actually the partners would have spent"; rather HL just needed to know "what the total amount of distribution expenditure would be". This is the case because "the level at which the distribution expenditure comes out [under the waterfall] is the same whether it is for Sony [or

Gala] - we are pari passu except for the shortfall amount" so HL "did know the amount that would be needed in gross revenue to get to that point".

(9) He agreed HL did not know the exact amount of the contributions. He accepted that, in principle, to work out what Gala would receive under the waterfall, HL needed to know what comes out of Gross Receipts in priority to payments to Gala. He agreed that HL did not know this as they did not have all the required information. However, he believed that they were in a position to arrive at a figure with the information that they did have "in terms of production cost, budget, shooting schedules, release dates" and "more importantly the amount of distribution expenditure that was projected to be spent". He thought they would have been able to say from that what needed to flow through the waterfall for a profit to occur for Gala, in addition to a sum equal to the Initial Expenditure, which would have to be recouped, and they came to a figure of just under a billion:

> "Those were the kind of figures that we were talking about with Justin Ackerman and [HL] and the question was would the waterfall achieve that. I know that you said yesterday that it was fanciful, but it wasn't. As things turned out, we were not that far off."

(10) He said that HL almost certainly would have known matters such as actors' salaries because:

> "we would have told them at that stage which of those films we were interested in, and the information was readily available to them via Sony. So they would have known things like the participations".

(11) It was put to him that HL did not know the likely level of receipts because they refer to 9 films only 3 of which were the subject of the transactions. He said:

> "HL and we would have known which films we are interested in. That's the slate that they would have known. Out of the 9 - we were never going to take 9 - that was the availability…We considered all films including some that are not on that list."

When pressed he said there were 9 films included in the list of films Gala were considering at the time. There were 2 or 3 other films that were also put to HL. He could not recall now, 19 years later, the exact process, but he knows that "every one of the films that was eventually acquired by the partnership formed part of the slate, and that was what we took information on" and that:

> "at the relevant time we talked about what would be required, in terms of Gross Receipts, and [HL] would have known the aggregate amount of distribution expense that was planned to be spent on each of the films in that list and the films we eventually acquired…."

(12) He agreed that HL did not know the 3 things counsel referred to but that was subject to the qualification he hoped somebody would put to him and he added that:

> "we and [HL] were in a position to have that information, and they did come to a conclusion on the specific films that we actually acquired, and they would have known the aggregate amount that we and Sony, in aggregate, would have put in, and could therefore have analysed whether or not we could have exceeded the minimum amount that we thought it would require under that waterfall for Gala to make a profit."

(13) It was put to him that HL did not know how much the Initial Expenditure would be because it was based on the SG loans and HL did not have the full final figures:

(a) He said it was mistaken to focus on the borrowings as HL was looking at the Gross Receipts in relation to the amount of distribution expenditure that was projected to be spent. They knew what that was, because they had access to Sony's information on that: "Whether it was 50%...or 30% shared by us, the global amount they would have known, and it's that which is relevant" and not the amount in the deposit agreement.

(b) He clarified that he meant that HL would have known the projected number for the amount globally that was to be spent by Sony on the distribution of the films and "it is that total number…that known number or projected number which would have to be deducted in order to arrive at the profitability". So whilst HL did not know what Gala were actually going to spend as their share, "they had the aggregate amount, which is what's needed for that analysis". They had the term sheet which shows the waterfall and who gets what.

He then agreed that HL did not have a figure for Gala's expenditure but said they did not need that figure in order to be able to assess whether the waterfall would chuck out a profit, and that is what matters.

192. In re-examination, Mr Yusef gave the following explanation of what HL knew when they provided the 2003 HL letter. He said:

(1) By that stage HL were in a position to assess and appraise whether Gala could reasonably look to a profit, as they were instructed to do as (a) HL would have known (i) the films that Gala were interested in, and (ii) by deduction, the amount of the Initial Expenditure given that they would have had the material in relation to all of those films, including how much the overall minimum expenses would be, which would include the amounts payable by Sony; and (b) HL would have had access to the term sheet, which includes the waterfall.

(2) There was resistance to HL having access to materials relating to the relevant films but he knew from discussions with Mr Davis that they did "because we won that point, they got themselves comfortable with HL as the appraiser, as against going to somebody else that they had no prior dealings with".

(3) HL went to the studio and had meetings there and had access in relation to each of the films, the detailed information, marketing information and projections that they were looking for. They were happy with that. They didn't feel that there were any obstacles that they met in relation to that. They did their own independent appraisal in relation to the documentation they had. They had their own proprietary database so that they could make adequate comparisons both in relation to the cast, in relation to the director and in relation to the genre of each of the films in the slate:

> "So I was left satisfied that sufficient information, including information regarding the waterfall, that they would be in a position to provide us with what we needed, which was to determine whether or not this slate had the potential to make a profit to Gala…They did know what the aggregate of the print and advertising budget for each of the films would be. Therefore, from the waterfall that they had in front of them, they could determine where we were likely to end up, should the films perform in the way that was projected."

193. Mr Ackerman was questioned about the differences in his role and that of HL:

(1) He confirmed that he stood by the following comment in his witness statement as regards their different roles:

> "our roles and the remit of our advice was completely independent. I provided very detailed analysis of the marketing plans from my meetings with Sony and considered the merits of the specific films comprising the slate whereas [HL]

> were providing an opinion on the broader parameters of the overall deal and financial implications of the investment in Sony's slate to Gala."

(2) He agreed that this comment is consistent with the fact that, under the contract, his services did not include the provision of financial analysis. He added, however, that should not be construed as him not providing the financial analysis that he did to Invicta, there is no language in the contract that forbids him from providing financial services or advice and recommendations to Invicta in connection with the Gala business and it is common in the film industry for "often services to exceed a narrowly defined scope in a specific contract". He added that he "certainly provided financial analysis", the level of that is borne out by the nature of his meetings with Sony over many months "in the dynamic moment of the marketplace" and those commercial assessments and tracking of data and financial matters were "certainly fulfilled over and beyond the narrower functions of the contract".

(3) It was apparent that Mr Ackerman did not mean that he provided a financial analysis of the type HL was asked to provide as regards Gala's prospect of profit but rather that he provided solely an analysis of Sony's data on the slate of films. He said:

> "at the time the relationship both with [LBPC] and Invicta was evolving. Not every single detail could be foreseen in terms of the contract that was written...since I was not involved in Invicta's negotiations with [Gala], nor was I involved in anything to do with the UK side of things - I was structurally forward facing to the studio partner - that relationship with the studio partner evolved, and as the information flowed it became necessary and it was obvious that I was the person to help Invicta digest and understand and make decisions on the financial data as we received it from Sony. Again, because of the dynamic nature of trading and distribution in the entertainment industry, this was a live event on a many, many months, several year basis in terms of tracking the films and looking and seeing where Sony was wanting to spend and where we agreed that Gala and Sony would spend together, what changes were being made to try to increase the commercial performance of the films in question, where expenditure had been incurred where it had not produced such good results and where artwork needed to be changed...McCann Erickson...an independent company, would be somebody I would speak with frequently to ensure that the data that I was looking at from Sony was indeed the data that they were in turn trading in the buying of radio ads or printing and advertising expenditures in other areas."

(4) When it was put to him that he was purely talking about Sony's data and not about Gala's profit and loss position, he said he was talking about the data he received from Sony and specifically the analysis of that data on his side, which he sent on to Invicta. He agreed that Mr Yusef knew and understood that difference between his role and that of HL. He said that it was correct that, as set out in his witness statement, he recalled attending a further meeting with HL but did not recall attending any further meetings and:

> "Mr Yusef wanted to keep [HL's] advisory role separate from my opinions and advice in order to I think have a number of different independent perspectives one from the other, and I was instructed not to continue with additional meetings with [HL]. [HL] had its direct relationship with Sony and received all of the elements upon which they were making their independent assessment, which they in turn forwarded directly to London without my involvement."

(5) He agreed that he did not have any knowledge of what documentation HL looked at in providing their reports. Comments he made in his witness statement on this were based on his previous experience of working with similar firms and:

> "I am speculating on the basis of my opinion, which I believe I have some expertise in the matter, and at the time I certainly knew of [HL]. They are an extremely reputable firm…Mr Yusef maintained a direct relationship with them, and the documents that I would have received would have been after they had been agreed to and after [HL] would have performed services, but I was not part of that - other than attending one initial meeting, I was then not part of subsequent meetings, phone calls and exchanges of documentation except for the end documents that would have been sent to me to be put in our filing system."

(6) He agreed that his further comments are not first-hand evidence of things that he personally experienced.

194. We have commented on this evidence in section 13, where we have set out the evidence regarding the 2004 HL letter. We note here that we do not accept that the HL letters evidence that Mr Yusef/Invicta/Gala had a serious interest in the level of Gross Receipts that Gala may receive under the waterfall or that there was a realistic prospect of Gala making a profit through the receipt of Gross Receipts under the waterfall.

Section 7 - Closing of the first transaction

Meetings – evidence of Mr Yusef

195. By 5 November 2003, 23 members had signed up and provided cheques for their cash contributions of around £13.8 million and, by 25 November 2003, 30 members had paid cash contributions of a total of £17,673,448. As set out in section 3 of Part A, various Gala meetings took place from 24 to 29 November 2003. The 35 investors who became ordinary members on 28 November 2003 received a package of information prior to the meetings on that day:

(1) Mr Yusef said in his witness statement that:

> "It was important for us that the prospective members learnt about the films that Gala would be acquiring. Our thinking was, the more information we gave each of the prospective members, the more likely it was that they would participate, and the more experienced and sophisticated they would become as members of a partnership involved in the film industry. This would in turn increase the likelihood that in subsequent rounds, they would form our bedrock round of people and our thinking was that, if we had a large number of experienced individuals willing to be involved in a further raise, it would be an amazing asset."

(2) The bundles contained letters dated 25 November 2003, which Mr Yusef sent by fax and post, to all of the prospective members to give them notice of the meetings scheduled for 28 November 2003. The letter states that (a) enclosed with it were (i) the 2003 HL letter (ii) a pro forma acknowledgement letter, with the date of 25 November 2003 inserted ("**the acknowledgement**"), which investors were asked to return prior to the meetings, and (iii) a waiver letter, and (b) investors would also receive by post over the following 2 days the film files and transaction documents. The acknowledgement included the following:

> "I write to confirm receipt of the transaction documents, film files and the [2003 HL letter] referred to in your letter dated 25th November 2003.
>
> I have formed an intention to participate in the Partnership's trade having reviewed the documents referred to above. Accordingly, please consider my application to be a member of the Partnership on an unconditional basis. In the event that I am admitted to the Partnership, please accept this letter as confirmation of my approval and ratification of the Partnership's acquisition of the films specified in the film files. I am also enclosing my signed Distributor Members' Waiver Letter, to be utilised in the event that I am admitted into the Partnership."

(3) In signing the acknowledgement, therefore, an investor agreed to become a member of Gala on an unconditional basis and, on admission, the letter was to be taken as the investor's confirmation of approval of the transaction. We note that (a) investors were required to return the acknowledgement prior to the meetings, before they had an opportunity to question any aspect of the transactions at those meetings, (b) they were provided with the transaction documents and film files at the most only 2 to 2.5 days before the meetings, and (c) they would only have had the means of knowing the films involved and the terms of the deal with Sony when they received those documents; the 2003 HL letter refers to a broader slate of films, and (d) the letter sent to members on 25 November 2003 did not include a written explanation or summary of the key, significant commercial terms, such as the waterfall; there was no explanation that a 30/70 profit share had not been agreed. In effect, therefore, members were required to commit themselves to the transactions with little time to review the full information which was only provided at this late stage and before they had had an opportunity to raise questions on the information provided at the meetings on 28 November 2003.

196. It was put to Mr Yusef that (a), as of 5 November 2003, all the investors had to go on in relation to Gala's activities was the IM, and (b) the fact that two thirds of those who invested in the first transaction had nevertheless paid substantial sums when they did not even have details of the films or the deal was a strong indicator that they were not particularly interested in Gala's activities and whether it would make a profit. He said that:

(1) The investors did not commit their money until certain steps took place. He agreed they had nothing to go on as to how the business would make a profit at that point but emphasised this was before the money was committed. There was a juggling act that had to take place: "There were negotiations going on…so we had to get the money in, but not committed."

(2) The members were very interested in Gala's activities, as he thought can be seen from material that they received and the work that they did to ascertain whether they wanted to vote in the partners' meeting. It is at that point that the commitment takes place.

197. Mr Yusef said that the investors had the relevant details by the time they made their commitment; by then they had the film files which included the screenplays, production budgets and so on. When it was put to him that the investors cannot have received the film files until 26 November 2003 at the earliest, (as they were posted on 25 November 2003) and the acknowledgements are dated 25 November 2003, he said that nobody would have signed the acknowledgement unless they had received and read the film files. He thought that in fact the investors would have signed them about 27 November 2003, after they had received the files; logically they must have been signed after 25 November 2003.

198. As regards what the investors considered:

(1) Mr Yusef said that he doubted that investors would have read all the legal documents but he recollected from talking to people after the event that many people read the screenplays:

> "Everybody looked at the production schedules. Everybody looked - commented on the titles we were proposing to acquire. These were serious people about to embark on this endeavour, and yes, they were focused. They had put a lot of money into this or potentially were going to commit to this. So…a 48-hour turnaround before the meeting is not in the circumstances unreasonable…."

(2) He added that "it was quite clear from the way that they were behaving that they were focused. We believed that they were focused because they had actually parted with money to be held on deposit. It was something that we had a right to expect, that they would be focused...I think if you talk to the Referrers, that will be substantiated". He expected the investors to read the 2003 HL letter, the production budgets, the screenplays of the films and he thought they did as "during the meetings and afterwards they were commenting on the quality of the films and all of that". So, in his view, they did not just sign up without looking into matters.

(3) He said he found the waterfall "simple, probably because I dealt with it" but for those not involved in the film business, "they would have looked at that waterfall and they would have said: "What does the [HL 2003 letter] say? What does Gala say? What do the people in Gala believe?" That's the analysis I think they would have made…"

(4) He thought that many of the investors returned the acknowledgement on the morning of the meeting, and if somebody had said they needed more time to review the documents, the meeting could have been put back. It was "important for us to know and to confirm that they had received and read and dealt with the film files before we accepted them into the partnership as a partner". He said this was not a nonsense, as counsel put to him, but a fact; they did have time to give proper consideration and they did so, at least in terms of the 2003 HL letter, the screenplays, the production budgets, the choice of films, as the things that would have been relevant to their decision. He accepted they would not have had the time to look into things like the legal documents, but principals very often do not get into those. He thought it perfectly possible and feasible for an intelligent person to look at the documents he had mentioned and the screenplays within a day. They had been talking about this for some time so when they needed to make the decision, to part with a lot of cash unconditionally, they would have been focused. It is not unreasonable to assume that that would have been the case.

(5) It was put to him that there was no chance of the investors getting into the detail of the waterfall the day before the meeting, without an explanation in a covering letter. He said they were concerned with being involved in a project that their advisers and their experts advised there was a reasonable prospect would make a profit for them. Hence, the 2003 HL letter was relevant to them given that HL studied the waterfall, and it is based on that that HL say that the slate is or can be profitable.

199. We accept that (1) although the acknowledgements were pre-dated 25 November 2003, it is of course possible that investors did not in fact sign them until later and may not have done so until after they received the documentation including the film files, and (2) at least some of the investors, who Mr Yusef spoke to, may have reviewed some of the documents whether before or after the meetings. However, much of Mr Yusef's evidence on whether and to what extent investors signed the acknowledgement after 25 November 2003 and on the scope of what investors would have read before signing (or at all) is largely speculation on his part. We consider that the likely behaviour of the investors in this regard is better assessed from the evidence of the Referrers as set out below in this section and in section 13. Nothing Mr Yusef said at the hearing detracts from the points made in [195(3)] (or those in [125] or [139(4)]) above).

Meetings

200. The minutes of the meetings on 28 November 2003 show 14 persons (including Mr Yusef) in attendance at the meeting approving the admission of the members and 8

persons present and 9 persons in attendance at the meeting at which the Gala transaction was approved including Mr Yusef, Mr Bamford and Mr Pritchard. It was put to Mr Yusef that in light of the low attendance, the meetings were just a formality or rubber stamping exercise. He said the meetings were "substantial" and whilst there was not a controversial discussion to be had, he knew that there was a discussion and a presentation did take place, either by him, or by Mr Bamford, or possibly both of them, on the process and the transactions before the formal meeting; he recalled that vividly although he could not recall how long it took. He added that the minutes reflect the end result and the fact that the formal meeting approving the transaction was called for 12.15pm does not mean that is when it actually took place; meetings often start later than anticipated. He said that the members paid a lot of money, they considered the situation carefully and were interested in entering into a transaction where they had the possibility to make money and:

> "we had countless discussions with everybody in the partnership. I met with the vast majority of them personally, which is not something that I do in a retail project such as sale and leaseback. So I don't accept the conclusion that it was a rubber stamp…everybody that did become unconditionally committed to the project would have had to signify that they had gone through this process, whether they attended the meeting or not."

201. When it was put to him that the arrangements were all about generating massive immediate purported losses to bring about an immediate cheque back from the exchequer, as referred to in the IM, the UBS marketing material and Ms Challons' letters (see section 4), he said "I very strongly say no. That is not what it was about. There is more to it than that, and I hope I will have the chance to explain why I am firmly of that view".

202. He confirmed that the members did not see the final versions of the documents before they were signed on 2 December 2003. He said the members did not need to see them as they would not necessarily have either had the expertise or the ability to review them. In his view, the important thing was that they knew what the commercial terms were. Taking account also of the evidence of the Referrers, we do not accept that the investors necessarily knew the terms of the waterfall when they signed the acknowledgements or that there was informative discussion of them at the meetings.

Evidence of the Referrers

203. The evidence of the Referrers set out below reinforces our conclusions set out in section 5.

Evidence of Mr Cadogan

204. Overall (1) the evidence demonstrates that Mr Cadogan proceeded to make his investment in Gala without obtaining any real understanding of the terms of the waterfall, although he plainly understood the importance of those terms as regards what amount of Gross Receipts Gala would receive, and (2) Mr Cadogan did so apparently in reliance on his faith in Mr Yusef/Invicta and the 2003 HL letter, despite its obvious limitations.

205. Mr Cadogan said in his witness statement that (1) he signed the pack of documents on 9 October 2003 (and it was received by Gala on 16 October 2003) to express his intention to invest in Gala and his understanding was that he could walk away at any moment until the point of his formal admission as a member on 28 November 2003, and (2) he did so after reviewing the IM and doing all he could in terms of due diligence to ascertain for himself the prospects of Gala making a profit. At the hearing, he confirmed that, in October 2003, he had still not seen any draft transaction documents, any deal terms or details of how many films would be involved and agreed, in effect, that he could not form a view on Gala's prospects of profit because

he did not have any of these necessary details. He said he was very confident that the process which Mr Yusef put in place would result in him being given that information and that it would satisfy him of the likelihood of success. He seemed to accept that at the time he knew that if Gala made a loss he would make a profit but said that was just one scenario.

206. He suggested in his statement that he received all of the documentation referred to in Mr Yusef's letter on 25 November 2003 but accepted at the hearing that he must have received the film files and documentation later. He said in his statement that:

(1) He read through the transaction documents thoroughly but could not recall his thoughts.

(2) Mr Yusef said HL were selected as the leading guys in the field and he was impressed by Mr Yusef's knowledge and understanding of the industry and trusted his judgement. The positive conclusion reached by HL:

> "further validated for me that the films referred to there had a high chance of making a profit. I was satisfied with HL's valuation, as anything more in depth, going into the figures etc would have been too speculative. Ultimately, it was a judgement call and I trusted their judgement."

(3) He recalled reading through the film scripts at home but could not remember if that was before or after he was admitted to Gala. He remembered going through the script for Something's Gotta Give and thinking Jack Nicholson and Diane Keaton could pull that off and he was definitely influenced by the fact that they were well known stars. Overall, he did not consider that his opinion on those film scripts would affect the decision on which films to choose as he had no way of evaluating the films. He understood that Gala sought advice from Mr Ackerman and HL, and he was confident to leave it to them to make the decision on which films to invest in. He thought he did go to a preview of Somethings Gotta Give (although he could not remember when) and thought it was going to make millions.

(4) He assessed all the factors which he understood to be essential to a successful business including the people involved, the advice from legal, financial and tax advisors, the structure of Gala and the fact that Gala could choose the films invested in. All these factors confirmed that it was the right investment opportunity for him and maximised the likelihood that Gala would make a profit:

(a) He knew it was by no means certain that he would make a return from this investment, as the film industry is fickle and unpredictable, but with everything that was in place and the financial projections he was shown, he thought he might make a return.

(b) He decided to invest because he wanted to make a profit by being involved in a different and interesting business he had not been involved in before. He felt he had the business background and professional skills to evaluate the Gala opportunity and, having done so, felt it satisfied his investment strategy and purpose.

(c) Moreover, he was impressed by the team behind Gala and had a lot of confidence in them after spending time with them. He felt they could do something special and could have a real opportunity on their hands. The advice from Mr Pritchard and Mr Fava, his tax adviser, further supported his view.

(d) He understood the tax mitigation advantage attached to the opportunity would increase his chances of success and, whilst it definitely played a part in his decision, it was not the major driving factor by any means. Ultimately, he

thought getting involved in Gala was worth it because if they chose some really great films and could get great multipliers he could potentially make some very decent returns.

(5) He thought he attended all Gala board meetings except 2 and that the resolutions were discussed and debated between members. At the closing meeting (a) there was a long introduction by Mr Yusef in which he provided a final explanation of the Gala proposal, (b) the 2003 HL letter was discussed at some length as Big Fish was not mentioned in it. After a long conversation it was agreed that this omission should not prevent Gala proceeding given that Mr Ackerman had recommended Big Fish, the big-name actors involved and the fact HL referred to the other 3 films. He understood that the members could vote to reject the slate or any film but, after all the due diligence, "we considered the films chosen had the greatest prospect of securing a return on our investment after a reasonable amount of time" and so a resolution was passed to invest in the selected films. Mr Cadogan did not specify in his statement that Mr Yusef covered the terms of the waterfall in his "long introduction" or that the members asked any questions about it.

207. At the hearing:

(1) Mr Cadogan accepted that knowledge of the films invested in by Gala is crucial to HL's analysis but HL plainly did not know the films. It was put to him he could not possibly have been satisfied with this as a "valuation" as HL did not know what they were supposed to be valuing and, if he was genuinely interested in the prospects of Gala making money from the films, he would have wanted to see an opinion regarding the specific films. He said that (a) the 3 major films Gala invested in are mentioned by HL, (b) their letter combined with "discussions with Niall and with Mohammed gave me the confidence that we were going to make a substantial profit" and he was perfectly happy that those films would be substantial hits. When pressed he maintained that "we felt confident these will be profitable films" and said this was a matter of considerable discussion at the meeting, and "we were satisfied with the responses given by Mohammed to those questions regarding the slate as it was finally agreed, and we were happy with the terms that had been agreed with the studio".

(2) He agreed that (a) the film files were substantial and there was a considerable amount of documentation, (b) it was only when he got this information that he found out what was actually involved in the arrangements and that Gala was to be involved with 4 films, of which only 3 were referred to in the HL letter, (c) he did not get any further letter from HL and he did not ask for one, and (d) there was no covering letter or other document sent to him which provided a simple explanation of what the deal terms boil down to; he did not ask for that but read the documents.

(3) It was put to him that, as he did not mention the waterfall in his statement, presumably he did not pull out a spreadsheet and model the waterfall. He initially said he sat down with Mr Thacker and spent hours going through this and he did do some analysis along those lines. He thought they spent the whole day together going through this but could not remember exactly. When asked what he put in the analysis for items such as Sony's expenditure and participations of the actors, he said he honestly could not recall. When it was put to him he did not and could not have had that information, he said he did not recall. When pressed, he agreed that on the basis that that information is not in the transaction documents, he could not have known it. He seemed to agree that unless he knew the various elements that feed into the waterfall (such as actors' participations, Sony's expenditure and

fees), he could not begin to work through how the waterfall works and what was likely to come through it. He said "but we did discuss that with Mr Yusef when we met before finally agreeing to go ahead with that slate". He accepted that even if good films were chosen, Gala did not stand a chance of making a profit if the terms were such that Gala would only receive 1p from a billion.

In our view, (a) it is unlikely that any review of the waterfall he undertook, gave Mr Cadogan any meaningful insight into its operation prior to the meeting, given he did not have the information needed to evaluate it, and (b) whatever information he was given at the meetings on 28 November is unlikely to have been sufficient to have given him any meaningful insight, given (i) the brevity of the meetings (of a total of 30 minutes) as recorded in the minutes, (ii) his lack of mention of the waterfall in his statement and at the hearing unless questioned on it, and (iii) his lack of any recollection of what the deal was under the waterfall.

(4) It was put to him that he did not and could not take a view on prospects of the film scripts. He said film is an image, and not a word, media, so how it is filmed decides much of the success. He agreed that he had no way of evaluating Big Fish. He thought he might have got the film files on 26 November 2003 because he and his colleague got together and he thought they had 2 days to evaluate it before the meeting. It was put to him that he signed the acknowledgement and so agreed to invest in films, including Big Fish, and approved the documents before he had asked anyone a single question. He said that his agreement was dependent upon him being admitted to Gala as a member; it was conditional upon his approval and ratification of Gala's acquisition of the films in the film files. He agreed that was not correct when he was taken to the wording of the acknowledgement and that, in effect, he approved the files before the meeting.

(5) It was put to him that the low attendance at the meeting is far from what one would expect if members are genuinely interested in the prospects of the investment vehicle being successful particularly, as this was their only opportunity to ask Mr Yusef about the agreed profit share and why Big Fish was not mentioned by HL. He said he was determined to be as closely involved as possible, as were Mr Thacker and Ms Livsey. He cannot speak for anybody else on that list. He believed Mr Laing was abroad at the time and thought that Mr Pritchard, who represented other members, was there to represent Mr Laing and suggested that other members may have had representatives attend on their behalf. When pressed, he said he could not answer for the other partners.

(6) It was put to him that he and the other members had no basis at all to form any view on the prospects of the first transaction films making any money for Gala. He said it is a judgment call as in any business and: "We were relying on a whole series of months of investigation, spending time with Mr Yusef and discussing the approach and how we were going about it. We had looked at the films and we were satisfied that there is always risk in any business transaction...[of] not achieving your goals...My belief was that we had a reasonable chance of making a profit for Gala" and the basis for that belief was principally the confidence he had in the principals involved and the films chosen.

(7) He seemed to be aware that Gala's entitlement to money from these films depended on the performance of all of the films as a whole. He said that his view was that 3 of the films had a great prospect of being profitable, so that even if the fourth film dragged it down, it would not have made a substantial difference. He thought that Something's Gotta Give was going to be very, very profitable and the money "we would earn as a partnership from it would be substantial". It is

apparent that this view was not based on any knowledge of the deal terms or what was to be deducted before Gala received a share of Gross Receipts. When it was put to him again that he did not know these things he said:

> "I relied on the fact that I had great faith in Mohammed Yusef and his judgment and his experience that...we would be successful. I mean, in the end you are only as good as the team you have around you, in any business."

(8) He agreed that Gala had not received a penny from the films by 2006. When it was put to him that his expectation and hope was that Sony would exercise the Call Option after 2 years, he initially said "my expectation was that we would have been in a very high revenue situation at this time. It would have changed the profile completely". When pressed, he said that he had no expectation of what Sony were going to do. However, when it was put to him that when he said earlier (see section 5) that he thought there was a very good prospect of making a return after 2 years, that was a reference to the Call Option being exercised, he said "Yes, in part". He accepted, therefore, in effect, that he expected to obtain the tax benefit but suggested that he thought that he may obtain an additional return from Gross Receipts.

(9) It was put to him that he said earlier that Gala provided a way to potentially earn decent returns in the medium return, but there is a whopping return in the short-term. He said "Assuming we didn't make losses, of course, yes" and clarified that he means if the partners made losses. When asked if his focus was just on the partner' positions, he said: "Of course, yes. I'm focused on us making a profit and having to pay tax on that, which I am perfectly happy to do". He agreed that his focus was not on the profit and loss position at the LLP level but on members and whether they made money.

208. In his statement, he said that Mr Pritchard regularly attended the Gala meetings to assist him (and on behalf of the other Oracle investors) and this was all part of his continuous attempt to make sure that the Gala opportunity was gold standard business. He was a bit disappointed about how poorly the meetings were attended by other members. He was determined to attend all that he could to ensure he could contribute to the running of the business and wanted to understand on a regular basis how the business was doing. However, this is undermined by his evidence at the hearing which shows that, in fact he had limited knowledge of the on-going position as plainly he had no recollection of the second transactions:

(1) He said that he did not recall if he knew that Gala entered into the second transactions. When shown the minutes of the relevant meetings he said he would expect that Mr Pritchard was his proxy at them.

(2) He could not say if he was sent the film files for the second transaction films or the 2004 HL letter. He thought he must have been aware of this and Mr Pritchard must have represented him but he could not remember. He said he would have been abroad at this time, otherwise he would definitely have attended the meeting - he would not have missed this meeting deliberately and he would have made sure he was represented.

209. He said in his statement he could not remember the details behind the Call Option exercise but did remember giving Mr Pritchard his proxy to vote for the proposal to extend the time limit as he felt that it was "to our advantage that Sony decided not to exercise but to extend" and that "it was a significant upside for us to hold onto the distribution rights for up to a further one year". He said he could not judge whether £75,000 was adequate consideration and Mr Yusef was in the best position to judge that.

Evidence of Mr Lewis

210. Mr Lewis gave the following evidence in his witness statement:

(1) He was aware of HL and he "gained further comfort as to the Gala arrangement given that there was a tier 1 financial advisory firm opining on the arrangement". He read the opinion in full, and in particular HL's conclusion and recalls thinking that this was as strong an assurance as he could possibly get from experts who knew what they were talking about. He was not concerned that the opinion was not more detailed as regards the research it was based on because of the standing of HL and, as a non-expert investor, he would not have expected to receive and wade through lots of detail.

(2) He reviewed the box containing the final transaction documents and various film files. He was "really impressed by the detail of this documentation and the amount that we were being shown, including details of the budget and copies of the scripts". He noted the famous producers, directors and actors involved and thought that "whilst you can still get flops, you could get a good idea that a film might be successful if it contained star names". He discussed each of the films with his wife, who is more interested in cinema than he is, and she reacted positively. Had she questioned the quality of the cast or the synopsis, this probably would have influenced him. However, the film files only fortified his interest in Gala and gave him comfort that this was a sound commercial investment and, if the films were successful, he might make a return on his investment.

(3) He expected, as based on his discussions with Ms Challons and going over the documentation, that (a) he would be involved in the film selection to a limited extent; the members would have to vote to purchase specific rights on the recommendation of the Los Angeles experts Gala had appointed, but (b) otherwise he was going to be a relatively passive investor attending meetings on an infrequent basis and getting updates from Ms Challons.

(4) He could not recall why he did not attend the first members' meeting on 28 November 2003 but assumed he was busy with his job at Credit Suisse. He did not recall attending any meetings before 2005 when he moved to Singapore. He exhibited a notice of members' meeting dated 7 November 2005, his proxy form and the meeting minutes and said this is how he would have mostly dealt with such matters, but his records are incomplete and he cannot recall if his approach was consistent.

(5) He recalls that he received a lot of documentation relating to Sony wishing to extend the option exercise date, and a recommendation from Gala's advisors, relating to that and details of how compensation was to be received. He was content to follow the professional advice received that the option should be extended, and did not think much more of it at the time. He was aware that Sony exercised the option shortly thereafter.

211. Overall the evidence demonstrates that Mr Lewis made his investment without seeking any information on the waterfall beyond that he was given by Ms Challons and despite the evident limitations of the 2003 HL letter and without raising any query as regards Big Fish which was not referred to in that letter. At the hearing, he accepted, in effect, that the 2003 HL letter has limitations but was insistent that he relied on it as of value and that he relied on the assurances he received from Ms Challons that there would be a 30/70 split of Gross Receipts:

(1) When it was put to him that the 2003 HL letter does not deal only with the transaction films, he said that he assumed it included those films.

(2) He agreed that HL do not state for precisely whom there is a reasonable expectation of profit. He thought that HL meant there was a good likelihood of the films invested in making a profit (from monies from box office receipts and DVD sales) and, therefore, that the members would get the return that they were looking for as: "Therefore the 30:70 distribution would work and the 30% would go to Gala and the members would therefore make the return". We note that Mr Lewis appears to have been unconcerned with checking there was such a ratio in the waterfall and when this profit-sharing ratio would apply under it.

(3) He accepted that the HL letter is a "pretty high-level" letter of only a couple of pages but said he could not believe that someone of HL's standing would make that statement if they did not believe it was correct. He said, in effect, that he took comfort from the letter as he read it as saying, "the films will be successful and Gala will make a profit because of that". He said he did not know whether he actually read the letter as meaning that members would make a profit but his assumption was that if the film made a profit, Gala would make a return/profit and, therefore, the members would make their return.

(4) It was put to him that the letter does not state anywhere what would happen if the Call Option was exercised. He said that he did not think HL were asked to opine on that. The opinion was on the quality of, and likelihood of profit on, the films. He agreed that Gala's profit position would be impacted by whether or not the Call Option was exercised but said he sees that as a side conversation as this is "an expert's opinion on the quality of the earnings on a slate of films…The funds from that would then flow through to Gala and therefore to members". He said he thought HL were referring to the reasonable expectation of the films performing well, in particular, as they referred to the period after the expiration of the term. He noted that he was investing for a period when the films would be exploited. He agreed that it does not state in terms that that would translate into a profit for Gala but he imagined that is what HL were asked to opine on and he assumed that "as media experts…they were being asked to advise on the likelihood of success of the films".

212. Whilst he emphasised that he looked at the documents, as noted, he plainly did not check how the waterfall operated.

(1) He said he certainly looked at the film files in order to get a better understanding of the films which gave him comfort. He did not go through every single line of every single document, because he had a financial adviser that he expected to have already done that. When pressed he said that he "absolutely did study the detail" that he thought was appropriate and, if HL had given him a real technical document explaining how films work, etc, "I don't think I would have understood it enough to opine. So I looked through what I understood, but there's a limit to my understanding of the subject". We note that Mr Lewis did not mention asking Ms Challons for confirmation that she had checked the position regarding the 30/70 split or for further details of how the waterfall operated.

(2) He thought the documents came by courier on 25 November; he knew they came very promptly by courier. He agreed that realistically 2.5 days was not enough time to go through all the materials in detail if you are to read them properly. He was asked if he did not study the waterfall in detail because ultimately he was going to make a return out of tax relief so the precise mechanics of the waterfall did not matter. He said that was not his thinking at all. His thinking was purely that there was an awful lot of documentation. He trusted his financial adviser to give him the right guidance and was comfortable that the figures he had seen (in terms of the 30:70 split of gross receipts) were sufficient

to make a return. We note that Mr Lewis did not have sufficient information to evaluate whether a 30/70 split of Gross Receipts at some point in the waterfall was in fact likely to result in him making a return.

213. He said his discussions with his wife and review of the film files gave him further comfort that his investment in Gala was a good idea, recognising that his previous film investment was in very low budget films that did not achieve his expectations. It was put to him that if his wife had said she did not like the cast or the films, realistically that was not going to have changed his decision to invest in Gala. He said that there was not much he could have done at that stage.

214. Mr Lewis was asked if he did not attend the meeting on 28 November 2003 because he wanted to sign up to the scheme, sit back and essentially let the tax relief roll in without his further active involvement. He said he expected to sign up and let the process run itself and the returns come in (seemingly meaning returns from Gross Receipts), not simply wait for the tax return. He said he was not aware there was a second transaction and that he hardly attended any of the members' meetings. At the time he was running a large operation at Credit Suisse. He was all around the world and did not have any time to attend to any of these meetings. He was asked if he was unaware of this simply because he was indifferent to it all or because no-one drew it to his attention. He said he could not recall receiving these minutes, but was sure that as a member he would have done.

Evidence of Mr Mallett

215. In his witness statement, Mr Mallett said that he was aware of HL (they were well known in the investment banking business for their restructurings and were known as being aggressive but effective) and he recalls reading the 2003 HL letter and:

(1) *It was the first time he was made aware of the specific films Gala would invest in.* Looking at the nature of the proposal and the big Box Office names in those films, he thought that that there was a reasonable prospect that one of them would be a hit. However, other than taking a passing interest in the stars of the film, he was not terribly interested in what the films were about, as he understood that picking out a hit is inherently difficult.

(2) He noted the conclusion. He understood that it is very difficult for anyone to be certain as to the likelihood of a film being a commercial success, but he expected that HL would have carried out a review of the relevant films, looked at what other films were coming out, and considered the stars and the directors to help them opine on this. He also knew that there is a certain amount of reputational risk at stake for HL if they got it wrong, so he considered their conclusion to be a third-party affirmation of the profitability of the slate. It just gave him a little bit more assurance that somebody with experience had actually looked at the movies in detail and it added further weight to his view at the time that investing in Gala might result in a profit.

216. We note that the above comments, as premised on the highlighted sentence, make little sense. As Mr Mallett agreed at the hearing (see [220]), it is not apparent from the 2003 HL letter precisely which films were to be subject to the transactions and one transaction film, Big Fish, was not included in the letter.

217. In his witness statement he commented as follows as regards the other documents:

(1) He did not recall doing so but thought that he would have given the transaction documents at least a "once-over".

(2) He thought it was unlikely that he reviewed the film files in any detail because he is not an expert in films and would not be able to gauge whether a film

would be a hit based on a review of a screenplay and they were not factored into his decision-making process.

(3) He recalled skimming the legal opinions relating to Gala to gain some reassurance from the conclusions but he had already, in his mind, committed to the Gala opportunity. Overall, he thought they contained an interesting academic discussion, but he was more concerned about the arrangement in practical terms and he had already understood the commercial purpose behind it. He reviewed the opinions, because he wanted to ensure that what had been stated in the IM as regards tax mitigation was correct. However, as he did not have any experience of this area of tax law, he did not attempt to work through the tax considerations to consider whether or not he had the potential to make a loss relief claim. He entered Gala because he thought he was going to make some money. He was glad to see that there was some protection should things go wrong but could not quantify anything more than that because he did not have the experience or the qualifications to do so and, more importantly, that was not his intention when investing in Gala.

218. He concluded in his witness statement that for all of these reasons, Gala seemed like a sensible investment opportunity from which he could make a return, in accordance with his overall investment strategy:

(1) Based on all of the documents, he thought that there was a real commercial purpose behind the Gala arrangements given the change in the accounting treatment of P&A expenditure in the US. He understood that this would affect the film studio's balance sheet quite significantly and saw a real commercial reason for the studio to get the P&A funded by someone else, but still take a percentage of the revenue, and having the ability then to call the option.

(2) He thought that given that the rights to certain films were going to be purchased from a slate of several films (including films with big names with Box Office pull such as Jack Nicholson in Something's Gotta Give), the risk was spread and there was an increased prospect that one or more of the films would be a Box Office hit, so that he would make a return on his investment.

(3) A third-party expert, who he was familiar with, had appraised the films, with the conclusion being that there was a reasonable expectation of profit.

219. He added that he expected (1) to be a bit more actively involved with Gala than the other investments he had in films. There were many more meetings and those who wanted to be more involved were able to be so, and (2) his involvement would be only through meetings because there was a whole team of specialists lined up to follow the members' instructions to select films and liaise with the studio in LA. As it happens, due to frequently being in Germany for work, he did not attend many meetings and relied upon receiving updates once they had taken place. He was not able to attend the meeting on 21 February 2006 when the extension of the call option agreement with Sony was voted on. However, he recalls thinking that any delay in Sony exercising the option was a good thing as, "if we could extend it another year and be paid to do so, then it may increase the value of our assets".

220. At the hearing he agreed that (a) Gala received his members' contribution on 24 October 2003, and (b) it must be the case that he did not receive some of the documents referred to in the letter of 25 November 2003 until after that date. As regards his comments on the 2003 HL letter:

(1) When taken to the letter, he agreed, in effect, that, from its terms, HL clearly did not know what films Gala would acquire rights in and so, contrary to what he said in his statement, he did not know from this what the transaction films were.

He imagined that the different timings of films in production meant that it was not 100% possible to fix exactly which ones were on the ultimate slate at this stage. As he read it, HL were looking at a larger slate, which was likely to include a number of those which would get on to the final slate. He agreed that, hence, HL opined without knowing what films Gala would invest in. He said that, however, HL analysed all of the ones listed and, given he was told previously that the slate is typically 7, his understanding was that the transaction films were likely to be drawn from these names; otherwise, HL would not have been asked to do the analysis. Hence, his assumption was that the slate would contain a number of the films listed in the 2003 HL letter but not all of them. He agreed HL did not know exactly how the slate would end up.

(2) It was put to him that it is difficult to see what sort of reputational risk would attach to HL given the limitations and disclaimers set out in their letter. He said that the disclaimers were absolutely standard practice and HL would not have been able to audit and independently verify the information that came from the studios. In his view, clearly if a significant number of these films appeared on Gala's slate (and many of them did) and did not meet the expectations, then there would be reputational risk that HL had not done their job properly in analysing those particular ones, that they had not looked at the waterfall, and/or had not looked at who the key actors were or all of those things. He agreed that he was not involved in the production of the 2003 HL letter; he was reading what they said they had done. They analysed certain information regarding the slate of films which Gala proposed and so presumably were in discussion with Gala at the time because otherwise they would not have been able to start on any names.

(3) He agreed that (a) he still did not know what films would be involved in Gala's transaction on 25 November 2003; it was clearly something of a moving target. He said this was first time he had seen a complete list of names set out in that form and the fact they were sent to HL, for their opinion, suggested to him that they would be major components of the slate, and (b) no deal terms had been agreed even at this stage as far as he knew; his assumption was that Gala as an experienced promoter would enter into the transaction on sensible terms.

221. He said the following as regards the other documents sent to him:

(1) He had no recollection of reviewing the film files but thought he must have done. As a layman, he had no particular means of knowing whether something was going to be a success or not. Gala had a team of people who were experts in the field. That for him was better than him making any sort of amateur judgment on what films were going be successful; he had no experience or skill in that.

(2) He was asked if he read the DA to see what was agreed as regards the profit share and it was put to him that he was indifferent to what had been agreed and so to whether Gala made any money. He said (a) he could not remember exactly what he did with those documents, (b) he relied on the promoters to choose the films and do the work required to establish that they were likely to be profitable, and (c) he had assumed it would be a 30:70 split because that was talked about previously. He did not think he checked that was the case but relied on Gala to do the necessary work.

(3) When asked if he knew what was agreed in the end, he said "probably not, no" and he could not remember or he would have done at some point, but he now did not know. When pressed, he said that this would have been discussed in the Gala meeting, but he could not remember the specifics. He emphasised again that he placed reliance on the experts to negotiate appropriate terms and that, being an

amateur, he would not have known what such terms were; he had no experience and had not been involved in this type of negotiation before and would not know what percentage is correct. It would depend on the type and size of film and such matters are beyond his scope of knowledge. That is what Gala were doing and why there were people in Los Angeles doing this as their day-to-day job. He absolutely expected that there would be the opportunity to make a profit from the films.

(4) When asked if he asked anyone what had been agreed, he said that at the time he probably would have done so but does not recall now what that was and he believed he did at one of the Gala meetings, but he could not specify when that was and "I don't know. Possibly I was told by Karina Challons, but again I can't remember that." Given his lack of recall on this point, we consider it reasonable to infer that Mr Mallett did not find out what had been agreed as regards the waterfall.

(5) He confirmed that he did not ask for an updated opinion from HL that considered the films that Gala proposed to invest in.

222. It was put to him that the actual agreement was that, after Gala had recovered around £2 million, gross receipts would be split in the ratio 99.7% and 0.3% of each dollar to the studio and Gala respectively, a ratio of 334:1, and that is a million miles off appropriate terms and a 30/70 split. He said he could not answer that as he did not know what would be appropriate in those circumstances and it depends when that ratio kicks in. He was asked if it sounded appropriate that for Gala to receive a penny from the waterfall $1 billion of gross receipts had to be received. When pressed, he referred again to his thinking that the earlier Terminator and Spiderman films had made over $1.3 billion and so he thought it was perfectly possible that sequels to those would make money. He agreed that those films are not mentioned in the 2003 HL letter and are not films Gala was involved in but said that was what he was introduced to and he was told that the major blockbuster typically exceeds substantially what studios project. When asked if he knew that the deal was for the performance of the films to be aggregated he said he assumed that was the case.

223. It was put to him that he did not even attend the meetings on 28 November 2003 to ask about the deal terms and so approved Big Fish even though it is not mentioned in the 2003 HL letter without asking any questions. He said (1) he was not able to attend that meeting for different reasons and he thought he would have looked at the transaction documents but does not remember what was in them, and (2) withdrawing from investing because of one film, when he could not judge the likelihood of success or failure, would have been very strange and he was not around to ask that question. It was put to him again that he was indifferent and again he said he relied on people who knew what was in those films and what the prospects were, because he has no skill and no knowledge and no experience. That is a big difference.

224. He agreed that when he was considering investing in Gala his focus was on whether he would make money as an investor and not on whether Gala was going to make a profit or not.

225. He said he was aware that there was a second closing but not of any details and he cannot remember now what the background was or if he was sent the films files for the second transaction films or the 2004 HL letter. It was put to him again that he was indifferent, and he said again that he was not but had many other things that he needed to do at work and he had entrusted this to the team of experts who, as far as he was concerned, would be acting in the best interests of the partners and he relied on their skill and expertise.

226. It was put to him that his decision to invest cannot have been based on any serious intention to make money from the films given the lack of interest in November 2003 and in January/February 2004 time and realistically it is all about the tax relief. He said that he is not a film expert and cannot tell if a film or slate is going to be successful whereas the promoters could do that so trying to make his own assessment would not have got him anywhere.

227. It was put to him that his statement that any delay in Sony exercising the option was a good thing is baseless speculation. He said that was his thought at the time. It was put to him that, given he was advised that it was important that Sony exercised the Call Option to retain the tax benefit (see section 5), it is implausible that he would have been pleased that any delay in Sony exercising the option was a good thing. He said he thought Sony would exercise the option, but on one of the exercise dates, including the fifteenth. Probably he thought the further it was pushed out, the better. So that was consistent with that thought. We do not accept Mr Mallett's evidence on this point in light of our conclusions on his evidence as regards the Call Option in section 5 and given that some of his comments indicate he had no actual recollection of what he thought about this at the time of the transactions.

228. We note that overall, the evidence demonstrates that Mr Mallett proceeded to make his investment in Gala (1) without (a) obtaining any understanding for himself of the terms of the waterfall, (b) asking Ms Challons or Invicta for confirmation of a 30/70 split of Gross Receipts and/or at what point in the waterfall that split applied, and/or (c) seeking any information on Big Fish, and (2) without any meaningful basis for his asserted view that he was confident he would make a return from Gross Receipts other than his reliance on Invicta/Ms Challons and on the 2003 HL letter. Moreover, it appears highly likely that he did not seek to inform himself what the transaction films were when he received the film files and transaction documents in light of (a) his evidence in his statement that the 2003 HL letter specified what films were involved. We regard his oral evidence as to what he thought about the 2003 HL letter at the time in question as unreliable given that plain but incorrect statement, and (b) his persistent references to films that were not subject to the transactions and his evident lack of attention to the detail of these transactions (see also section 5).

Section 8 - Execution of LBPC agreement

229. As noted, the LBPC Agreement was made just after the above meetings took place, on 1 December 2003. The main terms are as follows:

(1) The agreement was stated to be for a period of one year on the basis that, thereafter, it would automatically renew on a month-to-month basis. Invicta agreed to pay LBPC a fee equal to $150,000 payable in arrears in 12 equal monthly instalments of $12,500 on or before the last day of the month, commencing on 31 December 2003. Mr Ackerman described his fee as relatively low.

(2) It was noted that Gala had engaged Invicta "to provide limited administrative oversight and quality monitoring services" and Invicta wanted to engage LBPC, on a non-exclusive basis, to undertake those services. The administrative services to be provided were to consist solely of the following:

> "(a) Collecting, filing, reviewing, analyzing and evaluating information relating to the marketing, sales promotion, advertising and distribution of the Films;
>
> (b) Monitoring SPR's efforts towards the marketing, sales promotion, advertising and distribution of the Films;

(c) Reviewing, evaluating and auditing SPR's P&A expenditures with respect to the exploitation of the Films and the receipt of the underlying P&A services from the engaged P&A vendors;

(d) Responding to inquiries from Invicta, Gala and/or SPR for information regarding SPR's marketing, sales promotion, advertising and distribution of the Films and market research on film distribution, generally, including financial and statistical data on such activities;

(e) Attending meetings with SPR and other related parties and furnishing written reports to Invicta and/or Gala with respect to such meetings; and

(f) Furnishing regular, written reports to Invicta and/or Gala with respect to the foregoing services on a weekly basis (or at such other intervals as the parties mutually agree)."

(3) Invicta and LBPC acknowledged and agreed that the services to be provided by LBPC were of an auxiliary nature and "in no event shall LBPC or any of its employees, officers or agent" (a) "interfere with, insinuate itself into, or otherwise be involved in, the negotiation, conclusion, enforcement of contracts with third parties by Invicta, SPR or Gala, with respect to the marketing, sales promotion, advertising or distribution of the Films, including, without limitation, the P&A expenditures with respect to the Films" and/or (b) "have any authority to solicit, negotiate or conclude any contracts or agreements which may bind Invicta, SPR or Gala in any manner whatsoever".

(4) The services were to be provided "diligently and to the best of such provider's talents, skills and expertise," and the relevant persons, including Mr Ackerman were "to devote, such time to the performance of the Administrative Services as may be necessary therefor. In particular, Justin Ackerman shall attend all meetings with SPR and other related parties.... and prepare or actively supervise and approve all written reports furnished by Administrator..."

(5) LBPC agreed not to delegate the performance of any of the services to any individual or entity (other than its employees or officers) without the prior written consent of Invicta.

(6) Subject to Invicta's prior written approval as to the material terms of their engagement, LBPC was required to engage 2 independent contractors or employees to assist in providing the services to Invicta.

(7) It was provided that no agency relationship was intended or created during the term of this agreement, LBPC was an independent contractor and that nothing in the agreement shall be "deemed or construed to create a partnership or joint venture...the relationship of principal and agent or otherwise create any fiduciary duty or any liability whatsoever of either party hereto...." and that neither LBPC nor any of its employees or officers, "shall make any representation that it is authorised to act as agent of Invicta, SPR or Gala, nor "have any right to incur any obligation or liability on behalf of Invicta, SPR or Gala or to bind any of them in any manner whatsoever."

230. Under the LBPC Agreement, therefore, LBPC agreed to provide certain services to Invicta; it was not appointed to act as an agent for Invicta or for Gala. There is nothing in the agreement to suggest that LBPC or Mr Ackerman had any authority to agree changes to Plans on Gala's behalf or that Mr Ackerman or LBPC had any authority to authorise payments from the expenditure accounts. The exhaustive list of services did not cover the provision of advice on which films Gala should be involved with or how much Gala should (purportedly) contribute towards Gala Expenses on the transaction films.

231. In his witness statement Mr Yusef gave in some respects a broader and in other respects a more specific description of the services to be provided by Mr Ackerman/LBPC as follows:

> (1) to assist with the initial discussions with the studios to convince them to commit to the proposal. Mr Ackerman attended numerous meetings with the studios and assisted with the presentations given to them;
>
> (2) to be involved in and assist with the selection process for the portfolio of films drawn from the slate (all films in the Sony slate for that year were available unless they fell outside the agreed criteria);
>
> (3) to receive, review and provide advice in relation to the proposed budgets, marketing plans and release schedules for the selected films;
>
> (4) to appraise the screenplay of the films and to advise on their prospects of being successful;
>
> (5) to locate office premises for LBPC to work out of for the purposes of carrying out its day-to-day activities on behalf of Gala;
>
> (6) to attend various meetings with the studio's marketing team; to suggest changes to and agree revised marketing plans with Sony as set out in more detail below;
>
> (7) to attend conference calls with media buyers (the entities which handled media buying and held accounts with major print publications and television stations) and the studio to agree the media plans and relevant allocations;
>
> (8) to review the invoices received from the media buyers to ensure that expenditure had been incurred in accordance with the agreed marketing plans (whether varied or otherwise) and the daily payment schedules for P&A media buys;
>
> (9) to coordinate with Invicta, payment orders from the Gala distribution account; and
>
> (10) to act as liaison between Invicta and the studio on performance of pictures during the active distribution phase, and coordinate communication between Invicta and the studio."

232. Mr Yusef described the LBPC agreement as formalising the relationship but noted that LBPC had assisted Invicta since Gala's incorporation and, Mr Yusef had used Mr Ackerman as an experienced, reliable "sounding board" in relation to his informal plans with Gala before then. He said that LBPC was not formally retained "until Invicta were in a position to do so, and the fee for Mr Ackerman's services was uplifted to reflect the previous work that he had done". In his view, in reality, all the work carried out by LBPC prior to the execution of the LBPC agreement was on Gala's behalf. He added that LBPC was engaged for a further year because of: (1) the volume of work generated by Gala's activities which extended well beyond the first-year end; and (2) the importance of maintaining an LA presence close to the studios. He acknowledged that the definition of services in the LBPC Agreement is "perhaps more narrowly defined than the role which LBPC actually performed" and that Mr Ackerman's statement is consistent with his understanding of the tasks that LBPC performed for Gala.

233. It was put to Mr Ackerman that the agreement sets out in detail the services LBPC was to provide, and it is not correct that, as he said in his statement, it does not descend into detail and the definition of services is "intentionally drafted in a light touch way". He initially said, in effect, that although there is "considerable verbiage" in the contract, he would describe it as "light touch, certainly under procedural habits we have in the United States in the media industry". It was put to him that he seemed to suggest that

the contract is deliberately drafted not to reflect the reality of the situation in a misleading way. He said that was not the case; his attorney was ensuring that his exposure to any involvement in Invicta's business in the UK in connection with Gala specifically was limited, because the services agreement "is nothing to do with meetings and procedural matters in regard to the relationship between [Gala] and [Invicta]" but was "facing to Sony specifically and to provide administrative assistance to.... [Invicta] acting on behalf of [Gala]. That was my understanding, and my area of focus for [LBPC] and myself was specifically in connection with activities with Sony." He agreed that he meant that the contract is not intentionally drafted in a misleading way and that it reflects the correct position regarding the role of LBPC.

Section 9 – Detailed terms of the documents

Terms of the Option

234. Under the Option:

(1) In consideration of £1.00 paid by Gala to SPE (a) SPE granted Gala the exclusive option during the period from 2 December 2003 to 27 January 2004 (the "**Option Period**") to acquire from SPE or its applicable affiliate "Distribution Rights" in and to each of "the Pre-Release Pictures", and (b) SPE agreed, during the Option Period, to negotiate with Gala as regards the licensing of such "Distribution Rights" on the terms of the agreement to "Post-Release Pictures" selected by Gala:

(a) The "Pictures" are defined as the transaction films and such other theatrical feature films acquired by or licensed to SPE or its affiliates which satisfied the requirements to be a "Pre-Release" or "Post-Release Picture".

(b) A film produced by Sony qualified as a "Pre-Release Picture" if it had an anticipated initial theatrical release date after the date of the agreement and before 30 June 2004 and as a "Post-Release Picture" if it had a release date that had already occurred provided that, in each case, the relevant distribution expenditure incurred at the time SPE provided Gala with information material to Gala's decision as to whether to exercise its Option did not exceed 33% of the proposed total expenditure.

(c) The "Distribution Rights" are defined as "in respect of each Picture those rights to distribute or otherwise exploit that Picture in the Territory as more particularly specified" in the LA relating to that "Picture" (as set out below).

(2) During the "Option Period" (a) Gala was required to review the content of each Plan "prepared by Gala or, at Gala's request SPR" copies of which were attached to the agreement in respect of the first transaction films, (b) prepare or procure the preparation by SPR of a Plan in respect of "Secret Windows" and "Break Up Handbook" as soon as reasonably practicable after the date of the agreement, and (c) "commission an opinion from [HL] as to the commercial viability of each Picture". Gala acknowledged and agreed that neither SPE nor any of its affiliates had any responsibility for the content of such opinion, and once the Plan in respect of a Picture had been reviewed by Gala and the opinion received by Gala, "Gala will decide whether to exercise its Option in respect of that Picture based on the contents of such [Plan] and opinion".

(3) If Gala notified SPE it wished to exercise the Option in respect of a "Pre-Release Picture", under clause 5:

(a) SPE was required to notify Gala of the amount of the "Distribution Expenses" incurred in connection with that Picture,

(b) Gala had a period of 10 business days to give notice it wished to proceed and specify the particular amount which it agreed to advance towards the Gala Expenses to be incurred in connection with the Picture, and

(c) following the service of any such notice, (i) the parties were required to execute a LA on Gala paying a licence fee, and (ii) Gala was required to pay the specified amount into the expenditure account in accordance with the terms of a DA entered into by Gala with its sub-licensee and to specify to SPE or its applicable affiliate in the LA what amount of Gala Expenses it had committed to the "Picture". As noted, we refer to such specified sums as the Initial Expenditure.

(4) There was a similar process if Gala wished to obtain a licence of a "Post-Release Picture" but SPE had "sole discretion" whether to agree to such as licence.

(5) Gala was permitted to exercise its Option to enter into a LA with respect to a "Picture" only if (a) it had available, at such time, sufficient funds (from the contributions and the SG loans) to pay the Initial Expenditure and the licence fee relating to it, (b) the contributions were equal to or greater than the Gala Expenses committed by Gala to that "Picture" and all other selected "Pictures" and the SG loan to Gala was equal to or greater than the licence fee relating to such "Picture" and all other selected "Pictures", and (c) such Option was exercised no later than when 33% or more of the relevant "Distribution Expenses" had been incurred.

(6) Gala agreed that (a) no less than 91.5% of contributions would be advanced to the expenditure account and applied towards payment of Gala Expenses for the selected "Pictures", and (b) the Gala Expenses funded by the Initial Expenditure would be no less than, £82,350,000, and (c) an amount equal to 13.5% of the total contributions was to be used for the purpose of meeting the licence fees. This was subject to the proviso that if SPE had not, prior to 28 January 2004, included sufficient "Pictures" within the terms of the agreement to enable Gala to fully utilise the specified funds, Gala was obliged only (i) to advance such percentage of the contributions (not to exceed 91.5%) as equals the maximum amount of Gala Expenses which were capable of being funded with respect to the Pictures included within the terms of this agreement and/or (ii) to fund the maximum amount of Gala Expenses which were capable of being funded with respect to the Pictures included within the terms of the agreement, and (iii) to pay licence fees in an amount equal to 13.5% of "X", where "X" equals the product of (A) Gala Expenses which are capable of being funded by Gala multiplied by (B) 1.0929."

(7) At the same time as executing a LA in respect of a selected "Picture", Gala was required to enter into a debenture in favour of each of SPE and the applicable licensor in respect of the "Distribution Rights" in the form attached to the agreement.

(8) SPE acknowledged that Gala would grant a charge and security interest to SG over certain of its assets including its interest in the selected "Pictures" and undertook that it would enter into a deed of priority and subordination with respect to the priority over the security interests to be granted by Gala and its members in the form attached.

Terms of the LAs

235. *Licence*: Gala was granted the sole exclusive and irrevocable right in the specified territory for a term of 21 years to:

> "fix reproduce, perform, display, exhibit, distribute, market, promote, publicize, advertise and otherwise exploit, and cause and license others to exhibit, distribute,

> market, transmit, communicate to the public, make available, promote, publicize, advertise and otherwise exploit, the Pictures, trailers and clips and excerpts therefrom, in any and all languages and versions…"

236. *Sequel rights*: If the licensor or any affiliate acquired "Distribution Rights" in any "Sequel", defined as theatrical feature length sequels and/or remakes of the "Picture", Gala was granted:

> "the sole and exclusive option upon the same terms as set out in [the Option] to acquire the Distribution Rights in that Sequel on the same terms as set out in this Agreement."

The procedure was that (a) the licensor was to give Gala notice of any such rights it acquired, (b) if Gala wished to acquire such rights, it had to send the licensor written notice and procure the preparation of a Plan for the "Sequel", (c) if the Plan was approved by Gala, the provisions of clause 5 of the Option were to apply with regard to the exercise by Gala of its option in respect of that "Sequel" and, (d) if Gala exercised the option, the parties were to enter into a LA in respect of such "Sequel" on the same terms as set out here.

237. *Licence fees and Initial Expenditure*: The individual licence fee and amount of Initial Expenditure was specified in each LA.

238. *Payment of production cost*: It was provided that Gala would pay the licensor a sum equal to 60% of the total cost of production of the selected "Pictures" less an amount equal to the total licence fees paid by Gala (and not returned to Gala pursuant to the LA) in respect of such "Pictures" from all "Gross Receipts" in respect of the "Pictures" after deduction only of certain items as provided for under the waterfall, namely, (a) a distribution fee equal to 35% of such "Gross Receipts"; (b) all "Participations" payable in respect of the "Pictures", and (c) a marketing overhead charge equal to 10% of the Gala Expenses relating to all selected "Pictures" (see section 11 as regards the terms of the waterfall). If there were insufficient Gross Receipts to cover the sums due to each licensor, Gala was required to pay to each licensor a pro rata portion of such Gross Receipts according to the amount owed to each of the licensors and such licensors relative to the total amount owed to them until the full amount was paid. The licensor acknowledged that Gala's sublicensee would administer the Gross Receipts and Gala may irrevocably direct the sublicensee to pay the licensor the sum referred to in this provision and any such irrevocable direction would satisfy Gala's obligation pursuant to this provision and it would have no liability to the licensor or any affiliate if the sublicensee failed to pay such sum to the licensor.

239. *Restriction on Gala*: Gala covenanted that during the continuance of the licensor's security agreement it would not:

> "do or cause or permit to be done anything which may in any way depreciate jeopardise or otherwise prejudice the value to Licensor of any of the Charged Assets save as otherwise agreed by the Licensor in writing (and Licensor hereby agrees to Distributor entering into the Transaction Documents and the Permitted Encumbrances)…
>
> …carry on any business (without prior consent in writing of the Licensor) other than the business of contracting with Licensor, sublicensees approved by Licensor, and vendors providing services relating to the exploitation of the Pictures approved by Licensor for the purpose of the licensing, marketing and distribution of the Distribution Rights and incurring of associated Distributor Exploitation Expenditure relating thereto."

240. *Acknowledgements by Gala*: Gala agreed, in outline, that except as expressly set out in the agreement or in any other transaction document, neither the licensor nor any affiliate made any representations or warranties to Gala in connection with the

transactions covered and contemplated or otherwise and had no responsibility or liability to Gala, directly or indirectly, (1) concerning whether (or any extent to which) (a) any "Picture" would be favourably received by any distributor, exhibitor or member of the public, (b) Gala would or might realize or otherwise receive any level or amount of Gross Receipts from or in connection with the exploitation of the "Pictures", (c) any of the "Pictures" would be distributed or otherwise exploited by licensor or any of its affiliates or any other person in any media or any such distribution or exploitation would be continuous or generate or otherwise produce any level or amount of "Gross Receipts" or other sums, (d) Gala would recoup all or any of its investment in respect of the exploitation of the "Pictures" or receive any return thereon, and/or (2) concerning any tax consequences of any kind or nature arising out of, in connection with or otherwise relating to the consummation of any of the transactions covered and contemplated by the LA and/or the exploitation of the "Pictures" or otherwise.

241. Gala also (1) acknowledged and agreed that the licensor owed no duty of care to Gala and/or its members in respect of any tax liability of or the availability of any tax relief to, Gala and/or the members, and waived and released the licensor and its affiliates (and their respective directors, officers, employees and agents) from any liability in respect of any rights or claims that Gala or its members may have against any of those persons in respect of any such tax liability and the loss or restriction of any such tax relief and (2) agreed to procure that its members would also make the same acknowledgements and undertakings.

242. *Licensor's right to terminate*: The licensor had the right to terminate the LA in a number of circumstances including if (1) Gala was in breach of its obligations in the LA, (2) Gala carried out any activities other than those contemplated by the transaction documents, and/or (3) Gala's sublicensee terminated the DA.

243. *Gala's right to terminate*: Gala had the right to terminate the LA if (1) in certain circumstances the licensor was in breach of any material term of the LA, (2) any warranty given by the licensor was materially incorrect, or (3) by 15 March 2004 "the Picture" had not been theatrically released and did not have a scheduled release date prior to 30 June 2004. Gala's rights were limited to a right to terminate this agreement in accordance with these provisions or a right to recover damages, if any, in an action at law, and Gala waived any right or remedy in equity, including any right to restrain the distribution or exhibition of the Pictures, or to make a claim upon the "Distribution Rights".

Terms of the DA

244. *Introduction*: It was stated that Gala agreed "to licence to SPR the Distribution Rights in and to the Pictures and to appoint SPR as its agent for the purpose of incurring the Distributor Exploitation Expenditure upon the terms and conditions set out in this Agreement". "Distributor Exploitation Expenditure" is defined as the aggregate of (1) the Initial Expenditure, and (2) any amounts in addition to that, which Gala agreed to advance towards the Gala Expenses to be "incurred" in connection with the "Pictures" (including amounts referred to in clauses 6.3.1 or 7.4 of the DA and see the definition of "incurred" below). We note that in fact there was no sum falling within (2). The only expenditure which Gala purports to have incurred on the transaction films is the Initial Expenditure.

245. *Licence*: Gala agreed to licence to SPR the "Distribution Rights" in and to the "Pictures", essentially as defined in the same terms and under the same main operative provision as applied under the LAs, for a term of just over 8 years starting on 2 December 2003 and expiring on 28 January 2012. SPR assumed all of Gala's executory obligations under the transaction documents to the extent that such obligations relate to

the distribution and/or exploitation of the "Distribution Rights" and all other obligations arising out of SPR's distribution and/or exploitation of the "Distribution Rights".

246. *Expenditure account*:

(1) Immediately upon acquisition by Gala of each "Picture" pursuant to an LA, Gala was to advance the Initial Expenditure in respect of that "Picture" to the expenditure account which was to be in the sole name of Gala.

(2) Two representatives of Gala along with at least two representatives of SPR were to be signatories to the account. The signature of at least one each of Gala's and SPR's signatories were required to withdraw any monies including, but not limited to, "the Distributor Exploitation Expenditure" held in the account. No monies were to be deposited in the account other than "Distributor Exploitation Expenditure".

(3) Gala appointed SPR as its agent to withdraw monies from the account "solely to apply towards [Gala Expenses] to be incurred by Gala in connection with the relevant Picture and approved by [Gala] under the Marketing Plan or in accordance with clause 6.3 or 7" (see clause 6.2). In the definitions it was stated that the term "incurred" when used in the DA means:

> "in connection with [Gala Expenses], that they shall be treated as incurred on the date that the goods or services being procured are supplied to [Gala] or SPR as agent for [Gala], *which date shall be on or before 5 April 2004*". (Emphasis added.)

(4) No money was to be withdrawn from the account unless an invoice had been addressed to Gala or to SPR as agent of Gala.

(5) SPR agreed to apply sums from the account only on behalf of Gala in accordance with the Plan approved by Gala only on Gala Expenses.

247. *SPR's right to distribute*: It was provided that, subject to Gala's approval rights as summarised below, SPR had the right:

> "in its sole and unlimited discretion, to control the timing, manner and terms upon which each Picture is to be released, marketed, advertised, promoted, distributed, exhibited, licensed or otherwise exploited and subject to all Applicable Third Party Rights, SPR shall have the right in its sole and unlimited discretion to make such changes, alterations, cuts, additions, deletions and/or interpolations into and from each Picture as SPR may deem necessary or advisable for the effective release, marketing, advertising, promotion, distribution, exhibition, licensing or other exploitation of such Picture, and to select, designate or change the title of each Picture in SPR's sole discretion."

248. *Gala's approval rights*: The DA contained the following provisions as regards approval of the Plans for the "Pictures" and any increase or decrease in the sums to be provided by Gala to cover Gala Expenses from that listed in the LAs as Initial Expenditure (or any further approved sums):

(1) Gala had a right of approval over all material aspects of the marketing of the "Pictures" throughout the specified territory during the "Term" including the level of total Gala Expenses "incurred". However, this was subject to the proviso that once "the Distributor Exploitation Expenditure" had been "incurred" in full, then Gala's rights of approval were to be exercised by Gala and SPR jointly and, in the event of any disagreement, SPR's decision was to prevail. As it is stated in the definition of the term "incurred" in, effect, that the relevant goods and services to which the "Distributor Exploitation Expenditure" relates, would be supplied by 5 April 2004, it seems that the intention was that this proviso would apply from 6 April 2004 onwards. It was noted that Gala did not have a right of approval over those "Distribution Expenses" that do not constitute Gala Expenses.

(2) Gala undertook and agreed that the Plan for each Picture "shall be approved by [Gala] prior to the execution of the [LA] in respect of that Picture" and SPR acknowledged that Gala "enters into the [LAs] and this Agreement on the basis that the [Plans] (which have been commissioned from SPR or its Affiliates at [Gala's] request) are prepared in good faith by SPR or the applicable Affiliate."

(3) Representatives of each of Gala and SPR were to meet at SPR's offices once a week during the term of the DA or, on a less frequent basis if either party was unable to attend any weekly meeting for any reason, to discuss changes (if any) which SPR wished to make to the Plans.

(4) *Clause 6*: Under clause 6.3, if the Initial Expenditure for a "Picture" was not sufficient to pay for all of the Gala Expenses to be "incurred" in connection with that "Picture" and approved by Gala under clause 7, either (a) Gala "may" increase the "Distributor Exploitation Expenditure" in respect of that "Picture" and advance the same to the expenditure account "to meet the costs of the additional Gala Expenses to be incurred on its behalf in connection with that Picture" (clause 6.3.1), or (b) SPR "can" pay such additional cost from its own resources (clause 6.3.2). Under clause 6.4, if SPR wished to incur "Distribution Expenses" in respect of any "Picture" that do not constitute Gala Expenses, it could pay for them from its own resources.

(5) *Clause 7*: If SPR wished materially to increase the Gala Expenses set out in the Plans (by a sum in excess 10% of the previously approved such expenses) or to decrease them (whether materially or otherwise):

(a) SPR had to submit the proposed increase or decrease immediately to Gala for approval and Gala had to indicate its approval or disapproval within a short time limit,

(b) the failure of Gala to respond to any such proposal in the applicable time period was deemed to be approval by Gala, and

(c) Gala and SPR were each required to use their "reasonable endeavours" respectively to make available to SPR one or more representatives of [Gala], including a representative in the Los Angeles, California area, to grant or withhold its approvals set out in this clause..." and to contact Gala's representative to obtain all such approval (clause 7.3).

(d) It was provided at the end of clause 7.3 that, for the avoidance of doubt, Gala:

> "shall only have a right of approval in respect of a decrease or a material increase of the [Gala Expenses] and not of any changes in any other aspect of the Marketing Plan including (without limitation) any increase or decrease in Distribution Expenses which do not constitute [Gala Expenses] and any non-monetary aspects of distribution of the Pictures (including, without limitation, release dates) and SPR shall not be required to submit such changes to [Gala] for approval SAVE THAT for the avoidance of doubt, [Gala] shall not be entitled to disapprove [Gala Expenses] previously approved AND FURTHER SAVE THAT [Gala] does not have a right of approval over those Distribution Expenses that do not constitute [Gala Expenses]."

(6) As regards a decrease in Gala Expenses in respect of a "Picture":

(a) if Gala disapproved the decrease, SPR was entitled to terminate the agreement with respect to that "Picture" by written notice to Gala and the unspent Gala Expenses relating to that Picture were to be treated as unspent "Distributor Exploitation Expenditure" in accordance with clause 9.3 (clause 7.3), and

(b) if Gala approved or was deemed to approve the decrease, an amount equal to such decrease was to be applied in payment of Gala Expenses in respect of another "Picture" or, if not so applied by 5 April 2004, was to be treated as unspent "Distributor Exploitation Expenditure" in accordance with clause 9.3 (clause 7.5).

(7) As regards a proposed material increase in Gala Expenses in respect of a "Picture":

(a) if Gala expressly approved it in writing, Gala "shall" increase "the Distributor Exploitation Expenditure" in respect of the relevant "Picture" and advance the sum to the expenditure account to meet that cost (clause 7.4),

(b) if Gala was deemed to approve it, at its option, it could either increase "the Distribution Exploitation Expenditure" (as in (a)) or choose not to, in which case the following provisions in (c) would apply (clause 7.4), and

(c) if Gala disapproved it, at its option, either (i) the increased Gala Expenses "will not be incurred by" Gala (clause 7.6.1), (ii) they "will be incurred by" SPR and paid from its own resources and not from monies withdrawn from the account (clause 7.6.2), or (iii) SPR "can" submit a revised Plan for that Picture to Gala for approval and the above provisions would apply "mutatis mutandis to such revised [Plan]" (clause 7.6.3).

We refer to Gala Expenses in relation to which Gala agreed to provide funds into the expenditure account as "**approved Gala Expenses**". We note that Gala only agreed to provide the Initial Expenditure.

249. We find it difficult to make sense of the interaction between clauses 6.3 and 7.4 as, on the face of it, the provisions overlap but conflict. We note, in particular, that (1) clause 7.4 provides that if Gala approved any proposed material increase in writing, Gala was *required* to provide funds to cover the additional sum, but (2) clause 6.3 provides, in permissive terms, that either Gala *may* provide funds for, or SPR *can* from its own resources pay for, any increased Gala Expenses in any case where Gala approved them under clause 7. Clause 6.3 specifically states that it applies where there is insufficient Initial Expenditure to cover the Gala Expenses approved under clause 7 but, in effect, clause 7.4 operates where that is the case also. For example, if there was a material approved increase in Gala Expenses shown in the Initial Plan for that film (such as an increase from 100 to 120), the Initial Expenditure for that film, as a specified amount of the Gala Expenses shown in that plan (whether 100 or some lesser amount), would necessarily be insufficient to cover the increased sum.

250. *Payments by SPR*: The agreement provides for SPR to make payments to Gala as follows:

(1) In consideration of the grant of "Distribution Rights" to SPR, "SPR shall pay to [Gala], in Sterling, in addition to the sums payable pursuant to clause 9 below, an Annual Royalty payable on each Payment Date during the Term save that no Annual Royalty shall be payable after 28 July 2011...".

"Annual Royalty" is defined as an amount equal to annual interest computed at a specified rate, for the period ending on 28 January 2004 and thereafter the successive periods starting on 28 January in each year and ending 28 January in the next year or (if earlier) on the earlier of the last day of the Term or 28 July 2011 ("**Payment Dates**"). It was common ground that these sums were calculated to cover interest due on the SG loans and to produce a small profit over the term of the DA.

(2) The sums payable pursuant to clause 9 are:

(a) Under provisions in clause 9.1, which the parties refer to as "the waterfall", a share of the "Gross Receipts" derived from the "Pictures" as computed "in the aggregate during the term and from the specified territory on a cumulative fully cross-collateralised basis". "Gross Receipts" were very broadly defined to encompass many types of income arising to Sony from the exploitation of the transaction films. We have set out full details of the waterfall in section 11 below.

(b) The Minimum Amount, which SPR was required to pay to Gala on the earlier of (a) the last day of the "Term" (meaning 28 January 2012 or the date of any earlier termination under clause 7.3 or the provisions set out below) and (b) 28 July 2011, in which case "the [LC] shall be immediately discharged" (see clause 9.4).

The Minimum Amount is defined as the amount that would be standing to the credit of a notional account in sterling at a London branch of a bank on the day on which the "Term" ends or, if earlier 28 July 2011 ("**the End Date**") if (a) an amount equal to the Initial Expenditure had been deposited in the account on the date of the DA, (b) interest at the agreed rate had been credited to the account, as computed on the Payment Dates, for all relevant periods ending on or before the End Date; (d) the account had been debited on each of the Payment Dates falling prior to the End Date with an amount equal to the relevant Annual Royalty; (e) the account had been debited on the End Date with the Sterling equivalent on that date of all amounts ascertained and paid (and not retained by SPR) before the End Date to Gala by SPR pursuant to the waterfall.

251. *Abandoned Pictures:* If a "Picture" was not theatrically released on or before 30 September 2004 and was deemed abandoned pursuant to the LA then, the "Gross Receipts" derived from and the "Participations" payable in respect of another theatrical feature film owned or controlled by SPR or one of its affiliates which had a scheduled release date within 6 months after the date of the deemed abandonment and with a production cost and proposed Gala Expenses comparable to the abandoned Picture was to be designated by SPR and brought into account when calculating "Gross Receipts" and "Participations" pursuant to the waterfall.

252. *LC:* It was provided that (a) in order to secure the payment to Gala of the "Annual Royalty" at the end of each "Annual Period" and, by the end of the term, of the Minimum Amount "SPR shall procure the issue of the [LC] and [Gala] shall be under no obligation under this Agreement until the [LC] is received by [Gala]", and (b) to the extent that any payments were made to Gala pursuant to the LC, such payments would satisfy SPR's obligations to make the payments it was required to make to Gala.

253. *Security*: It was a condition precedent to SPR's obligations under the DA that SPR had received an executed debenture from Gala substantially in the form attached to the DA. Under this debenture, Gala (a) agreed to pay and perform all its obligations under the DA, (b) granted SPR a fixed charge over (i) the rights licensed to it under the DA, (ii) all sums payable to Gala under the DA and (iii) all materials relating to the transaction films, (c) assigned absolutely to SPR its right, title and interest in items (i) and (ii), and (d) granted SPR a floating charge over all of its assets, undertaking and goodwill. This security became enforceable if any event or circumstance arose pursuant to or, as a result of which, SPR was entitled to terminate the DA. Gala covenanted that it would not, without SPR's prior written consent, create or attempt or agree to create in favour of any person, other than SPR, any encumbrance over the charged assets or dispose of the charged assets or any part of them or attempt or agree to do so (in each case, other than as regards certain permitted encumbrances). As HMRC noted, these

provisions are broad enough to apply to the Initial Expenditure in the expenditure account.

254. *Acknowledgement:* This agreement contained the same acknowledgements, agreements and undertakings as those set out in the LAs described at [240] and [241] above. The Call Option also contained similar provisions.

255. *Restrictions on Gala*: It was provided that:

(1) Notwithstanding any breach, default, event of force majeure or other event or occurrence of any nature, Gala shall not "terminate or rescind this Agreement or the license of Distribution Rights granted to SPR hereunder at any time-prior to the expiration of the Term".

(2) In the event of any breach by SPR of the DA, (a) Gala's right were limited to a right to recover damages, if any, in an action at law, and (b) Gala waived "any right or remedy in equity, including, any right to terminate" the DA, or "to rescind SPR's right, title and interest in and to the Pictures or any other right granted to SPR" under the DA or "to enjoin or restrain the distribution or exhibition of the Pictures or the use, publication or dissemination of any advertising in connection therewith", and (c) without limiting the generality of (b), SPR's rights with respect to the Pictures could not be terminated, cancelled, rescinded or otherwise affected by any failure of SPR to pay any amounts payable under the DA accruing or becoming payable by SPR to Gala and Gala's sole remedy in any such event was limited as already set out.

256. *Termination*: It was provided that:

(1) (a) SPR could give Gala notice to terminate the DA if Gala was dissolved, liquidated or there was a similar event, and (b) (i) the DA would terminate in respect of a "Picture(s)" with immediate effect if the LA relating to the "Picture(s)" was terminated in certain circumstances, or (ii) in respect of all "Picture(s)", immediately following the exercise by SPE of the Call Option on payment of the price for doing so. Subject to (2), following such termination SPR would have no further obligation to Gala under the DA in respect of the "Picture(s)" other than the obligations to repay any part of the Gala Expenses pursuant to clause 9.3 (see [258]).

(2) On termination under these provisions or under clause 7.3, the "Distributor Exploitation Expenditure" relating to the relevant "Picture" which was yet to be "incurred", in respect of a termination before 5 April 2004, at Gala's option, or in respect of a termination thereafter, at the option of SPR, was either (a) to be applied in payment of Gala Expenses relating to another "Picture" or (b) to be treated as unspent "Distributor Exploitation Expenditure" in accordance with clause 9.3 (and the reference in clause 9.3 to 5 April 2004 was to be taken to be to such later date, if applicable, of any termination).

257. *No agency*: It was provided that:

> "Nothing in this agreement is intended to or shall operate to create a partnership or joint venture of any kind between the parties or, except as provided in clause 6, to authorise either party to act as agent for the other. Neither party shall have authority to act in the name or on behalf of or otherwise in any manner which would indicate or imply any such relationship with the other."

258. *Underspend*: Under clause 9.3, it was provided that on 15 May 2004 all unspent "Distributor Exploitation Expenditure" at such date ("**Underspend**"), would be allocated between SPR and Gala as follows:

(1) An amount calculated by (a) dividing the Underspend by the aggregate Distributor Exploitation Expenditure, and (b) multiplying the result by an amount

equal to 13.5% of the aggregate of funds subscribed to Gala by all of its members, would be deducted from the Underspend and paid to Gala (subject to certain provisions which, in effect, allowed SPR to off-set any such sum against any licence fee which a licensor was obliged to return). In effect, therefore, SPR was obliged to repay to Gala a portion of the benefit it initially received as the licence fees.

(2) The Underspend remaining, after deduction of any amount paid to Gala under (1), was to be advanced by Gala to SPR as a loan, which was repayable on the date upon which the Minimum Amount was due to be paid by SPR pursuant to clause 9.4 on the basis that payment of the Minimum Amount included amounts constituting the repayment of such loan in full on such date and that interest was to accrue on such amount.

Mr Yusef's evidence on the operation of the contracts

Sequel option

259. It was put to Mr Yusef that under the Option the option to acquire rights in "Sequels" had to be exercised in the Option Period because it was granted "on the same terms as this option agreement". He said that:

(1) The object was to enable Gala to acquire rights to any "Sequel" under the same terms commercially as applied under the Option.

(2) It makes no sense for that ability simply to expire in February 2004; this was intended to deal with the situation going forward as the "Sequel" rights would not materialise until perhaps 3 to 5 years after that date. So counsel's interpretation would render the option pointless. The period during which the option could be exercised was meant to extend to the time the rights to "Sequels" materialised.

(3) He did not think that the Option Period was extended for any reason to do with this option. It was extended in relation to the transaction films and:

> "not to sequel rights that had not even been given birth. It was not in the forefront of people's minds to talk about sequel rights when they were still dealing with whether or not to exercise options over the pictures. That was the focus, not sequels."

Licence fees

260. Mr Yusef did not agree that licence fees of £15.1 million were paid to Sony by Gala as the "studio benefit" (although he had himself referred to it as such in the documents) or financial reward for participating in the structure. He said, in effect that (1) the licence fees were paid in respect of the rights granted under the LAs and the benefit for the studio was derived from Gala paying a portion of the expenditure; they were paid for a bundle of rights, which included those passed on to SPR under the DA, and (2) "it is only partially the benefit" and more significantly "the reason why Sony did this deal in the first place", quite apart from the licence fees, was so that somebody else could pay for a portion of the expenditure. That was the initial driver for the deal which was "a considerable additional benefit to the studio and the original reason why we began discussions with them".

261. It was put to Mr Yusef that (1) it was remarkable that Gala informed the studios in advance of the maximum amount that it was prepared to pay for the licences and no serious business with a serious commercial outlook would do that, and (2) for example, in a proposal to Viacom it was stated that the purchase price was to be negotiated but "Gala's acquisition costs may not exceed 13.5% of the fund capital for the portfolio of films. The purchase price is a non-refundable fee to the studio". He said that a serious businessman will make very clear from the outset what "the sticker price will be", in

particular, as regards studios who are quite used to "pushing people around, because they feel they have an inequality of bargaining power in their favour". So, in his view, it was very important to make clear what "our red line position" would be to make it quite clear from the outset that "we weren't going to be pushed around" and that is an appropriate negotiating position to adopt in an aggressive environment such as this. He added that, in his experience, this is completely commercial, it is a highly practical position and what he would expect to see in a tough negotiating position, and it is more likely to lead to a successful outcome "if the flavour of the negotiation and the way you intend to adopt it is made clear from the outset".

262. When it was put to him that there is a complete absence of any evidence of negotiation, he said that (1) how this deal was negotiated is completely within the scope of how this is done with a studio, (2) they did not "go there with the intention of setting out a paper trail for the benefit of a tribunal that takes place after the event" and "were dealing with a highly volatile, highly fast-running situation", (3) he made a number of initial enquiries to test what the appetite for this type of structure was with the studios and, by the time he sent out the proposals to studios, he had the benefit of very deep discussions with a contact at Paramount. By the time he got to Sony, therefore, he already had the benefit of person-to-person discussions with all the other major studios and his pitch "was fairly well designed", (4) this level of negotiations does not take place by exchanges of e-mails (even if e-mails were used that much in those days); it is very much a people business where trust between people has to be generated so the numerous discussions were on a person-to-person basis, and (5) the negotiation was not just for a couple of hours but over several sessions, and the culmination of that was the term sheet, which itself was the subject of discussions and negotiations when he was in Los Angeles meeting with the studio. At the time, he was tired, not just from jetlag, but from the effort that was undertaken to get these things off the ground.

263. In re-examination he emphasised that (1) normally, particularly in America, with studios, much of the discussion and negotiation is face-to-face. It is very rare that a transaction of this size is dealt with remotely. Great store is placed on interpersonal relationships. Hence, all of the material aspects of the negotiation were conducted face-to-face, and (2) the term sheet, which is a standard feature of transactions of this size and nature, is the point at which both parties are willing to commit themselves to paper but it cannot be seen in isolation. It is the culmination of a huge amount of discussion and negotiation and to-ing and fro-ing. The term sheet is the critical thing leading up to then going to the next stage. That is the point at which "you know you've got a deal".

264. It was put to Mr Yusef that it was uncommercial that the licence fees were calculated under a formula and were not determined by a market valuation or negotiation and that they always had to add up to exactly 13.5% of the contributions:

(1) He seemed to agree that is how the licence fees were computed and that they exactly match Gala's SG loan. He said that is logical because an investor does not borrow more or less than it needs and Gala knew exactly how much it needed to borrow for the films that it was looking to finance. He agreed that he always knew and intended that the aggregate licence fees would equal exactly Gala's SG loan and said that most commercial deals are the subject of a formula:

> "Once you agree what the parameters of a commercial transaction will be, you look to see and try to formulate an understanding of those figures within the context of that transaction. So you could say most things boil down to a formula. In this case what we had was a finite amount of money that we knew we could raise, and therefore it's unsurprising that we would start off with, if you like, a pot of money and say: How can we make the best economic use of that money?"

(2) He added that "the amount that we had was finite", and it was necessary to allocate that to ensure that the full amount of cash available would always be enough to ensure that Gala could (a) acquire all of the selected films, and (b) have enough money to pay for the approved Gala Expenses.

(3) He agreed that the amount of the licence fees is "fixed "but said that:

(a) This was "the product of the negotiation or the straitjacket that we placed on the studio" and basically, in simple terms, Gala/Invicta said from the outset that this was the maximum amount that they had and they would pay an amount which cannot exceed that and "if you want to do the deal, this is what it has to be".

(b) In accepting this, Sony made a commercial decision: Sony knew they could not get more, they did not want less, so "they agreed on the maximum amount we agreed to pay".

(c) The number had to add up to 13.5% because "we had…to come to a definite number because that is all we had. We didn't have an open tap of money that we could resort to. We had a finite amount of money".

(d) This is commercial because Sony accepted it because they wanted the main benefit to them from this transaction which was not:

> "the measly, in their view, £15 million that they got for the so-called studio benefit, but the fact that they were getting a third party to pay for part of their P&A. That was the driver for the studio."

(e) £15 million is less than the annual salary of a middle ranking executive in those circumstances and the board of Sony:

> "would not get excited about $15 million coming to the bottom line at a time when their profits had gone down by 92.3%. The driver for this deal and the commercial logic for this deal for the studio was the fact that they needed our P&A money."

(4) He agreed that he had not referred to this reduction in profits in his witness statement but said that it is in the 2002 financial statements of Sony group and:

> "the figure is embedded in my mind. It shows 92.3% reduction in net profits for that year. It was a disastrous year for them. They were very, very keen to talk to us. Remarkably, it was in a year when their studio was experiencing better results than the rest of the divisions, but they were hungry for money, and that was the reason why they did this deal."

265. As noted, (1) Mr Yusef's view that Sony did not enter into the transactions to receive the "measly" £15 million of licence fees as their "benefit" but for other reasons such as, as he said here, that "they were hungry for money" is a repeated feature of his evidence, and (2) we do not accept his evidence in this regard for the reasons given in sections 2 and 10. We accept that such negotiations and/or communication as there were between Invicta/Gala and Sony in relation to the terms of the transactions may well have taken place orally. However, in our view, the unfavourable terms of the DA from Gala's perspective, in particular, Gala's lack of a meaningful entitlement to a share of Gross Receipts under the waterfall and to input into the distribution process (see below and section 11), of itself renders implausible the assertion that there were extensive negotiations and/or, as Mr Yusef seemed to suggest at various times, that Gala fought hard for particular terms and achieved a successful outcome (see also our comments on this in sections 2 and 11).

266. Moreover, we cannot see that it makes commercial sense for an entity such as Gala to specify to its counterparty the level of licence fees it is prepared to pay in advance. As a matter of commercial common sense, such a strategy, in effect, closes

off the prospect of the counterparty accepting a lower sum. It is plain from the documentary evidence, as Mr Yusef appeared to accept, that Invicta set the maximum aggregate licence fees simply as a percentage of the total contributions and not according to any valuation of the rights to be acquired by Gala under the LAs. Mr Yusef's comments that the number had to add up to 13.5% because Invicta had to come to a definite number because Gala did not have "an open tap of money" but "a finite sum of money" does not provide any further insight as to why that particular percentage was chosen. Of course, ultimately, once Gala had raised funds from investors, it had a defined pot of money with which, together with its SG loan, it could fund the costs of the transactions, namely, the licence fees, the Initial Expenditure and the costs and expenses of putting the structure in place. If Invicta had decided to allocate a lesser or greater amount as the maximum licence fees, as a percentage of the total contributions, that would simply have increased or decreased the amount available for payment of the other expenses. We also note here our comments in section 13 at [373] to [380].

Rights under the LAs and DA

267. It was put to Mr Yusef that the Rights granted to Gala under the LAs were, in effect, passed straight back to another Sony entity under the DA such that, throughout the 8-year term of the DA, in reality, Gala had no effective rights of substance to distribute the films:

(1) He said that there was no "pass through" of the Rights and Gala was not just a funnel. He based this on his view of the legal and commercial position. He noted that the licences granted to Gala were for a longer 21-year period and asserted that Gala had a right to distribute through Sony as its agent, which was "buttressed by the fact that we actually spent money" from the expenditure account funded by Gala on Gala Expenses that were incurred both practically and legally by Gala. As he understood the arrangement both legally and commercially, Gala granted Sony "the sub distribution rights and were conducting distribution, which we were paying for directly, and at the time engaging SPR in respect of those activities as our agent". As set out below, we do not accept that this is the effect of the arrangements.

(2) He did not agree that the fact that Gala charged the Rights in favour of Sony reinforces the point put by counsel. He said essentially that this was a common arrangement and:

> "When a producer is granted intellectual property rights by a third party, customarily there will always be a debenture to ensure that the rights are dealt with in the way that was commercially contemplated. There was nothing unusual about being granted rights and then by way of security...those rights being granted back [so that the] grantor can sleep at night knowing that the rights they granted are going to be dealt with in a proper fashion and that if the licensee, in this case Gala, behaved in a way that was contrary to what was contemplated, they had the right to enforce their security, which would be in addition to the rights that they would have had under the contract."

In other words, Gala were granted rights which they then assigned by way of security to ensure that their obligations were complied with. It was never the case that Gala simply was used as a funnel. The debenture was there "to ensure that we did what we say we were going to".

(3) As regards the restriction in the DA and debentures on Gala's ability to conduct business expect that provided for under the transaction documents:

(a) He said the provision in the DA in this respect is perfectly standard and commercial in the film and music industry and is perfectly understandable and commercially realistic; it would not be commercially sensible for Sony "to

grant rights which we could then trot off to a competitor and exploit...elsewhere" and "it would be commercially suicidal for SPE...to grant us rights and then give us the freedom to go off and go to Disney and exploit the pictures there. Heads would roll". He said this provision reflects "what happens in real life beyond the contracts. This security is the way in which they ensure that that promise is kept".

(b) He said that none of the debentures are uncommercial:

> "The very nature of a debenture is to restrict the activity of the grantor, and in all of those circumstances the restrictions were within the boundaries of commerciality and standard practice. So, for example, it would be inconceivable that SPE would grant rights into their assets without placing a restriction on where those assets could be sub-licensed. It would be inconceivable that Sony would agree that we could go and sub-licence to Paramount. It would never happen. So the restriction there is commercially logical and…standard. Similarly, the debenture that we grant to SPR, there is nothing there which is not standard and not uncommercial. Also, I have never come across, over almost 40 decades, a loan agreement for any amount...where the borrower does not grant a debenture, a charge."

He concluded that the debentures are what anybody that is used to this kind of transaction would say is bog standard: "We did nothing in terms of granting security that is uncommercial or non-standard or artificial for that matter."

(4) It was put to him that Sony was not going to let Gala, a special purpose vehicle, which was set up for the purposes of a tax avoidance scheme, anywhere near its rights to distribute films. He said:

(a) That is precisely what they did because they needed money and, whilst counsel suggested they did it for the sake of $15 million, Sony would describe that "as chump change" and that is not "a consideration that would move a studio of this size. They were looking to vast sums of money coming by way of additional distribution rights. That is what drives this deal".

(b) The agreements reflect what would normally happen, which is "rights are granted. The rights are secured. The rights are restricted so that rivals cannot take advantage of the rights that were granted". Throughout the time he has been involved in the film business such arrangements are "perfectly standard" and he would be surprised "if any studio would have granted rights without the ability to control them" in the way provided for in the documents.

(c) Gala was not the first to have a structure like this: "We in effect rented the studio system" and, for the reasons given it was "not a paper transaction...Gala was an institution of substance in this transaction is the position that I not only adopt but believe in sincerely...it is not a funnelling exercise".

(5) He did not agree that Gala never owed a substantive obligation. His view was based on (a) his view of the legal effect of the transactions, in particular, that Gala had obligations under the LAs which it retained, and (b) the assertion that the real purpose of this activity was to enter into a DA with a studio where Gala participated in the distribution. He added that there are things that go on in addition to that, some of which relate to providing security to each party to ensure that "what we say will happen does happen", but:

> "there is not one single step in this series of transactions which is artificially introduced in order to simply give effect or, as you say, window dress the real purpose of this transaction. There is not one single artificial step that you would not see in a similar transaction of this nature."

(6) He was taken to a provision in the LAs that the "Distributor may procure that distributor's sub licensee undertakes to perform....If and to the extent distributor procures such undertaking from distributor's sub licensee, distributor shall have no further liability pursuant to this clause 7 to the licensor." It was put to him that this is drafted on the basis that there was uncertainty about whether Gala would sub-licence the Rights to SPR but there was no uncertainty, as the DA was entered into at the same time as the LAs. He said that (a) that is the way lawyers draft things, he did not find this provision surprising, it was in numerous transactions that he had been involved with and of itself is not artificial, and (b) the term "may" was used rather than "shall" as, whilst it was contemplated that the sub distribution rights would go to SPR, there was always a possibility that it would go to somebody else in the group. He did not accept that when the documents were entered into there was no ambiguity because they are all set up as a package and were signed at the same time and were designed to give the impression of meaningful rights, obligations and activity.

(7) When it was put to him that Sony retained the substantive rights and substantive obligations in relation to the films, he said he strongly disagreed:

> "These are designed to do what they actually achieve, which is to grant rights to us. We don't grant the same bundle of rights down. We retain important rights and the document achieves what was designed to achieve."

268. As regards the scope of Gala's rights under the DA in relation to the Plans:

(1) Mr Yusef agreed that it was a condition of the DA that the Initial Plans were reviewed and approved. He said that was so that, at that time, the parties were "at one" in terms of substantially how the films were to be marketed and "in effect the agreement could not have been entered into unless that had happened". He said that it is "not abnormal for parties to go through various steps in order to get to a point where they [are] both of the same mind," and "we could not have approved that [Plan] unless various steps had taken place prior to that agreement being entered into."

(2) It was put to him that the sum effect of clause 7 of the DA is that any changes to the Plans, other than to the amount Gala was purportedly going to contribute to the marketing budget, were a matter for Sony. He said:

> "No, because there were certain things that could have happened and in some instances did happen after the [DA] was entered into…we wanted to ensure that what Sony was spending either on its own behalf or on our behalf as its agent, or we were spending directly by way of invoicing to us, was in accordance with what we had agreed, and any deviation from that to the extent that it was material...would have been the subject of our approval with certain consequences arising from that. This was not a passive role that...Gala had both before and after the event."

(3) It was put to him that if Sony wished to increase the marketing spend on the films, it could do so by simply incurring that expenditure. He said that Sony could not just simply arbitrarily do that halfway through the distribution of a film without going through the approval process set out in the DA and could not just do whatever they liked:

> "The commercial reality, which...is what governs how people behave in this contractual situation, is that it was not SPR's preferred position to simply spend all the money however it liked in any single way. If it wanted to do that, it wouldn't have involved us in the first place. Its desire for our money meant that they would have to get from us consent or... more like consensus. They obviously have to have a mechanism that ensures we do not destroy the distribution process mid-course. So what was agreed was if they came to us

> with a material change and we disapproved of it, we couldn't use that as a mechanism to stop the production. So it was commercially realistic and plausible that they would then have the right to spend that money, but that was not what they were choosing to do. It would be commercially not sensible for them to say: "Let us enter into this complicated transaction and then just do what the hell we like". That is not what happened and it was not the state of mind of the parties at the time."

(4) He agreed that if Sony wished to decrease the marketing spend on the film, it could do so "with different results" and, if Gala objected, Sony could simply terminate the agreement. He added that the likelihood of that scenario, "was commercially acceptable as a very low risk" as it is safe to assume that would be because it would be commercially unsound to spend the money originally envisaged if the film was not performing and "we probably would be as keen to decrease the budget as they would be in those circumstances. The likelihood that we would be in a conflict with Sony in those circumstances is extremely remote".

(5) It was put to him that Gala did not even have a meaningful right to be heard, because Sony could unilaterally cancel meetings (as they could be cancelled if a party could not attend). He said that to cancel meetings of substance without good cause would be an act of very bad faith and there was no "commercial logical reason why they would do that". In fact, the experience throughout the whole period was that Sony were happy to meet Mr Ackerman and he met with them on a collegiate basis at least 3 or 4 times a week, sometimes more, and was a respected person within that process. He said he was aware there were times when meetings were rescheduled and, in his view, if a meeting was cancelled, there would be a good reason for it.

(6) He added that the rights were meaningful and the approval of the Plans did happen. Even though the Plans had to be approved as a pre-condition to entering into the licence, "it is nevertheless the case that Gala had substantial rights to look at and approve the guts of the transaction, which is the [Plans]. Whether it happened before or afterwards was a matter of commercial convenience". It would have been "cumbersome and would have delayed the marketing process if we had simply entered into" the licences "and then gone through the same approval process and work that we had done before the agreement. It was much more convenient to do the work before, approve the process and then enter into the agreement. The approval rights actually were exercised...And were substantial".

269. In re-examination, as regards Sony's ability to increase or decrease the amount of Gala Expenses (and other expenses):

(1) He noted that Sony, "despite their size and strength were not in a position to just simply do what they want or push us around. There was a mechanism or mechanisms in place to ensure that other interests were protected". He essentially made the same comments as he made under cross examination as regards Sony's ability to decrease the spend.

(2) As regards Sony's ability to spend more on expenses for a film if Gala did not want to do so, he added that (a) it was right that Gala would have that right not to spend more, (b) Sony had 2 rights. They could spend the difference and recoup it or, "if the situation at that stage had become egregious and controversial, they would have the right to terminate", and (c) commercially speaking, that right was judged at the time to be one Gala could agree to because:

> "within the context of why the studio wanted to enter into this transaction, they wanted more and more of our money, not less and less. The likelihood that that

> situation would arise, in circumstances where we knew upfront how much the overall expenditure would be, and we had decided that we could cope with that, we didn't think that that kind of situation would arise, given that Sony -- they are not really interested in spending more money than they need to maximise the performance of a film."

270. It was put to Mr Yusef that the reality is that Gala surrendered control of the expenditure account to Sony and, to all intents and purposes, the sum in that account was Sony's money as (a) in reality, Gala provided £102 million to SPR who put that sum on deposit and agreed to pay it back to Gala, (b) the account was charged in favour of SPR and Gala agreed not to do anything with sums in it without SPR's prior written consent, (c) it was preordained that the monies were to be spent by SPR in marketing its films, using its Plans, which Gala had notionally approved before signing the DA, and (d) SPR was entitled to withdraw monies from the expenditure account and to spend them in accordance with those Plans on the basis of invoices addressed to it. He disagreed:

(1) He recalled, as there was a lot of discussion about it at the time, Sony wanted (a) to be a signatory to the account for the sole purpose of making sure that, once they had committed to their counterparties, such as McCann Erickson, based on the placement of Gala's share of the distribution expenditure, Gala could not simply withdraw the money, and (b) to be sure that there was a provision in the document which gave them power to do so as an agent so that there would be some reason why their signatory was co-signing. They thought there would be an exposure to litigation in those circumstances. He added that there was no way in which Sony could simply just take money from the account as they pleased. Gala had the control, and whilst Sony had some degree of control, "to say we surrendered control is simply factually and legally not correct".

(2) It was put to him that he was speculating about Sony's intentions and concerns. He said his comments are reflected in the actual arrangements. If Sony wanted to simply put monies into an account, they would have used their own account. They would not have gone through the process of agreeing for Gala to have an account. The money was not Sony's but Gala's and:

> "we wanted to ensure that the money went in a specific way, which it did. There was no arbitrary way in which Sony could just take money willy nilly. Theirs was a defensive posture and not one of control. They wanted to make sure we didn't do what they feared we would do, not the other way round. It wasn't what actually happened".

(3) The money in the account was not Sony's money as a matter of fact and law. Sony did not control and did not have a unilateral right to take that money and spend it any way it liked. It could only be spent, as the DA states, in the distribution of the transaction films, and the security agreements are perfectly standard and were entered into to protect SPR and ensure that SPR's understanding of the deal actually is what happened in the sense that, as the secured party, like under a mortgage, it could exercise its rights if Gala was in default.

271. In re-examination, Mr Yusef emphasised that there was a provision for there to be 2 Sony signatories to the expenditure account in the DA because Sony "was making commitments on our behalf with the various agencies, they were engaging on our behalf as our agent" and wanted to know, "once we had committed that sum, that we couldn't unilaterally withdraw it". In addition (a) there were certain payments which Sony could incur on Gala's behalf but in their name, because they had amazing discounts and benefits that arise from their volume deals that they had with these counterparties, and

Gala wanted to enjoy the benefit of that, (b) but in all other respects all the transaction costs were directly incurred from that account against invoices in Gala's name, and, in practice, although Sony had the ability to co-sign the mandate, it did not have the ability to unilaterally take money out, even if they were entitled to that money. Gala had to agree to it.

Conclusions on the meaning of the contractual arrangements and their effect

272. In our conclusions we have in mind (1) the guidance given in *Ingenious UT* on the correct approach to be adopted by the tribunal as a matter of contractual construction and the interaction of that analysis with a purposive approach to the construction of legislation (see [17]), and (2) our comments, in light of that guidance, of the approach to take to Mr Yusef's views on the documentation (see [41]).

273. There was not a complete match between the Rights granted to Gala and those it granted to SPR under the DA in that, under the LAs (1) Gala was granted the Rights for 21 years whereas, under the DA, Gala granted SPR equivalent rights for a period of only 8 years, and (2) Gala had an option to acquire rights in "Sequels". However, these rights were of limited benefit to Gala:

(1) The plain meaning of the relevant provision in the LA is that Gala had to exercise its option to acquire rights in relation to any "Sequel" within the Option Period (of 2 December 2003 to 27 January 2004). We acknowledge that the documents are to be interpreted in accordance with business common sense and that, as Mr Yusef said, "Sequels" were not likely to be in contemplation until a later stage and an option which gave Gala rights only in such a limited window was not likely to be of much (if any) practical use to it. However, (a) the reference in the LAs to Gala's right to acquire rights in "Sequels" on "the same terms" as set out in the Option is unequivocal and without limitation, and the Option Period is plainly a term of the Option, (b) as a matter of business common sense, (i) it seems unlikely that the intention would be for Gala's right to subsist for an unlimited period with no end date, and (ii) given the overall effect and terms of the composite set of documents of which this document forms part, it is reasonable to suppose that the parties were willing to insert such a provision in the Option in the expectation that it was unlikely to have any practical utility. As set out below, a number of provisions were included in the documents which, on the face of it, give the impression that Gala had substantive rights/obligations as regards the distribution of the transaction films but which, on closer scrutiny, lack meaning and consequence.

(2) In any event, Invicta/Gala can have had no realistic expectation that the LAs would remain in place for 21 years and/or that it would have any opportunity to acquire rights in "Sequels" given that, as we have concluded for the reasons set out in section 15, Invicta/Gala expected SPE to exercise the Call Option at the first opportunity and designed the arrangements so that it was inevitable that SPE would do so.

274. Under the DA, Gala otherwise granted SPR "Distribution Rights" that were described in the same terms as the Rights it was granted under the LAs. Whilst the rights granted to SPR were subject to Gala's rights of approval, these were very limited in nature and effect. Overall, for the duration of the DA, SPR was free to distribute the transaction films as it wished and, in doing so, to incur such distribution expenses as it wished, including any approved Gala Expenses, albeit that SPR had to go through the process set out in the DA to be able to utilise the funds in the expenditure account to meet those expenses. Gala had no meaningful contractual right to control or limit expenditure on the marketing and distribution of the transaction films and/or to require

SPR to take account of its views in relation to the level of Gala Expenses (or other distribution expenses) or its views on any other aspect of SPR's Plans. We note that:

(1) It was specifically stated in the DA that SPR assumed all of Gala's executory obligations under the transaction documents in respect of the Rights and that, subject only to Gala's approval rights in clause 7, SPR had the right to distribute and market the transaction films "in its sole and unlimited discretion". For the reasons set out in [279] to [281] below, we do not accept that SPR was appointed, or acted, as Gala's agent in the exercise of its rights under the DA.

(2) Whilst the DA states that Gala was to have a right of approval "over all material aspects of the marketing of" the transaction films including the level of total Gala Expenses incurred but not of any other "Distribution Expenses", this broad statement was, in effect, limited in that:

(a) Gala agreed that the Plan for each transaction film would be approved by Gala prior to the execution of the LA in respect of that film.

(b) This right was subject to the proviso that, once "the Distributor Exploitation Expenditure" had been "incurred" in full, as it was intended to be by 5 April 2004 (see the definition of "incurred"), Gala's rights of approval were to be exercised by Gala and SPR jointly and, in the event of disagreement, SPR's decision was to prevail.

(c) It was stated that Gala only had a right of approval in respect of any proposed decrease, or a material increase, of the Gala Expenses and "not of any changes in any other aspect of the [Plan]" including (a) "any increase or decrease in Distribution Expenses which do not constitute [Gala Expenses]" and (b) "any non-monetary aspects of distribution of the Pictures…".

(3) In effect, therefore, (a) Gala's only substantive right or obligation to input into the distribution process was a right of approval of any material increase, or decrease, in approved Gala Expenses proposed by SPR, and (b) that right fell away as at 6 April 2004, by which time it was intended that the total approved Gala Expenses would have been "incurred". With that context in mind, it is reasonable to interpret the requirement in the DA for representatives of Gala and SPR to meet once a week (unless either party was unavailable) to discuss changes SPR wished to make to the Plans, to contemplate meetings at which SPR would present any proposed material increase, or decrease, in approved Gala Expenses.

(4) Under the DA, the consequences of Gala approving or objecting to any proposed material increase, or decrease, in approved Gala Expenses did not provide Gala with any meaningful way of controlling the level of those expenses or with any commercial advantage:

(a) It is notable that (i) if Gala objected to a proposed decrease, SPR could simply terminate the DA in relation to the relevant transaction film and the unspent sum was to be dealt with as "Underspend" (and the licensor could terminate the LA in such circumstances), and (ii) if Gala approved or was deemed to approve it, an amount equal to the decrease was to be applied in payment of Gala Expenses for another transaction film or, if not so applied by 5 April 2004, was to be dealt with as "Underspend".

(b) As set out at [248] and [249] the position is more complicated and less clear as regards any proposed material increase in approved Gala Expenses. However, it is apparent that (i) Gala's right of approval, in effect, gave it the ability to choose whether to provide further funds into the expenditure account in respect of any such expense, but (ii) if Gala chose not to do so (whether by expressly not approving the increase, or where it was deemed to approve it, by

electing not to provide further funds), SPR could or was required to incur the increased expense using resources other than those in the expenditure account. It is arguable that the effect of clause 6.3.2 is that SPR was entitled to pay for any such increased expense from funds other than those in the expenditure account even where Gala was required, or chose, to provide further funds although, of course, in practice, there would be no commercial reason for SPR to do so if Gala provided the funds.

(c) As explained in section 11, if SPR met any such additional Gala Expenses from resources other than the funds in the expenditure account, it was entitled to recover those sums from Gross Receipts under the fifth provision of the waterfall, in priority to Gala's entitlement under the sixth provision to recoup from Gross Receipts an amount equal to the sums it put into the expenditure account.

(5) We do not accept Mr Vallat's submission that it mattered in commercial terms whether Gala approved of a proposed material increase as, if Sony bore an increased cost itself because Gala did not approve it, Sony could then recover that cost only in a lower position in the waterfall, under the eighth provision. That is an inaccurate description of how the contractual provisions operate and, as set out in section 11, we cannot see what would fall in the eighth provision that would not be captured under the fifth provision. Mr Vallat also emphasised that there is more than one possible outcome where SPR proposed a decrease in Gala Expenses. That is of course correct but Gala's rights in that respect ultimately only had the consequences already set out.

275. We consider that Mr Yusef's view of how the provisions operate is consistent with this analysis although, as set out at [41], strictly his views are not relevant to the construction of these provisions. Whilst Mr Yusef said "no" when counsel put to him that Gala only had rights under clause 7 of the DA in respect of changes to Gala's Expenses, he seemed to accept that in his further comments:

(1) After he said "no", he added that (a) Gala could check that what was spent from the expenditure account was in accordance with what had been agreed, and (b) that "any deviation from that to the extent that it was material...would have been the subject of our approval with certain consequences arising from that".

(2) He seemed to suggest that, in practice or, as he put it "commercial reality", Sony would not necessarily choose to exercise its rights to incur additional Gala Expenses if Gala did not approve them under the process set out in the DA and that the level of expenses incurred was agreed by consensus due to Sony's desire for Gala's money. This was plainly not a comment on the legal effect of the provisions and, as noted, we do not accept that Sony's participation was driven by anything other than its receipt of £15 million as licence fees. We have set out the evidence on how the approvals process operated in practice and our comments on that aspect of the arrangements in section 14.

(3) He agreed with counsel's description of how the provisions work as regards any proposed decrease in Gala Expenses and said the likelihood of that scenario, "was commercially acceptable as a very low risk".

276. We cannot see that, in practice, there was any incentive for Gala to exercise its right, in effect, to choose to put further funds into the expenditure account beyond the Initial Expenditure, and it did not do so. Rather, there was a disincentive for Gala to do so, given that (a) SPR could fund any increased expense from other resources, and (b) it is reasonable to assume SPR would do so, as the relevant approval provisions were in point only if SPR proposed an increase in approved Gala Expenses:

(1) As the documents were drafted, any further sum which Gala put in the expenditure account to meet an increased Gala Expense would not be covered by the shortfall guarantee and related security arrangements. As explained in full in section 11, Gala would have to rely on recouping any such sum from Gross Receipts under the sixth provision in the waterfall. As noted, SPR was entitled under the fifth provision to recoup expenditure (including Gala Expenses) it incurred using resources other than those in the expenditure account in priority to Gala's entitlement under the sixth provision.

(2) Gala's position under the waterfall would not otherwise be affected materially by whether any such increased Gala Expense was funded by additional monies Gala put in the expenditure account or by Sony from other resources: (a) the first to fourth provisions of the waterfall allocated Gross Receipts to SPR, (b) the fifth and sixth provisions operated as stated in (1), and (c) the level of Gross Receipts available for allocation between Gala and Sony under the remaining seventh to eleventh provisions of the waterfall would be the same, whether Sony or Gala was entitled to recoup any increased Gala Expense under the fifth or sixth provisions respectively. We note here also that how the total sum in the expenditure account was allocated between the transaction films could not affect Gala's position under the waterfall (see our comments in section 13 at [373] to [380]).

277. We note that:

(1) Pursuant to the security arrangements, Gala assigned absolutely all of its rights under the LAs to SG and the relevant Sony entities. The security agreements in favour of SG secured Gala's and the members' obligations under the SG loans and the security agreements in favour of SPE, SPR, Columbia/Screen Gems secured Gala's obligations under the Call Option, DA and LAs respectively. There was no point in time at which Gala held rights under the LAs (or the DA), which were free of the security agreements. As the UT held in the similar circumstances of *Ingenious* (see [156] of the UT's decision and the Court of Appeal's decision at [36] to [40]), the effect of the security arrangements was that, in principle, Gala had an equity of redemption, but this was a theoretical rather than a real right. An equity of redemption implies that the holder has a right to redeem the security and enjoy the rights which are secured. However, there was no way for Gala to redeem the security whilst keeping the Rights under the LAs.

(2) Moreover, in the LAs and debenture granted to SG, Gala covenanted not to carry on any other business and so could not avail itself of any future opportunities, and Gala had no right to terminate or rescind the DA during its "Term" even if SPR was in breach of its obligations.

278. Mr Yusef emphasised repeatedly that, in his experience, a studio such as Sony would not normally grant distribution rights such as the Rights to an entity such as Gala without imposing restrictions and requiring security of the kind in place here. However, we are not in a position to assess these transactions by reference to other circumstances of which we have no details, and whether aspects of the arrangements can be described as "normal" or "usual" by comparison with such circumstances does not inform our analysis of the commercial and economic effects of the particular arrangements embodied in these contracts. Mr Vallat said that the circumstances of this case are materially different to those in *Ingenious* and do not justify findings of the kind we have made: (1) In *Ingenious UT*, the UT regarded the security arrangements as significant because, as a result of them, the LLPs did not in a meaningful sense own the relevant assets which they asserted was their stock in trade, and (2) here (a) Gala had all the

rights in relation to the transaction films which it needed to fulfil its obligations and carry on its trade, (b) its Rights went above and beyond those it granted to SPR under the DA, and (c) the security rights simply affect cashflow and ensure that primary obligations are discharged. We have set out details of the *Ingenious* decision in Part C. We do not accept Mr Vallat's view of these matters and/or their significance for the reasons already given and as set out in sections 10 and 11.

279. We do not accept that, as Mr Yusef and Mr Vallat suggested, under the terms of the DA, SPR was engaged to act as Gala's agent in relation to engaging with the third parties to whom the approved Gala Expenses were paid. We note that:

(1) It is stated in the introduction to the DA that Gala had agreed both to sub-licence the Rights to SPR and to appoint SPR as Gala's agent for the purpose of "incurring the Distributor Exploitation Expenditure upon the terms and conditions set out in the [DA]".

(2) However, there is no substantive provision in the DA under which Gala expressly appointed Sony to act as its agent in contracting with the third parties to whom approved Gala Expenses were or would be due:

(a) The only express reference to SPR's appointment as agent, in clause 6, stated that (a) Gala appointed SPR as its agent to withdraw monies from the expenditure account "solely to apply towards [Gala Expenses] to be incurred by Gala…", (b) no money was to be withdrawn from that account unless an invoice was addressed to Gala or to SPR as agent of Gala, and (c) SPR would apply sums from that account only on behalf of Gala to meet approved Gala Expenses.

(b) There are various other references in the DA to approved Gala Expenses being *incurred* by/for Gala. The definition of the term "incurred" provided that, in connection with approved Gala Expenses, such sums were to be treated as "incurred on the date that the goods or services being procured are supplied to Gala or SPR as agent for Gala".

(c) It was expressly stated that the DA did not operate to create any agency otherwise than as provided for under clause 6.

280. Hence, in effect, Gala expressly authorised SPR to take monies from the expenditure account, which was held in its name, for the specified purpose of meeting approved Gala Expenses on the basis that, as was simply assumed to be the case, those expenses were to be incurred by Gala and the relevant goods or services were to be supplied to Gala or to SPR as its agent. However, we cannot see that there is any substantive provision in the DA (or any other document) which underpins what is essentially simply an assertion or assumed position. In fact, the suggestion that, in engaging with relevant third parties, SPR was confined to acting only as Gala's agent rather than on its own account and for its own benefit, is entirely inconsistent with the overall effect of the contractual arrangements. It is otherwise plain from the terms of the DA that (a) Gala retained no relevant Rights in respect of the distribution process, which it could appoint SPR to exercise as its agent, and (b) the contractual relationship between Gala and SPR lacked the essential qualities of an agency relationship:

(1) As set out in [274], under the DA Gala sub-licensed the Rights to SPR, in effect, in their entirety, subject only to Gala's limited rights of approval in clause 7. Accordingly, (a) SPR was free to take such action as it chose to market and distribute the transaction films, whether that involved putting together Plans, tracking the films, deciding on the best way to market the films, or engaging third parties to market and distribute the films and liaising with them, and (b) it was

free to do so acting entirely on its own behalf in its own interests and for its own gain and had no duty to act in Gala's interests.

(2) This is reinforced by the fact that the DA makes clear that SPR had no responsibility or liability to Gala as regards the distribution of the transaction films. SPR could choose not to distribute them and owed no duty to Gala in respect of its decision-making process.

(3) It is a characteristic of agency that the principal is in a position to control the agent, even if that control ultimately rests in the principal's power to revoke the agency. Gala was not in a position to exercise any control over SPR. It could not terminate the authority for SPR to withdraw sums from the expenditure account to meet approved Gala Expenses, because the DA provides expressly that Gala was not entitled to terminate or rescind the DA under any circumstances.

(4) We consider that, in the absence of any other evidence and in light of the points made above, the fact that the DA specified that funds were to be released from the expenditure account only on receipt of invoices addressed to Gala or SPR as Gala's agent, does not of itself suffice to demonstrate that SPR was engaged to act as, or acted in its dealings with such parties as though it were, an agent for Gala only. Such limited evidence as there is indicates that Sony simply informed the third parties that invoices were to be addressed to Gala and otherwise its dealings with those third parties were unchanged by the arrangements with Gala (see [431] to [434], in particular, [433]). In light of that and given the contractual terms, we consider it reasonable to infer that SPR had the liability to pay such parties for the provision of their services and, in doing so, discharged its own liability, acting on its own behalf; that accords entirely with its sole and unlimited discretion to distribute the transaction films as it chose.

281. Overall, therefore, our view is that (1) under the licence granted to it under the DA, SPR had the right as principal to distribute and market the films, acting in its sole and unlimited discretion, including the right to engage with third parties as regards the approved Gala Expenses, (2) viewing clause 6 in the context of the overall provisions of the DA, it is confined to operating to appoint SPR as Gala's agent only for the limited purpose of making administrative arrangements on its behalf, as Gala was the holder of the expenditure account, for the release of sums from that account, which SPR was entitled to use to meet approved Gala Expenses, which it incurred on its own behalf, and (3) the reference to goods and services being supplied to Gala or SPR as its agent is, as HMRC put it, "window-dressing" without any contractual consequence. We note that Mr Yusef's assertions as to what Sony thought about the provisions in clause 6 regarding the release of funds from the expenditure account are not relevant to the contractual analysis (see [17] and [41]).

282. In summary, in light of our findings as set out above and those set out below in sections 10 and 11, (a) the overall effect of the transactions is that, as a single composite transaction, Sony entities sold distribution rights in respect of the transaction films to Gala (under the LAs) only for Gala immediately to sell them back in all material respects to another member Sony entity, SPR, (under the DA) and (b) in reality, under the DA, Gala had no meaningful right or obligation in respect of the distribution process and/or, to contribute to, or provide any material economic or commercial benefit to the sub-distributor, SPR, as regards that process, from which Gala stood to make any profit or loss.

(1) From Sony's perspective:

(a) As set out in sections 2 and 10, the economic benefit to SPR of Gala fulfilling its obligation under the DA to put the Initial Expenditure into the

expenditure account to be used to meet approved Gala Expenses was cancelled out immediately by SPR simultaneously providing Barclays with the Deposit, so that it could comply with its obligation under the DA to procure that Barclays would issue the LC. Gala did not otherwise have any other material rights or obligations under the DA to provide any meaningful input into SPR's distribution and marketing of the transaction films. As set out in section 11, correspondingly, Gala had no meaningful entitlement to a share of Gross Receipts under the waterfall.

(b) Overall, therefore, the effect of the DA and related security arrangements for Sony was, during the term of the DA (a) in commercial terms, simply to put SPR, in all meaningful respects, into the same position as the original owner of the distribution rights as regards its ability to distribute the transaction films (albeit it had to follow a process as regards the use of the funds in the expenditure account to meet approved Gala Expenses), and (b) in economic terms, to leave SPR in a neutral position as regards the Initial Expenditure and Deposit and, due to the operation of the waterfall, as the party who stood to gain or lose from the exploitation of rights to distribute the transaction films. The only benefit any member of the Sony group received from Gala's interposition in the structure relating to the distribution process was the £15 million of licence fees paid to the Sony licensors.

(2) From Gala's perspective, for the duration of the DA, Gala did not have any meaningful rights or obligations to conduct or provide input into the distribution process, the exercise of which could affect, in any positive way, its economic and commercial position in relation to the transaction films:

(a) As set out in full in section 10 (i) the provision of the Initial Expenditure, in effect, in return for SPR providing the shortfall guarantee and procuring the provision of the LC (as funded by the Deposit) meant that Gala was as certain as it could be that it would receive back from SPR/Barclays a sum equal to the Initial Expenditure and interest thereon regardless of the success of the exploitation of the transaction films and of terms of the waterfall, and (ii) this aspect of the arrangements had nothing to do with any purported trade of film distribution.

(b) The exercise of such limited rights and obligations as Gala had to approve or disapprove any proposed material increase, or decrease, in approved Gala Expenses could not affect, in any positive way, Gala's entitlement, or outcome, under the waterfall.

(3) We note also that, in our view, the limitations and restrictions on Gala's activities in the relevant documents show that Mr Yusef's claim that he had a long-term vision for Gala and ultimately wanted to float Gala on AIM (see section 1) is implausible.

283. We have considered Mr Yusef's evidence on how matters worked in practice below. We note here that, as in much of Mr Yusef's evidence, he asserted that Sony had particular aims and intentions, but Sony did not give evidence at the hearing and there is no documentary evidence to back up what he said in this regard. For the same reasons as set out in section 2, our view is that if Gala wishes to rely on Sony having particular aims and intentions, other than those apparent from the design and nature of these arrangements, it is incumbent on Gala to produce evidence from Sony on the relevant points.

Section 10 – Arrangement for repayment of the SG loans

Overview

284. Mr Yusef was questioned extensively about the aspect of the arrangements which, in effect, ensured that Gala would receive sums sufficient to repay the principal of, and interest on, the SG loans regardless of the level of Gross Receipts. To recap, as set out in section 3 of Part A and section 9 of this Part, overall, under the composite set of arrangements completed under the relevant transaction documents which took effect simultaneously on each closing:

(1) Gala assumed an obligation under the DA to provide the Initial Expenditure of a total of £102 million into the expenditure account on the basis that it could be used only to meet approved Gala Expenses.

(2) SPR assumed obligations under the DA, (a) to pay to Gala (i) the Minimum Amount, which was due at the end of the term or on an early termination, of an amount equal to the Initial Expenditure/total principal of the SG loans of £102 million, and (ii) the Minimum Royalty Payments, due annually during the term, of amounts sufficient to meet the interest due on the SG loans (and over the course of the term to produce a small profit), and (b) as was a requirement for Gala's obligations under the DA to take effect, to procure the issue of the LC by Barclays.

(3) SPE agreed under the Call Option that, if it exercised the option to acquire Gala's "business" (as for the reasons set out in section 15, we consider it was inevitable that it would), it would pay a price of an amount at least equal to the principal of the SG loans/Initial Expenditure/Minimum Amount of £102 million.

(4) Under the LC, which Barclays duly issued, Gala could demand from Barclays payment of sums equal to the Minimum Amount/option price and other Minimum Sums on the basis that payment of the relevant sum under the LC would satisfy SPR's obligation to pay the corresponding Minimum Sums. In effect, therefore, Gala took a commercial credit risk on Barclays, rather than on SPR, as regards the receipt of these sums.

(5) SPR assumed obligations under the security arrangements to Barclays, to reimburse Barclays for sums it paid under the LC and to place the Deposit of a sum equal to the Initial Expenditure/total principal of the SG loans of £102 million in an interest-bearing account held with Barclays. The funds in the account were subject to a charge in favour of Barclays and Barclays agreed to use the funds in the account to meet its obligations under the LC.

(6) The effect of the SG loans and relevant security arrangements was that, in practice, the sums which Gala could demand under the LC, as funded by the Deposit, (a) were to be used, and could only be used, to meet interest on, and the principal of, the SG loans, and (b) were to be paid direct by Barclays to SG and applied by SG in settlement of sums due under the SG loans.

We refer to the arrangements summarised above as "the loan repayment arrangements".

Evidence of Mr Yusef

285. Mr Yusef agreed that:

(1) All of Gala's 65 members took out the maximum borrowing from SG and the Minimum Sums were designed to match the interest and the capital due on the total SG loans. He said that the arrangements under the related LC amounted to "a fallback guarantee"; it was designed to pay up, if necessary, the difference between what Gala received under the normal income stream and the principal of the loans and the interest thereon.

(2) Under the arrangements, the SG loans would be repaid in full, as regards both interest and capital, irrespective of how any film did commercially and even if Gala received no income from the films. He said that would normally be the

case in any film transaction where there is distribution involved; it would be abnormal if the sub-distributor did not pay an advance, (a) on account of the distributor's share of revenue and/or (b) as a minimum guarantee due irrespective of any payments under the waterfall. He emphasised that there was actually an activity of film distribution in relation to which SPR agreed to pay the Minimum Sums and to guarantee them under the LC; they were to be paid as consideration for SPR's acquisition of distribution rights and were due irrespective of the performance of those rights. He said it is not abnormal but customary for a distributor to place obligations upon itself so that if the performance does not reach a particular level, the licence holder receives a minimum amount. It is "not an artificial arrangement that is put in place simply to put into effect a desired result" and reflects "what actually happens in the business…there may be some exceptional cases, but it is the normal course of business for a distributor or sub-distributor to pay an advance for a minimum guarantee".

286. Mr Yusef said that the fact that the Minimum Sums and the aggregate loans comprised the same amounts was not an accident because:

> "of course, the members...would want to know that in the worst-case scenario, if they don't make the profits...anticipated, there would be sufficient monies to repay the full recourse loan. They were totally on the hook to the bank. They would need to have that assurance. And that's perfectly normal…the payments themselves are not dependent on the performance of the business, but then they were a minimum guarantee. They were never intended to be. They were meant to be a guarantee of a minimum amount."

287. In re-examination (1) he emphasised that it would be bizarre, unusual, and it just does not happen that a distributor is granted sub-distribution rights without a commitment to pay a minimum guarantee, and (2) in this case, it was normal (and prudent) to couple that with a requirement for the sub-distributor to provide a LC given that, in the year in question, the Sony Group suffered a 92.3% reduction in its net earnings.

288. Mr Yusef agreed that (1) the total amount paid by Gala to Sony as Initial Expenditure, was equal to the total SG loans (plus the Interest Margin), (2) the clause in the DA which stated that provision of the LC was a pre-condition to Gala's obligations under it taking effect is "critical", (3) it was an integral part of the structure that Sony would provide the Deposit required for Barclays to issue the LC, and (4) it was part of the proposition that Gala would receive an LC.

289. As regards the funding of the LC:

(1) He did not initially agree that it was *part of the proposition* that the studio would fund the LC. He said: "We just wanted a letter of credit. How it was funded was not our concern". He knew how it would be funded, but the placing of the cash deposit "was not necessary" in that, for example, Sony may have had relationships with other banks who would have issued such a letter without a cash deposit if they were happy with the credit of Sony. He found out that there was to be a cash deposit but "it did not need to happen that way". All he needed was a LC "to back up the contractual obligation to provide minimum guarantees. How Sony funded that was initially not my business..."

(2) Mr Yusef was taken to a chain of correspondence between Barclays, Sony and lawyers relating to the LC and deposit:

(a) In an email of 10 November 2003, Barclays sent Sony a marked-up version of the term sheet "to reflect the changes that we have been discussing, including the additional letters of credit that may be issued at the beginning of next year".

(b) In an email of 11 November 2003, lawyers wrote to Barclays with comments on the term sheet and noted that: "In general, consideration needs to be given to whether there will be multiple letters of credit and deposit or whether we have a single letter of credit and deposit."

(c) In an email of 12 November 2003 to Sony and the lawyers, Barclays said that "[SG] have confirmed the requirement for separate letters of credit for each transaction, and understand that Invicta has also confirmed this. We will also be speaking to Steve [at Sony] on this point."

(d) In an email of 12 November 2003, SG said to Barclays that Mr Yusef had discussed "the single/multiple LC point with both Lin and Steve at Sony last night" and "I understand that all parties are now in agreement that there will be a separate letter of credit and deposit for each tranche".

(3) Mr Yusef said that this demonstrated his point that the deposit was not provided for at the outset as a done deal and that it was during the course of the discussions and the negotiations for the LC that this was confirmed. He added that "all we cared about was that there would be a letter of credit to back up the obligation. How Sony did that was their affair. I guessed, because it is not abnormal, that that is what would happen". He "came to know that that is what would happen" and it was always intended that the transaction would have a LC and he understood the possibility that it could be collateralised by a deposit but it did not need to be. Sony could have supplied the LC without putting a deposit there if it had the credibility. He came to understand that that was not what was going to happen during the course of the discussions, and at a certain point it became clear and it was agreed that there would be one LC with a deposit. That was what was eventually agreed.

(4) He was taken to a draft term sheet sent to a studio (Disney) which stated: "The distributor will be required to procure a standby letter of credit from a bank acceptable to Gala and its bankers to secure payment in the event that the distributor fails to pay...Distributor must fund this incident from its own resources." He then seemed to accept that he knew Sony would have to fund the LC. He said that this reinforces that the LC had to be funded by Sony but that *how* it funded it was a matter for Sony. His further comments include that:

> "So at that point it didn't matter to me how the letter of credit was funded, as long as it was funded….Whether it was funded from its own resources or from using the money that it received from Gala, it did not matter at that point to me…I didn't know at the point in question that the studio would use the money that it received as part of the transaction to fund this letter of credit, because it didn't matter as long as it funded it…*What we are talking about is how it funded it. I always accepted that the studio - in fact, we insisted that the studio funds it. It is a question of how it funds it...As long as they put up a deposit for the letter of credit, how they did it was not of concern to me*." (Emphasis added.)

290. The day following the cross-examination set out above, Mr Yusef said that he wished to correct a point. He noted that the previous day Mr Davey asked him if he was aware of the deposit, and his answer was in the negative but that was untrue:

> "I won't go into why I said that, but I do accept that what I said was incorrect. I wish to apologise to the tribunal for that mistake, error, incorrection, and to also say that what I should have said, unreservedly, without any ambiguity, I should have said that my answer to Mr Davey's question was an unqualified "yes". I was aware of the deposit and again I apologise to the tribunal for that."

291. In light of the questioning the previous day and Mr Yusef's responses, we take him to mean that he accepted unreservedly that it was part of the proposition from the

outset that Sony would support the LC with a cash deposit. We note that, by the end of that line of questioning the previous day Mr Yusef appeared, in effect, already to have accepted that.

292. Mr Yusef did not agree that, given the Deposit arrangements, in substance the monies borrowed under the SG loans were themselves used to repay those loans. He (1) stressed that the loan arrangements were entirely normal and commercial for the reasons set out below, and (2) was insistent that there was no circularity as regards the movement of funds due to the different functions of, and separation between, the funds in the expenditure account (as funded by Gala and used to meet approved Gala Expenses) and those deposited with Barclays (as funded by SPR and used to secure its obligations to meet the Minimum Sums).

293. He emphasised that the monies were borrowed on a full recourse basis from SG and did not go to Sony but were put into the expenditure account "for the sole purpose of defraying the distribution expenses incurred by Gala". He said that (1) the money was locked into that account from day 1, and the only way in which it could leave that account was against invoices in the name of Gala, and (2) Sony put money on deposit with Barclays using its own funds and not Gala's money:

> "So there was not a circularity of the same money washing around the banking system. The money that goes on deposit from Sony is completely Sony's money, and the money that goes in to pay the distribution expenses and can only go out of the [expenditure account] against invoices in the name of Gala is a completely different set of money coming from a different bank and owned by a different entity…it is not just a circular wash..."

294. He accepted that the amounts in the expenditure account and put on deposit with Barclays are the same but:

(1) The function of the money provided to Barclays was "to secure the obligations of Sony, and…that was necessary...because Sony in 2002 had posted a fall in…their net profit, of a staggering 92.3% from the previous year. So Barclays were never going to accept them just issuing the letter of credit...that money had to match our obligations to SG, a different entity....".

(2) The money that went from SG into the expenditure account "goes towards the distribution expenditure that's actually incurred as a matter of fact by Gala. The money happens to be the same amount of money…"

295. He accepted, in effect, that the SG loans were guaranteed to be repaid but stressed again that there is a distinction, in his view, between (1) the funds borrowed from SG, which were paid into the expenditure account to defray costs, and were not paid to give Sony the ability to issue the LC, and (2) funds paid on Deposit for the LC which is there "to guarantee that sufficient monies come back through the waterfall". Gala required SPR, as is customary and standard, to secure the payments under the waterfall under which Gala was entitled, at a certain point, to receive a share of Gross Receipts equal to £102 million, and so to make sure that an amount equal to "money we have forked out under the [DA]" comes back. That is the function of the LC and the Deposit. There is otherwise no guarantee that money will come through the waterfall but, if and to the extent that it does not, it would nevertheless be guaranteed through the LC to this extent.

296. It was put to him that the borrowing of £102 million was superfluous and that is a non-commercial feature of the transaction; the entire structure could have operated in the same way without the borrowing. He again said that this deal would never have happened if the studio was to receive only £15 million:

> "The only way in which this deal was ever going to get done was if we satisfied the avaricious nature of the studio. They would not have got out of bed for 15 million, which is the studio benefit you describe. They were only interested in

> volume. The only way to achieve that volume was for the borrowing to take place. Anything else that flowed from that was a consequence of that…the reason to borrow the money was to ensure that we could get to the negotiating table with a volume of cash that the studio would accept."

297. It was put to him that (a) the funds from the SG loans were paid into the expenditure account on condition that Gala would receive back an amount equal to the borrowings plus interest, as the provision of the LC was a precondition to Gala's obligations under the DA taking effect, (b) Gala did not suffer a real-world practical detriment and economic burden as regards these funds, and (c) the purpose of the movement of funds was to inflate Gala's purported loss. He said:

(1) That is not a proper description of what actually happened as it fails to address the purpose of the borrowing as far as the members were concerned. The monies were not borrowed, introduced into the partnership capital account and then given over to Sony. Actually, the monies, which were borrowed on a full recourse basis, were put into the expenditure account to defray the distribution costs that were incurred directly by Gala. There were a good room full of invoices in the name of Gala.

(2) Gala suffered a detriment because it defrayed the expenditure to the extent that it agreed to do so in the DA. The purpose was emphatically not as counsel asserted; it was to incur an obligation to pay expenditure under the DA and to engage in a trade of distribution. The tax relief that was derived from that undertaking was designed to mitigate the potential for loss in the event that Gala did not make a profit from film distribution. It was downside protection.

(3) Gala had agreed voluntarily to enter into a DA with SPR in order to engage in the trade of distribution and participate in the distribution of the transaction films and, in the course of that, it (not SPR) actually incurred expenditure. He agreed that, if the expenditure had not included the borrowed monies, the loss and the tax relief would only have been a fraction of that claimed. He emphasised again that the members' SG loans were on a full recourse basis and was not risk free: So to include the full recourse loan element in the equation (as well as the cash contributions) was both commercially and, in every other respect, fair and proper. He added that the borrowing was not "primarily" to inflate the loss but was to do with the "entry level that was required in order to enter into the transaction in the first place" as:

> "Sony's main interest was to secure alternative funding for its P&A burden at a level and at a volume that would make an impact on its overall business…had we said that we were going to raise and participate at a level of, say, 20 million, they wouldn't have entertained this transaction at all…they were disappointed with the fact that we only introduced 100 million…the primary purpose of the borrowing of each individual member was to put the partnership in a position where it could become…a player in the transaction. Had we not done that, we wouldn't have done the transaction. The transaction wouldn't have happened…the primary motive…was to raise enough money for the partnership to make an impact…"

298. He was questioned again about the purpose of the licence fees and of the scheme:

(1) It was put to him that the £15 million was the benefit Sony received in return for being involved in the scheme; it was the scheme fee. He said that "to all intents and purpose...it was the payment for the licences" and the principal studio benefit was that Gala paid for a percentage of the overall distribution expenditure on the transaction films. That was the primary reason why Sony entered into this transaction:

"$15 million in the scheme of things does not get the executives of Sony excited. What excited them was...the fact that somebody else was going to pay a portion of their distribution fees and, more importantly, the possibility that a larger sum would be paid in that way, thus relieving part of the burden that they had arising from the accounting problems that they were encountering at the time."

(2) It was put to him that it was a scheme fee, and the purpose of the scheme is the generation of the purported loss and the tax relief. He said that he disagreed very strongly for the reasons he had stated. When pressed, he said "no" and:

"The principal purpose of the borrowing was to put [Gala] in a position where it could engage in a meaningful way with the studio…the studio wasn't interested in contracting with us unless we were able to provide a deal size that would make sense for them…the real benefit to the studios is that under this transaction as contemplated a significant amount of money was going to be put on the table to enable the studio to be relieved of a portion of its P&A commitment. That was the real purpose of this transaction and it was the driver, and the amount of money was significant. The level of input had to be significant and therefore the borrowing was to enable [Gala] to contribute a significant sum…a £15 million fee would not have got Sony or any other studio to the negotiating table, if that's all that they were going to benefit from."

(3) When it was put to him that he was speculating about Sony's intentions he said he was not speaking for Sony or any other studio but "for the state of mind that existed on our side and what we needed to do to get Sony to the table, not only in relation to my negotiations with SPE and SPR, but it was clear to me that from discussions with all of the studios that volume was king". He said that expression had been put to him. It was clearly made known to me that this transaction would only happen if "we were able to introduce volume".

299. In re-examination:

(1) Mr Yusef emphasised that there was no circular movement of funds: (a) in fact the funds contributed by the members went to the expenditure account which was used to defray an amount deployed to defray the Gala Expenses, and (b) the amount that went from Sony to Barclays is not the same money that was raised by Gala. It was Sony's own money.

(2) He also stressed that the SG loans were full recourse loans but however small the risk was perceived at the time it was not entirely risk free as events showed. In the banking crisis, Barclays was able to continue functioning without resorting to a bail-out from the government, but those events (in 2006 to 2008) showed that a guarantee from a bank was not necessarily as copper bottom as you would imagine. He thought that a number of the investors were aware of that and he remembered having discussions with several of them who said they understood the LC arrangement was not without risk. Not all of the 65 members were investment bankers. In fact, quite a small number of them were.

Conclusions

300. HMRC's submissions on the conclusions which the tribunal should draw from this part of the arrangements and Mr Yusef's evidence on it is apparent from their cross-examination of Mr Yusef. Mr Vallat made similar points to those made by Mr Yusef: (1) the arrangements relating to the LC and Deposit were not in the control of Gala and, as Mr Yusef said, the Minimum Sums and payments under the LC had different functions. Gala's right to earnings/accruals from the arrangements arose from SPR's obligation to pay the Minimum Sums and a share of Gross Receipts under the waterfall. The LC arrangements simply operated as a cash flow or security mechanism in respect of those sums, (2) the SG loans were not risk free as the banking crisis of 2008

demonstrates, (3) whilst the LC was fundamental as it provided Gala and the members with certainty that they would have the cash to discharge their SG loan obligations as they fell due, it was not a necessary part of the deal that the LC was funded in any particular way, and (4) the fact that, under the debentures and related arrangements, payments were made direct to SG is just a matter of convenience and cannot affect the analysis of the arrangements.

301. HMRC did not suggest that these transactions are shams and we accept that, in legal terms, there is, of course, a distinction between (1) SPR's primary obligation to Gala, under the DA, to pay the Minimum Sums, (2) Barclays' obligations to Gala, under the LC, to pay Gala equivalent sums, if Gala did not otherwise receive the Minimum Sums, and (3) Barclays' agreement with SPR, in effect, that it would meet its obligations under the LC, subject to being funded and reimbursed by SPR, and that it would use the funds in the Deposit to do so.

302. We also accept that (1) the parties' substantive rights and obligations under the relevant documents are not affected by the fact that, pursuant to the relevant security arrangements, Barclays was to make payments due under the LC (as funded by the Deposit) direct to SG, and SG agreed to utilise them in settlement of sums due under the SG loans, and (2) evidently SPR could not, and did not, physically use the monies of £102 million which Gala put in the expenditure account to fund the Deposit. Under the terms of the DA, the Initial Expenditure could only be used to meet approved Gala Expenses.

303. However, none of the matters accepted in [301] and [302] detract from the fact that (a) the overall purpose and, on Gala's analysis, effect, of the loan repayment arrangements was, as HMRC put it, "to inflate" the loss or, as we would put it, to create a "self-funded" loss in the sum of £102 million, and (b) the manner of the creation of the intended "self-funded" loss had nothing to do with the operation of a trade in relation to film distribution. In effect, in economic, practical and commercial terms, in fulfilling its obligation under the DA to put £102 million of Initial Expenditure into the expenditure account, Gala itself funded the return of £102 million to it plus the receipt of sums sufficient to meet the interest cost on the SG loans:

(1) In overall economic and commercial terms, SPR gained nothing from this aspect of the arrangements except the ability to fund the Deposit without an actual cost to it:

(a) SPR's entitlement under the DA to use the Initial Expenditure to meet approved Gala Expenses relieved SPR of the need it would otherwise have had to fund them from other resources. As set out in section 9, in our view, SPR spent those funds acting on its own account in the course of its own trade and not acting as agent for, or otherwise on behalf of, Gala.

(b) However, plainly SPR did not thereby obtain any funding benefit given that, simultaneously, in order to induce Barclays to issue the LC, SPR had to provide Barclays with the Deposit of £102 million. As noted, it was a condition to Gala's obligations under the DA taking effect, that SPR procured the issue of the LC to Gala.

(2) Gala and the members had no material risk of suffering an actual economic loss of £102 million. In economic and commercial terms:

(a) Subject to the remote risk referred to in (b), Gala was guaranteed to receive back £102 million by no later than the end of the term of the DA plus, in the interim, sums at least equal to interest due on the SG loans, regardless of the success or absence of success of the transaction films and of whether Gala

received any sums under the waterfall and of whether the arrangements were terminated early (whether on exercise of the Call Option or otherwise).

(b) As Gala emphasised, Gala (and ultimately the members) did, of course, have a risk inherent in any such security arrangements, that the issuer of the LC, Barclays, may not be able to meet its payment obligations. We consider this was a residual risk as it is reasonable to suppose that there was only a remote risk of both Sony, as a major, very successful corporation, and Barclays, an established bank, being unable to meet their obligations (such as if they became insolvent).

(3) We note that the overall arrangements could have operated in precisely the same way if Gala had been funded only by cash contributions and a much lower amount of Initial Expenditure had been provided.

304. As Mr Yusef accepted, the amount of the Initial Expenditure (as determined under a formula) was set to tally exactly with the principal amount of the SG loans. On a realistic view of the facts, Gala was not, as Mr Yusef and Mr Vallat suggested, wholly disassociated from the Deposit and related arrangements. That SPR would provide the Deposit to Barclays and enter into the related reimbursement arrangements with Barclays was part and parcel of the overall composite set of arrangements, which were contemplated and discussed between the parties (see [288(2)]), and which were completed, in effect, simultaneously on each closing. Moreover, as a matter of commercial common sense, it is highly improbable that:

(1) SPR would have agreed, under the DA, to procure the issue of the LC, knowing that Barclays required it to provide the Deposit in order for Barclays to proceed to do so, unless SPR was simultaneously to receive from Gala a sum equal to the Deposit. That is particularly so given that the only material benefit Sony received from the Gala arrangements was £15 million (see section 9), and

(2) Gala would have agreed, under the DA, to provide the Initial Expenditure unless it considered that would ensure that the LC, as a critical or fundamental part of the structure, would be issued to it. Invicta/Gala can hardly have expected SPR to be willing to provide the Deposit, without it being put in funds to do so, given they were evidently aware that the only benefit Sony would obtain from participating in the arrangements was £15 million.

305. That, from the outset, the arrangements were designed to operate as set out above, and that it was an important part of the overall plan that they would do so, is evidenced by the fact that (1) the proposal documents sent to the studios set out that (a) the Initial Expenditure would be a specified proportion of the contributions, (b) the studio would provide a shortfall guarantee and a letter of credit and would be required to fund the letter of credit, and (c) the studio would have a Call Option (see [85]). Mr Yusef essentially accepted that this was all part of the Gala proposal from the outset and, as noted, that the provision of the LC to Gala was critical/fundamental, and (2) the IM, the UBS presentation and the letters from Ms Challons all set out details of the shortfall guarantee, LC and Call Option, and the financial illustrations set out in the scenarios take those arrangements into account (see section 4). Given that these documents were prepared at a time when, according to Mr Yusef, the deal terms with Sony remained subject to negotiation, it appears that these elements of the overall proposal, and their interaction, was very much a given or required element.

306. We do not accept Mr Yusef's explanations for why Gala took out, or arranged for the members to take out, SG loans of a total amount of £102 million and/or his rationale for the shortfall guarantee and related security arrangements. In particular:

(1) We do not accept that, as far as Mr Yusef/Invicta/Gala were concerned, the principal purpose in taking out or arranging for SG loans of a total of £102 million and providing the Initial Expenditure of £102 million was to put Gala in a position where it could engage in a meaningful way with Sony, as Sony wanted to secure a large volume of funding for its distribution expenses:

(a) For the reasons already set out, it is plain that the effect of the arrangements was not to provide Sony with any funding for its distribution expenses. In that regard, it is irrelevant whether Sony had a funding need, as Mr Yusef asserted, due to substantial losses the previous year. These arrangements simply did not provide it with any funding which could assist with any such need. Moreover, for the reasons already set out in sections 2 and 9, we do not accept Mr Yusef's repeated assertion that Sony was motivated by anything other than receiving £15 million, essentially, as its fee for its participation in the transactions, or that Gala provided Sony with any other commercial benefit.

(b) As set out in section 2, it is reasonable to infer that, if Sony had received more "volume" from Gala, in terms of a higher level of Initial Expenditure as funded by a higher level of SG loans, SPR would simply have been required to make a Deposit of a commensurately larger sum to fund the higher Minimum Sums/option price required to finance the repayment of the increased principal of, and interest due on, the SG loans. It would remain the case, therefore, that, in economic terms, SPR would not receive any funding for its distribution expenses from Gala however large the amount of Initial Expenditure was.

(2) It makes sense that a sub-distributor would agree to pay a distributor/licensor a shortfall guarantee and to support that obligation with a letter of credit (a) in return for the grant of a right to distribute films, on the basis that that right is potentially of value to it, and/or (b) in return for the provision by the distributor/licensor of something else of value to it under the relevant transactions. However, that is not the situation here: (i) the arrangements operated essentially simply to pass the Rights, in all material respects, from one Sony entity to another, via Gala; following closing, SPR was in substantially the same position as regards its entitlement to distribute the transaction films as it is reasonable to suppose the original Sony owner of those rights would have been in but for these transactions, and (ii) overall, the only material benefit that Sony received from its involvement with Gala was £15 million paid as licence fees to the licensors, in reality, as a fee for Sony's participation in the structure (see, in particular, section 9).

(3) Realistically, the shortfall guarantee and related security arrangements cannot be viewed, as Mr Yusef, in effect, suggested, as an arrangement made to secure payments which Gala hoped to realise under the waterfall in operating a trade of film distribution on the basis that Gala had put £102 million at risk or forked that sum out under the DA for the purposes of that trade. As set out above, (a) the very effect of these arrangements was that Gala did not put any part of the sum of £102 million at risk in the operation of any activity related to the distribution process, whether by funding SPR's distribution activities to the tune of that sum or otherwise, and (b) Gala had no realistic prospect of receiving a share of Gross Receipts under the waterfall in excess of its notional entitlement to receive a sum equal to the approved Gala Expenses (see section 11).

307. Overall, in light of the design and operation of the loan repayment arrangements as described above, as viewed in the context of the operation of the overall composite arrangements, the object and purpose of Gala taking out and arranging for the members

to take out the SG loans of £102 million and of Gala providing the Initial Expenditure of £102 million was (1) in an immediate narrow sense, to ensure that SPR would provide the Deposit of £102 million so that Barclays would issue the LC and, hence, that those funds (and interest accruing on them) would, and could only, be used to pay to Gala a sum equal to the Initial Expenditure/principal of the SG loans plus sums sufficient to cover interest on those loans, and (2) in a broader sense, to enable Gala to claim it had incurred a loss of £102 million in the 2003/04 tax year (so that the members could obtain tax relief in the desired amount) without Gala/the members being at material risk of suffering a corresponding economic loss of £102 million. We note that, in suggesting in the course of cross-examination on this topic that the inflation of losses was not "primarily" the purpose of Gala, and that the "primary purpose" was to enable Gala to be a player in the transaction, Mr Yusef appeared to accept that facilitating tax relief was at least, in part, a purpose of the Initial Expenditure. He also accepted that the loss/tax relief would have been a fraction of that claimed in the absence of the SG loans.

308. It follows from this and our other findings (see, in particular, section 9) that we also do not accept that (1) as far as Mr Yusef/Invicta/Gala were concerned, the sole or main purpose of arranging for and taking out the SG loans was to defray the agreed Gala Expenses, and/or (2) the agreed Gala Expenses were "incurred directly by Gala" as evidenced, so Mr Yusef said, by "a good room full of invoices in the name of Gala", and (3) the tax relief was "designed to mitigate the potential for loss" if Gala did not make a profit from its asserted trade as a form of downside protection.

Section 11 - the waterfall

Provisions of the waterfall

309. We have set out below full details of the material provisions in the waterfall in clause 9.1 of the DA. We note that the waterfall made extensive reference to how abandoned films were to be dealt with but we have not set these out as there were no such films.

310. *First to third provisions*: These provided for SPR to receive:

(1) first, an amount equal to 35% of the Gross Receipts "to be retained by SPR as a distribution fee",

(2) second, "an amount equal to all Participations payable in respect of the Pictures", broadly being sums payable to persons such as actors, and

(3) third, an amount equal to 10% of "the Distributor Exploitation Expenditure" in respect of the Pictures "to be retained by SPR as a marketing overhead charge",

311. *Fourth provisions*:

(1) The fourth provision stated that (a) Gala was to receive an amount equal to 60% of the total "Cost of Production" of the "Pictures" less the total licence fees in respect of the "Pictures" (subject to certain provisos), which Gala was to pay to the licensors on the basis that each licensor was to receive a pro rata portion of such Gross Receipts according to the amount owed to that licensor relative to the total amount owed to all licensors until the Cost of Production of the "Pictures" was paid in full, and (b) Gala irrevocably directed and authorised SPR to pay such amounts directly to the licensors.

(2) Mr Yusef said that (a) the reference to Gala in this provision is a mistake – the provision should say the relevant sum would be received by SPR - and that this was picked up by everybody at the time, and (b) this provision was the subject of heavy negotiation and that is why he knew that the mistake was known to everyone. In our view, however, the reference to Gala is unlikely to be a mistake

given that this provision corresponds to the provision in the LAs which required Gala to pay such a sum to the licensors. In any event, it is clear that the relevant sum was to be retained ultimately by Sony group members whether payment had to be routed through Gala or not.

312. *Fifth provision*: Under the fifth provision, SPR was to receive an amount equal to "the SPR Shortfall Exploitation Expenditure in respect of the Pictures". This is, in respect of a "Picture":

(1) "Distribution Expenses" paid for by SPR from its own resources referred to in (a) clause 6.3.2, which applies where the Initial Expenditure for a Picture was not sufficient to pay for all of the Gala Expenses to be incurred in connection with that Picture and approved by Gala under clause 7, or (b) clause 6.4, which applies to expenses which did not constitute Gala Expenses.

(2) "Distribution Expenses paid for by SPR from its own resources referred to in clauses 7.4 and 7.6.2, disapproved or not paid (as appropriate) by Gala *because there was insufficient Distributor Exploitation Expenditure in respect of that Picture to pay for the same*" (emphasis added). We find the highlighted wording difficult to make sense of. We note that:

(a) "Distributor Exploitation Expenditure" is defined, in respect of a transaction film, as the Initial Expenditure relating to that film plus any further sum which Gala agreed to advance towards the Gala Expenses to be incurred in connection with that film.

(b) Clauses 7.4 and 7.6.2 apply where SPR wished to increase materially the approved Gala Expenses relating to a transaction film. Broadly, if Gala either (i) did not approve the increase, or (ii) was deemed to approve the increase it was not required to or could choose not to pay a sum equal to the increased cost into the expenditure account, and SPR could pay for it from resources other than those in the expenditure account.

(c) Hence, if SPR rather than Gala provided the funds to meet any such increased sum, necessarily there would be insufficient "Distribution Exploitation Expenditure" to pay for the same; as set out in (a), any such increased sum would become "Distributor Exploitation Expenditure only if Gala agreed to put the relevant funds in the expenditure account.

(3) "Distribution Expenses" incurred by SPR in respect of a "Picture" prior to the date of the LA relating to that "Picture".

313. It is useful to illustrate the position with (1) financial illustrations produced by Sony, included in the bundles, in which Sony use their actual figures for Gross Receipts and relevant expenses for the period to 31 March 2006 and their projections of such sums in a period of around 10 years thereafter, and (2) financial illustrations produced by HMRC using Sony's figures. Sony's data shows "the SPR Shortfall Exploitation Expenditure" as $207,168,476 and the approved Gala's Expenses as $179,852,622.

314. *Sixth provision*:

(1) Under the sixth provision, Gala was entitled to an amount equal to the "Distributor Exploitation Expenditure" in respect of the "Pictures" expended on approved Gala Expenses, to be applied by Gala in recoupment of such expenditure.

(2) This was subject to a proviso that, at SPR's sole option, the sterling equivalent of all Gross Receipts payable to Gala pursuant to the waterfall (defined as "**the Distributor Share**"), up to but not exceeding an aggregate amount equal to the total of all "Distributor Exploitation Expenditure" put in the expenditure account on 2 December 2003 and 28 January 2004, could either be (a) paid to

Gala, or (b) retained by SPR until the date upon which SPR was due to pay the Minimum Amount (pursuant to clause 9.4 of the DA) when it would be paid to Gala on the basis that "payment of the Minimum Amount includes amounts constituting the payment of such amount in full on such date". Interest was to accrue on any such retained Distributor Share at an agreed rate and was payable as part of (and was included within) the Annual Royalty.

(3) Mr Yusef said that the distribution expenditure that Gala was due to receive at this particular level was, in fact, guaranteed by the Minimum Amount and the proviso is in effect saying "because we are guaranteeing that you will receive a Minimum Amount, we don't need to pay you monies that fall due until such time as that money equals the money that we have on deposit" under the LC, which supported the Minimum Sums. In our view, it is unrealistic to suppose that, if SPR were to receive Gross Receipts sufficient to trigger Gala's entitlement under this clause before the end of the term of the DA, SPR would pay the relevant sum to Gala immediately rather than exercising its right to retain it until such time as the Minimum Amount was due (so that it would then be regarded as included in that amount). There is simply no commercial reason for SPR to want to make an earlier payment. Therefore, as a matter of commercial reality, we view Gala's entitlement under this provision as notional. In practice, the effect of the sixth provision and the proviso is that (a) Gala was to receive a sum equal to the Initial Expenditure as the Minimum Amount, and (b) its entitlement to Gross Receipts under the remainder of the waterfall was not to take effect until there were sufficient Gross Receipts for it to receive notionally an amount equal to the Initial Expenditure/Minimum Amount.

315. *Seventh provision*: Under the seventh provision:

(1) Until Gala had received an amount equal to 2% of the "Members Equity Contributions", namely, the total cash contributions of £25,168,254, (a) Gala was entitled to an amount equal to 30% of the "Distributor Portion" and (b) SPR was entitled to an amount equal to 70% of the "Distributor Portion" and to the balance of the Gross Receipts in excess of the "Distributor Portion".

(2) The "Distributor Portion" was a sum to be computed each and every time it was payable under the waterfall, as a percentage of the Gross Receipts relating to the "Pictures" which, when the computation was to be made, remained to be applied under the waterfall (after the payment in full of all prior payments and claims under the waterfall):

> "equal to the percentage of the total Distribution Expenses in respect of the Pictures incurred (through the date of such computation) by Gala out of the Distributor Exploitation Expenditure."

(3) Using Sony's figures the "Distributor Exploitation Expenditure" is \$179,852,622 and, expressed as a percentage of the total "Distribution Expenses" of \$387,021,098, the "Distributor Portion", is 46.5%. This provision, therefore, entitled Gala to 13.95% (30% of the "Distributor Portion" of 46.5%) of the remaining Gross Receipts (after application of all the prior provisions) until it received 2% of the cash contributions, namely, as calculated by HMRC, £503,365 or \$875,156.

316. *Eighth provision*:

(1) This provided that SPR was entitled to an amount equal to "the SPR Discretionary Exploitation Expenditure". This was, in respect of a "Picture", the costs of distribution:

"paid for by SPR from its own resources referred to in clauses 7.4 and 7.6.2 but *excluding those Distribution Expenses disapproved or not paid (as appropriate) by [Gala] and incurred by SPR because there was insufficient Distributor Exploitation Expenditure in respect of the Picture to pay for the same*".

(2) Given the highlighted wording, this provision is premised on the basis that SPR may pay for "Distribution Expenses" falling within clauses 7.4 and 7.6.2 which are not captured within the second limb of the fifth provision. However, in light of the points we have made above on the interpretation of the highlighted wording (which mirrors that in the fifth provision), we cannot see what could fall within these clauses which would not fall within the second limb of the fifth provision. Therefore, it seems that in reality it is highly unlikely that there would be any sums which fall within this provision – as they would already be covered by the second limb of the fifth provision.

317. *Ninth provision*: Under the ninth provision, until Gala had received under the seventh provision and this provision an aggregate amount equal to 5% of the total cash contributions, (1) Gala was entitled to an amount equal to 20% of the "Distributor Portion" and (2) SPR was entitled to an amount equal to 80% of the "Distributor Portion" and the balance of the Gross Receipts in excess of the "Distributor Portion". This entitled Gala to 9.3% (20% of 46.5%) of the remaining Gross Receipts (after the application of the above provisions) up to an additional 3% of cash contributions (which HMRC calculated to be £755,048 or $1,312,734).

318. *Tenth provision*:

(1) Under the tenth provision, until Gala had received under the seventh, ninth and this provision an aggregate amount equal to 8% of the total cash contributions, (a) Gala was entitled to an amount equal to 10% of the "Distributor Portion" and (b) SPR was entitled to an amount equal to 90% of the "Distributor Portion" and the balance of the Gross Receipts in excess of the "Distributor Portion".

(2) This entitled Gala to 4.65% (10% of 46.5%) of the remaining Gross Receipts (after application of the above provisions) up to an additional 3% of members' contributions (which HMRC calculated to be £755,048 or $1,312,734). In total under the seventh, ninth and tenth provisions, as calculated by HMRC, Gala was entitled to a total of £2,013,460.

319. *Eleventh provision*:

(1) Finally, under the eleventh, provision (a) Gala was entitled to an amount equal to 1% of the "Distributor Portion", and (b) SPR was entitled to an amount equal to 99% of the "Distributor Portion" and the balance of the Gross Receipts in excess of the "Distributor Portion".

(2) At this stage, therefore, Gala was entitled to 0.465% of the Gross Receipts remaining after the 35% distribution fee and Sony was entitled to the balance (in addition, of course, to the distribution fee). As calculated by HMRC, for every $1 entering the waterfall: (a) Sony was entitled to 35 cents under the first provision (as the distribution fee of 35%), (b) Gala was entitled to 0.465% of the remaining 65 cents (approximately 0.3 of a cent in every $1) and Sony was entitled to the balance, and (c) overall, therefore, Gala was entitled to 0.3% of the $1 and Sony is entitled to 99.7% of the $1, a profit sharing ratio of 1:334.

320. Under clause 9.5 of the DA, upon payment of the Minimum Amount, if Gross Receipts payable to Gala under the waterfall and retained by SPR pursuant to the proviso were less than the total of all "Distributor Exploitation Expenditure" raised and

advanced to the account on 2 December 2003 and on 28 January 2004 ("**the Shortfall**") then Gala waived its rights to receive, and SPR could retain for its own benefit, any further Gross Receipts payable to Gala pursuant to the above provisions of the waterfall, until such further Gross Receipts exceeded the amount of the Shortfall. Once SPR had retained pursuant to this provision an amount of Gross Receipts equal to the Shortfall then any further Gross Receipts payable to Gala pursuant to the waterfall were to be paid to Gala.

Sony's figures and HMRC's illustrations

321. As noted, HMRC produced some useful illustrations of how the waterfall works using the figures produced by Sony. Sony's figures show:

(1) Gross Receipts of $735,640,830 (of which $644,352,882 were actual receipts to 31 March 2006 and the balance were projected receipts over the next 10 years).

(2) A 35% distribution fee of $255,236,126 to be recouped under the first provision of the waterfall.

(3) A total of $671,067,397 to be recouped from the Gross Receipts under the second to sixth provisions of the waterfall comprising (i) $56,796,771, as regards Participations, (ii) $18,012,262, as regards SPR's marketing overhead charge, (iii) $205,554,401, as regards 60% of the total Cost of Production, (iv) $210,851,340, as regards "SPR's Shortfall Exploitation Expenditure", and (v) $179,852,622 of approved Gala Expenses.

(4) On the basis of the above figures, the Gross Receipts are insufficient to cover $190,662,693 of the total sums to be recouped under the second to sixth provisions.

322. HMRC calculated that:

(1) $1,032,411,380 of Gross Receipts would be needed so that, after Sony takes its 35% distribution fee, the remaining 65% of Gross Receipts would be sufficient for the full sums specified in the second to sixth provisions to be recouped:

(a) 65% of Gross Receipts remaining after the distribution fee = $671,067,397, and

(b) total Gross Receipts before the distribution fee = $671,067,397/0.65 = $1,032,411,380.

(2) For Gala to receive its full entitlement under the seventh to tenth provisions, assuming in Gala's favour that Sony incurred no "SPR Discretionary Expenditure", a further $75 million of Gross Receipts would be required:

(a) The seventh provision entitles Gala to £503,365 or $875,156:

(i) At this stage, for every $1 that enters the waterfall (i) Sony is entitled to 35% as a distribution fee, (ii) Gala is entitled to 13.95% of the remaining 65%, and (iii) Sony is entitled to the balance.

(ii) Around $9.7m would be needed for Gala's entitlement (to 13.95% of 65%) to equal $875,156.

(b) The ninth provision entitles Gala to £755,048 or $1,312,734:

(i) At this stage for every $1 that enters the waterfall (i) Sony is entitled to 35% as a distribution fee, (ii) Gala is entitled to 9.3% of the remaining 65%, and (iii) Sony is entitled to the balance.

(ii) Around $21.8m would be needed for Gala's entitlement (to 9.3% of 65%) to equal $1,312,734.

(c) The tenth provision entitles Gala to a further £755,048 or $1,312,734. Approximately $43.6 million of Gross Receipts are required for Gala to receive this amount.

(i) At this stage for every $1 that enters the waterfall (i) Sony is entitled to 35% as a distribution fee, (ii) Gala is entitled to 4.65% of the remaining 65%, and (iii) Sony is entitled the balance.

(ii) Thus around $43.6m would be needed for Gala's entitlement (to 4.65% of 65%) to equal $1,312,734.

(3) At the end of the stages set out at (1) and (2), (a) for the full sums to be paid under the first to sixth provisions, and (b) for Gala to receive its full entitlement under the seventh, ninth and tenth provisions of $3,500,624 or £2,013,460, there would have to be total Gross Receipts of $1.1 billion.

323. As regards the eleventh provision and the sum required for Gala to make a profit, HMRC provided 2 examples:

(1) Example 1: On the assumption that the Call Option was exercised in 2006 on payment of a price equal to the Minimum Amount and disregarding any Minimum Sums paid before the exercise of the Call Option:

(a) Gala would need to receive around £23.4 million or $40.7 million to recoup in full the sums which it was not guaranteed to receive (namely, the Minimum Amount/option price), being a sum broadly equal to the total of licence fees of £15.1 million and fees to Invicta of £8.3 million.

(b) Assuming that Gala received the maximum amount of $3,500,624 or £2,013,460 under the prior provisions of the waterfall, Gala would need to recoup a further £21.4 million or $37.2 million under the eleventh provision.

(c) As, at this stage of the analysis, Gala is entitled to 0.3 cents of every $1 of Gross Receipts, the transaction films would need to generate a further $12.4 billion of Gross Receipts for Gala to receive the required sum.

(d) In total, therefore, approximately $13.5 billion of Gross Receipts would be needed for all of Gala's costs to be recouped which is over 18 times more than the $735 million shown in Sony's figures.

(2) Example 2: On the same assumptions as in example 1 but in this case, taking account of the Minimum Sums received prior to the exercise of the Call Option, as reducing the sums Gala would otherwise need to receive in order to make a profit:

(a) Gala would need to receive roughly £10.3 million or $17.9 million. This is £23.4 million or $40.7 million less (A) the Minimum Sums payable in January 2004, January 2005 and January 2006 of a total of £11.1 million or $19.3 million, and (B) $3,500,624 or £2,013,460 received under the prior provisions in the waterfall. HMRC noted that, in this case, strictly, the amount of expenditure to be recouped should be increased to take into account sums required to pay interest on the SG loans, but for ease (and in Gala's favour) this is left out of account in their calculation.

(b) As, at this stage of the analysis, Gala is entitled to 0.3 cents of every $1 of Gross Receipts, the transaction films would need to generate a further $6 billion of Gross Receipts for Gala to receive the required sum.

(c) In total, therefore, approximately $7.1 billion of Gross Receipts would be needed for Gala to break even and then make a profit.

324. HMRC submitted that the tribunal should take account of their example 1 in assessing whether Gala was likely to realise a profit for the purposes of the "with a view

to profit” test. Their view is that the Minimum Sums should not be taken into account in the analysis on the basis that:

(1) The “circular” arrangements relating to the repayment of the SG loans had nothing to do with Gala’s alleged trade. They were put in place to inflate Gala’s alleged expenditure and so to increase the amount of the loss and the resulting tax relief for members. This is similar to the situation in *Icebreaker 1 LLP v HMRC* [2011] STC 1078 (UT) (“*Icebreaker*”) and *Acornwood LLP and ors v HMRC* [2016] STC 2317 (UT) (“*Acornwood”*), where it was held, broadly, that sums which LLPs claimed to have incurred wholly and exclusively for the purposes of a film distribution trade but which were guaranteed to be returned to the LLPs were not, on a realistic analysis, part of such a trade at all. In *Icebreaker*, for example Vos J held, at [64], (a) not only that the relevant sum was not so incurred but that indeed it was “not made for the film distribution trade at all”, and (b) it was made so that the LLP could be assured that it and, therefore, its members, would recover the loans that its members borrowed from the bank, and which had been used precisely to finance previously that sum by way of investment into the LLP: “The sum…was expended and disbursed for the sole purpose of investment and security and not for Icebreaker’s film trade properly so regarded.” We have set out further details of this case in Part D.

(2) Further or alternatively, viewing the facts realistically, on the type of analysis in *Ramsay*, the Minimum Sums were matched by an equal liability under the SG loans owed, in effect, by Gala; such sums are not intended to be taken into account in computing “profit” as an excess of income over costs. In substance, Gala assumed the responsibility for the members’ SG loans, in particular, given that they were to be repaid from the Minimum Sums (see the description of the loan terms in section 3 of Part A).

325. HMRC added that, in any event, there was no prospect of Gala making a profit even taking account of the relevant Minimum Sums because (1) it was inevitable and pre-ordained that (a) the Call Option would be exercised by SPE at the first opportunity, and (b) the option price would not exceed the Minimum Amount, and (2) therefore, the Minimum Sums paid prior to exercise and the option price would not of themselves generate a profit, and (3) Gala had no possibility of receiving by that time a share of Gross Receipts under the waterfall sufficient for it to recoup its/the members full outlay under the transactions. We have commented on HMRC’s points below and in our conclusions on the trade issue and “with a view to profit” test in Part C.

Mr Yusef’s evidence

326. Mr Yusef was questioned extensively about the waterfall at the hearing:

(1) Once he had been taken through the provisions, it was put to Mr Yusef that (a) the eleventh provision is a truly remarkable end to a truly remarkable waterfall: The initial major sums all go to Sony, sums go to Gala under the sixth provision but subject to the proviso, the sums under the seventh, ninth and tenth provisions give Gala “pitiful entitlements” to revenues until it has recovered an amount equal to 8% of £25 million and, under the eleventh provision, Gala gets 1% and SPR 99%, and (b) assuming that of every dollar that comes through the waterfall there is 65 cents left at the eleventh stage, Gala would get 1% of “Distributor Portion” (1% of 45%,), namely, 0.46% of the 65 cents or 0.299 of a cent of a dollar and Sony would get 99.7 % and the profit sharing ratio is 1 to Gala and 334 to Sony. He agreed with these ratios without questioning these figures or any hesitation.

(2) It was put to Mr Yusef that the waterfall gives a result far away from the 30/70 split he said he was seeking under the tough negotiations he referred to (which HMRC do not in any event accept took place) and it is an "absolute joke". He said:

(a) It was not a joke at all and there were extensive negotiations over the phone and in person. In negotiation, he was seeking to strike a balance between 2 competing requirements (i) "to maximise or get as close to 30% as I could get" and (ii) "equally important, if not more important...to strike a deal whereby I could provide the maximum amount of downside protection for the investors".

(b) In seeking to strike this balance (i) he got the shortfall guarantee, "which is very important at a time when in that year...or in the previous year Sony's performance went down in terms of net income by 92.3%", and (ii) when it became obvious that Sony was trying to limit that 30% or anywhere near it as much as possible, he secured that Sony was entitled to receive not 100%, but 60% of its production cost and even that number is depressed by the amount of initial licence fees. So "at the end of the day when we concluded this negotiation, it wasn't that we were steamrolled over".

(3) He was asked how much Gross Receipts would need to come through the waterfall in order for Gala to receive a single penny. He said that "we went through that exercise at the time, and I presume so did [HL]" and for "Gala to receive an amount in excess of the amount that it put in, the Gross Receipts of all of the 6 pictures would have to exceed I think roughly a billion. I don't have the sum." It was put to him that there is no evidence of an extensive exercise. He said that:

(a) There are the HL letters, HL would have gone through that exercise and there is no way that:

> "they would have come up with that one sentence without putting the films and the assets into their model. They would know exactly what the breakeven point would be…[and] what the profit point would be. That information would be available to David Davis...and in addition to that, there would be a variety of other things he would have done before he would have issued that report".

(b) There is also the evidence of Mr Ackerman and himself who were the:

> "ones that were going through that exercise on a regular basis, not just once, but several times...in particular Mr Ackerman would have gone through film by film to determine the potential profitability of the films within the context of the recoupment position that we had".

We note that it is clear from Mr Ackerman's evidence that he did not carry out any such exercise as Mr Yusef later accepted.

327. Mr Yusef was taken to the document prepared by Sony with the figures set out above which HMRC used to make their calculations:

(1) It was put to him that Sony referred to the approved Gala Expenses as "SPR Exploitation Expenditure". Mr Yusef said that this document was prepared by Sony's accounts team, who are not used to this kind of transaction, and on the face of it they made a mistake; legally and accounting-wise it was not Sony's expenditure. He said that there was also a mistake in that the 60% recoupment of production cost should be less the initial licence fees as was raised with Sony at the time.

(2) It was put to him that these figures show that, even if around three-quarters of a billion comes through the waterfall, there is still a yawning gap to be measured in hundreds of millions before Gala gets a penny. He said that, apart

from various mistakes, the document shows that the *actual performance* of the transaction films was three-quarters of a billion. However, in 2003/04, "when we were assessing the viability of these films from the point of view of Gala receiving profits", Invicta was looking at whether Gala would receive sums under the waterfall in excess of the distribution expenditure that Gala, not SPR, directly incurred, plus the cash contributions. The document shows that they achieved three-quarters of what they hoped to achieve and, "in this industry a margin of error in terms of actuals and estimates of 25% to 30% is well within the margin of error. This is a highly volatile business." He thought that as an industry position it is not a joke and it is not unreasonable.

(3) He emphasised that the fact that the transaction films "did not perform as we had hoped was a disappointment to us, as it was a disappointment to Sony, but if they had achieved in excess of their projections they would have not only "made money - not a lot, but we would have made money" but also:

> "our downside….was protected, first of all, by the amount that we restricted Sony in terms of their production recoupment and, secondly, because we had the downside protection of the tax. The combination of these three elements made this a very good deal for the investors."

(4) He agreed that, on the basis of the Sony figures, in order for Gala to recoup £102 million of Initial Expenditure/principal of the SG loans around a further 300 million of Gross Receipts (in addition to the $735,000,000 shown in the document) would need to come through the waterfall.

(5) It was put to him that for Gala to receive a sum equal to the cash contributions of around £25 million prior to the Call Option being exercised in 2006, $7 billion would need to come through the waterfall. He asked for this to be explained. Counsel said he had been through every millimetre of the waterfall, shown Mr Yusef the relevant percentages and, on the basis of the Sony figures, Mr Yusef had agreed that to get to the starting blocks a billion of Gross Receipts would need to come through the waterfall. Counsel added that around $13 billion of Gross Receipts would need to come through the waterfall on the assumption that the Call Option was not exercised in 2006. Mr Yusef said that he did not recognise that "in terms of the exercise that we did at the time". When it was put to him that there is no evidence of that exercise other than one page in HL's letters, he said the letters cannot be just dismissed:

> "They are not a fly by night firm. They would have looked at that. They would have looked at the waterfall. They would have examined the films,…and they would have come to the conclusion that we can make a profit."

(6) It was put to him that many billions of Gross Receipts would be required for Gala to receive £25 million but that is totally fantastical and in practice not a penny came through. Mr Yusef said that:

> "in practice not a penny came through, because the films didn't perform as projected, but the reality is, had they [performed as] projected, we think that we would have made a profit. That's what we believed at the time…because of the work that we did and the appraisal that we received. That's what we believed. If you are saying to me, "What you believe wasn't correct", that's a different matter, but what I believed, what Mr Ackerman believed and what [HL] believed was that based on that waterfall we would make a profit."

(7) It was put to him that he did not believe or was disinterested in a profit on the basis of film income and/or there was no possible rational basis for any such belief, as billions and billions of Gross Receipts would have to come through the waterfall for a profit to be realised and that, whilst the aspiration was a 30% profit

share for Gala, the parties signed up to a profit share of less than a third of 1 cent. He said that he disagreed very strongly.

(8) It was put to him that (a) from the INDb website there were $741 million of box office receipts in respect of the transaction films, (b) a letter from Mr Bold at SFP dated 18 October 2005 states that all the films apart from Breakin' All the Rules were successful box office releases earning between them over 700 million and a further 300 million from home entertainment, and (b) the films were successful and the actual receipts were exactly in line with Sony's projections. He said that "in terms of what we needed the films did not perform" and Sony's predictions "were not our predictions" and:

> "our predictions were based on the information that we got from Sony, plus also the projections that were made by Mr Ackerman and myself and the total bundle of analysis that was undertaken by [HL]. So for the films to perform to three-quarters of what we anticipated and hoped is I think a good result, not a bad result, but it nevertheless was not what we were hoping for…It was not Sony's expectation that these films would only gross 750 million…"

(9) He later noted that the figure Mr Bold referred to constitutes Sony's gross receipts and not the Box Office receipts; first, there is the aggregate ticket price from which theatre owners take their cut which could be as much as 50%, depending on the film, then the distributor receives its share from which it pays the participants (people like the actors and the director) which is usually calculated by reference to box office receipts. So he thought Mr Bold's reference to "Box Office" receipts is wrong but he is right to say that the films were successful in terms of the performance.

(10) He added that (a) Sony's document is not a prediction of receipts as such but a statement of actual receipts of Sony, as at March 2006, plus a projection of receipts for the next 10 years, whereas (b) "at the time we believed that….the slate of pictures could generate in excess of $1 billion" and in 2004 when they made their projections, they were not projecting income of 730 to 750 million but "monies far in excess of that as being the projected possibilities for those 6 films" and "that is a totally different exercise" and it was disappointing because that did not happen in terms of the actual performance. When it was put to him he had not put this figure in his statement and he was asked what the figure was that he hoped for, he said "we believed...we needed to get to break-even was 1.1 billion" and, when pressed on what he thought the films would result in "a low of 1.2 and a high of 1.5 billion…for the first cycle". When it was put to him that would have left Gala billions and billions of pounds short of a profit, he said he did not agree and "we didn't understand that to be the case at the time".

(11) He agreed that in order for Invicta, SG and Sony to get their fees from the scheme and for the members to obtain tax relief not a single ticket to a single cinema needed to be sold. He said, however, that Sony's remuneration was in respect of the grant of rights under the LAs and was "always tied to the grant of rights rather than to the exploitation of the rights" thereby granted. It is not a studio benefit in the normal sense of leasing.

(12) It was put to him that a slate wide profit was not something that was focused on or aimed, his statements that he negotiated a deal with Sony which would put Gala high up the food chain and would allow Gala to make a good return if Gala chose a commercial hit is demonstrably incorrect and Gala's position under the waterfall was so poor that, despite Box Office returns of three quarters of a billion, Gala did not get a penny. He said it was the focus and they "put a lot of effort,

time and reliance on the analysis that was made at the time"; Gala expended money:

> "as an expense in the hope that that money would come by way of the waterfall, the bums on seats, as it were….we did a lot of analysis. We relied on the [HL] analysis, which had this waterfall. [HL] knew the aggregate amount of expenditure roughly that was projected to be spent, and we relied on that. As it turned out, the performance was not as hoped for. That's all I can say about that, but to suggest…we were not interested in the profit motive, I can't agree with that…"

(13) When pressed, he said that Gala got all or most of its distribution expenditure:

> "through the waterfall there was a recoupment of distribution expenses, which was guaranteed by letter of credit. So we didn't receive that money only because it was going to flow through a different way, but to say that we didn't receive that money one way or the other is not correct."

(14) It was put to him that all parties would have been in exactly the same position as they were in had not a single ticket had been sold to a single transaction film. He asked if counsel was looking at the situation at the end of the 2003/04 year or forever as he could give a different answer depending on what counsel meant. He then said "I would have to say no but I could have said yes if you had asked me a different question" and he hoped to clarify that later.

328. Mr Davey later sought to clarify the figures he had put to Mr Yusef. He said that (1) he was looking at what Gross Receipts would need to come through the waterfall for Gala to recoup a sum equal to the total cash contributions of around £25 million, (2) if, as happened, the Call Option was exercised after 2 years, Gala would have received Minimum Sums of about £12 million and would need to receive another £13 million or so through the waterfall, and (3) given the bottom-line ratio of profit sharing under the waterfall is 334:1 on the basis that of every cent, Sony receives 99.701 and Gala receives 0.299, for Gala to receive that sum would require a further $7 billion of Gross Receipts to come through the waterfall. Mr Yusef said that he understood what counsel was saying the first time and did not recognise that figure. He added that:

> "The fact is that we submitted the waterfall to interrogation at the time. We engaged one of the 3 foremost appraisers of film libraries and film performance, which is [HL]. They had all of the relevant information that was needed in order for them to make the appraisal that they did. Most notably, it was a condition of our discussions with Sony that [HL] would have the same level of access to the material that Mr Ackerman had in terms of the information that he was given…they weren't interested in the screenplays - but all of the other information to do with the distribution of these pictures, they would have had direct access to, not through Mr Ackerman but directly from Sony. They also had their own independent information based on not just their knowledge of the distribution business generally but specifically of Sony distribution and Sony pictures. They had the specific information about the slate, and in addition to that they had the actual waterfall, which was at various stages, various iterations, but the final one we are talking about now, they had access to that directly as well, and that's a matter of fact. It was embodied in the term sheet, which is one of the documents that they specifically refer to. So based on that, the conclusion that they came to was unequivocal. That conclusion, whichever way you want to look at it, led me and others within our side of the organisation to the belief that there was a possibility, and that that possibility was reasonable, in the light of what they say…that the slate in aggregate could exceed in revenue to Gala what was actually received. That is what I recall at the time and that's what we relied on."

329. It was put to Mr Yusef that if one were to exclude the £12 million of Minimum Sums from the calculation, for £25 million to be recouped, around $13 billion of Gross Receipts would need to come through the waterfall. Mr Yusef said he understand the logic but "you can't ignore something that actually did happen" and:

> "The minimum guarantee payments, is a feature of the distribution business. It is very rare for a licence holder to grant distribution rights without a minimum guarantee. Very rare indeed. I've seen it on a couple of occasions when the parties have got a very close relationship, but the payment or the demand for a minimum guarantee is standard. Nobody argues with it. The only issue that comes under discussion is the level of that guarantee. But the concept of a guarantee is not one which anybody in the industry would have a problem with. So to ignore it, and say you would need twice the amount is a statement of fact, but it is illogical, in the context of what we are trying to do."

Conclusions

330. In our view, HMRC's illustrative computations demonstrate that, from the outset, in light of the disadvantageous terms of the waterfall for Gala:

(1) There was no realistic possibility that, by the time of the first exercise date, or when the Call Option was actually exercised, Gala would receive under the waterfall a share of Gross Receipts sufficient for Gala and the members to recoup their outlay under the structure in excess of £102 million, which the structure was designed to ensure was returned to Gala (plus interest thereon) regardless of the level of Gross Receipts; namely, a sum equal to the cash contributions of £25 million. That is the case whether or not the Minimum Sums are taken into account in the computations as income receipts of Gala.

(2) There was no realistic possibility that, over term of the DA and beyond, Gala would make a profit in respect of the transactions, if the Minimum Sums are left out of account as income receipts of Gala (as we consider they should be for the purposes of the "with a view to profit" test (see Part C)).

Gala's lack of any meaningful entitlement to Gross Receipts reflects that, as set out in section 9, Gala had no contractual entitlement or obligation to make any meaningful contribution to the distribution process and that Sony received no financial or other benefit from these transactions, other than £15 million paid to it as licence fees.

331. We consider that, for the purposes of the relevant aspects of our decision (in, particular, in assessing whether Gala carried on a trade "with a view to profit"), it is reasonable to make an assessment of Gala's prospects of receiving Gross Receipts (1) on the basis of Sony's actual and projected figures (as at 31 March 2006), and (2) on the assumption that the Call Option would be exercised in 2006 (as it was):

(1) It is reasonable to suppose that Sony was in the best position to produce actual and estimated figures of the relevant receipts and expenses and that it took reasonable care in doing so given (a) its status as a major film studio, (b) that it produced and marketed and distributed the transaction films and had all the relevant financial information, and (c) that Sony plainly had an interest in working out as accurate a position as possible as, on any view, it had a great deal at stake financially in relation to the exploitation and success of the transaction films. Mr Yusef said that Sony and Gala both initially estimated greater Gross Receipts than those shown in Sony's figures. However, as set out below, (i) there is no evidence of, or of any viable basis for, any such higher estimates, (ii) Sony's figures correspond broadly to what was actually achieved and, (iii) in any event, assessing the position as set out in [330], Mr Yusef's estimated higher Gross Receipts are still fall far short of what was required for Gala and/or the members to make a profit/return from Gala's share of them.

(2) We have concluded in section 15 that Invicta/Gala structured the arrangements so that it was inevitable that SPE would exercise the Call Option at an early stage (and that was how Invicta/Gala intended to ensure that the members would make a positive return from the transaction in the form of the tax benefit). As set out in section 4, our view is that a "business" such as Gala and a reasonable investor in it, who had a serious interest in whether and to what extent the "business"/the investor could make a profit/return from a purported trade of film distribution (a) would realise from the design of the arrangements, at least that it was likely (if not inevitable), that Sony would exercise the Call Option as soon as possible, and (b) therefore, would want to consider the likely level of Gross Receipts and Gala's likely share of them as at the first exercise date (albeit that they may want further assessments by reference to later dates). See also our conclusions on the trade issue and the "with a view to profit" issue in Part C.

332. HMRC's illustrations show that, assessing the position on that basis, using Sony's figures, if the Call Option was exercised in 2006:

(1) Total Gross Receipts of $1,032,411,380 would be required for the sums referred to in the second to sixth provision of the waterfall to be paid in full.

(2) Total Gross Receipts of $1.1 billion would be required for Gala to receive its full entitlement to $3,500,624 or £2,013,460 under the seventh, ninth and tenth provisions of the waterfall.

(3) Total Gross Receipts of $13.5 billion (if Minimum Sums paid prior to exercise of the Call Option are not taken into account as receipts of Gala) or $7.1 billion (if such Minimum Sums are taken into account as receipts of Gala) would be required for Gala to recoup its expenditure of around £15 million on the licence fees and of £8.8 million on Invicta's fees.

(4) These sums are far in excess of (a) the expected Gross Receipts which Sony's calculations show of around $735,000,000, (b) the actual receipts of around $741,000,000 from box office receipts and around $300,000,000 from other exploitation, and (c) the Gross Receipts Mr Yusef said Invicta/Gala estimated would arise as set out below. In fact, Gala did not receive a penny under the waterfall, even though the transaction films were regarded as "successful" (as set out in Mr Bold's letter) and the transaction films generated sums in line with Sony's predictions.

333. Mr Vallat placed significance on Mr Yusef's comments that he did not recognise the $7.1 and $13.5 billion figures and submitted that HMRC were not able to clarify them adequately. HMRC did not put their full set of calculations to Mr Yusef, which they produced after he had given his oral witness evidence. However (1) Mr Yusef accepted that (a) the waterfall operates as HMRC put to him, and (b) once the eleventh provision in the waterfall takes effect (after Gala had recouped just over £2 million), for every $1 of Gross Receipts, Sony and Gala were entitled to 99.7 cents and just under one third of a cent respectively, and (2) in doing so, he was clear that he understood HMRC's analysis of the waterfall and accepted that analysis without hesitation. We note also that (a) as set out at [198(3)], Mr Yusef said he found the waterfall "simple" to understand, (b) he did not put forward details of the basis on which he/Invicta/Gala considered Gross Receipts of just over $1.1 billion would produce a profit. He mentioned only in his statement that Gala was expected to make a profit within 5 years, and (c) other than in making this comment, and in disputing HMRC's stance that the Minimum Sums should not be taken into account and that it was inevitable that the Call Option would be exercised, neither he nor Gala's legal team sought to comment on, or otherwise to challenge, the figures put forward by HMRC to illustrate how the waterfall

works and the principles on which they are based, whether on a mathematical basis or otherwise.

334. As set out in sections 1 to 3, Mr Yusef emphasised in his witness statement that the aim was to enable members to make a commercial return from the arrangements and, in support of this, that (a) the aim was for (i) Gross Receipts to be shared on a 30/70 basis between Gala and Sony respectively, and (ii) to put Gala higher up the "food chain", by limiting the studio's entitlement to recoup its "Production Costs", and (b) Gala/Invicta relied on HL's opinion, and Mr Ackerman's view, that there was a reasonable prospect of profit from the transactions. However:

(1) At no time in his lengthy statement did Mr Yusef explain precisely what he/Invicta/Gala/HL considered or estimated, when the arrangements were put in place, as regards the likely level of Gross Receipts from the transaction films, what Gala may receive as its share under the waterfall or what level of Gross Receipts was required to enable Gala/the members to recoup their full outlay under the transactions, whether over the term of the transactions or by the time of the first exercise date. It was only at the hearing that (a) when questioned on the IM, he suggested that Gala expected to realise Gross Receipts in excess of those shown in scenario 3 (see section 4), (b) when questioned on the HL letters, he referred to HL coming up with a figure of just under $1 billion of Gross Receipts for Gala to receive sums in excess of the Initial Expenditure (see section 6), (b) when cross-examined in relation to the waterfall, he initially gave a figure of over $1 billion of Gross Receipts and said he did not have the sum but added later, as though he were certain of the position, that the figure "we believed...we needed to get to break-even was $1.1 billion" and, when pressed, the figure Invicta/Gala thought would be achieved was a low of $1.2 and a high of $1.5 billion of Gross Receipts for the first cycle on the basis, so he said, of a very extensive exercise carried out by Invicta with HL and Mr Ackerman. He asserted, therefore, that the transaction films did not perform as expected although he considered that what was achieved was still a good result in a volatile industry.

(2) Nor did Mr Yusef mention in his witness statement (a) what the actual ratio for sharing "Gross Receipts" was under the terms of the waterfall, (b) why it was he apparently thought that a 30/70 ratio could be achieved or that this was "tempting" for Sony (see [92]) in light of the huge disparity compared with the actual ratio ultimately achieved, and/or (c) what difference confining SPR's recoupment of "Production Costs" was likely to make to Gala's overall position in the waterfall given the rest of its terms.

(3) As set out below, Invicta/Gala did not make any realistic appraisal of Gala's prospects of receiving Gross Receipts.

335. We conclude as follows:

(1) Mr Yusef's evidence on the figures he gave regarding Gross Receipts is unreliable given (a) that he did not include these figures in his statement and did not explain that a 30/70 ratio for sharing Gross Receipts was not achieved, (b) the changes in his evidence on the likely level, and Gala's estimated share, of Gross Receipts, (c) the lack of any mention of these figures in the documentary evidence, (d) as set out in sections 6 and 13, the lack of evidence that Invicta/Gala in fact carried out any exercise which enabled them to make a realistic assessment of what may come to Gala through the waterfall, whether through HL or otherwise, and (e) that he presented Mr Ackerman as having carried out or been involved in such an assessment when, in fact, as Mr Ackerman was very clear, he did not do so and Mr Yusef knew that was not Mr Ackerman's role. On Mr

Ackerman's evidence, Mr Yusef deliberately kept Mr Ackerman's role and that of HL separate and Mr Ackerman only attended one meeting with HL. We refer also to our comments on Mr Yusef's credibility as a witness at [337].

(2) In any event, as set out above, Mr Yusef's own estimated figures of likely Gross Receipts of $1.1 to $1.5 billion do not provide a reasonable basis for the proposition that Gala and/or the members had a realistic prospect of making a profit/return through Gala's receipt of a share of Gross Receipts.

(3) As HMRC illustrated, in going through the terms of the waterfall and, as Mr Yusef accepted in cross-examination, the actual ratio for sharing "Gross Receipts" amounts to nothing like a 30/70 split (after various deductions). Mr Yusef maintained that the waterfall was a good deal for Gala on the basis that it was an achievement to obtain SPR's agreement to limit its recoupment of "Production Costs" and to pay the Minimum Sums (as supported by the security arrangements) thereby providing the members with "downside protection". Mr Vallat relied on these factors in support of his submission that the waterfall was commercial, and Gala/Invicta expected to make a profit under it. However, (a) in our view, any benefit for Gala from limiting SPR's recoupment of "Production Costs" is so theoretical as to be illusory, given that, as the waterfall otherwise operates, for Gala/the members to make a profit/return from Gala's share of Gross Receipts would require such vastly greater Gross Receipts to be generated than those actually realised or those which Mr Yusef states were estimated, and (b) as set out in section 10, the Minimum Sums and related security arrangements were plainly included in the structure as part of the arrangements for Gala to seek to generate an enhanced "self-funded" loss of the desired amount without Gala/the members having a material risk of a corresponding economic loss.

336. As regards Mr Yusef's awareness of the position under the waterfall:

(1) We consider that, when the transactions were completed, either (a) Mr Yusef was aware of the real scale of Gross Receipts that would need to come through the waterfall for Gala and/or the members to make a profit/return from such receipts (whether looking at the position if the Call Option was exercised at the first exercise date or the position if the arrangements stayed in place for a longer period), or (b) if he was not so aware, that lack of awareness can only be explained on the basis that he was indifferent to and disinterested in what would be needed.

(2) As regards our conclusion in (1)(a), we note that (a) Mr Yusef plainly understood how the waterfall operated and what the ultimate ratio for sharing Gross Receipts was. As noted, he said he found the waterfall simple to understand, (b) he/Invicta designed and put the arrangements in place, (c) on his own evidence, he/Invicta/Gala received full relevant financial information from Sony, such as information on the level of Participations and overall distribution expenses, (d) for the reasons set out in section 15, it is implausible that Mr Yusef did not expect SPE to exercise the Call Option on the first exercise date, in particular, given that he designed the arrangements to have run their course by around the end of the 2003/04 tax year and he/Invicta operated Gala on that basis, and (e) in light of the points made in (a) and (b), it is also implausible that he did not understand that, on exercise of the Call Option on or around that date, Gross Receipts of $1.1 to $1.5 billion would leave Gala billions of pounds short of making a profit (and of the members making a return but for the effect of the tax relief).

(3) As regards our conclusion in (1)(b) we note that (a) even if Mr Yusef did not focus on the precise figures, he was evidently aware that the terms of the waterfall fell far short of what he said he tried to achieve in terms of a 30/70 profit sharing ratio. In light of the points made in [335(3)] above, his asserted belief that the waterfall achieved a good result for Gala is implausible, (b) for the reasons already given, we do not accept that Mr Yusef/Invicta had negotiations with Sony on the terms of the waterfall as he set out, and (c) neither he nor anyone else involved in the Gala arrangements sought to make or obtain a meaningful appraisal of Gala's prospects of receiving Gross Receipts under the waterfall whether by reference to the first exercise date or otherwise (see section 7, section 13 (at [385] to [397]) and our conclusions in Part C).

(4) For all the reasons set out in section 15 (and see our conclusions in Part C), Mr Yusef's lack of concern with the likely level of Gross Receipts and what share of those receipts Gala may receive under the waterfall and with obtaining a meaningful appraisal in that regard is explicable by the fact that he/Invicta/Gala intended and expected that the members would make a return from the tax relief claimed in respect of the loss alone, on the basis that they designed the arrangements so that it was inevitable that SPE would exercise the Call Option as soon as it could so that the members would obtain the tax benefit.

337. Mr Yusef said at various points that he could not be expected to include everything in his witness statement. However, the negotiation of the terms of the waterfall and its operation under the agreed terms is plainly a matter of central importance to the issues in this case. In our view, Mr Yusef's credibility as a witness is undermined by (a) his failure to address the points set out in [334] above in his witness statement, and (b) his on-going insistence at the hearing that Gala obtained a good deal for the members under the waterfall, notwithstanding how far the profit sharing ratio is away from that he apparently sought to achieve. We do not accept that the other factors Mr Vallat put forward demonstrate the commerciality of the waterfall and/or are conclusions that can be drawn from the evidence:

(1) We have set out in section 13 why we do not accept that the work done by, and appraisals received from, Mr Ackerman and HL provide a basis for Mr Yusef's/Invicta's/Gala's apparent belief that the films would make a profit for Gala.

(2) We have set out in sections 2, 9, 10 and 15 why we do not accept Mr Yusef's evidence that the vision was that this was just Gala's first phase, Sony were not interested in a deal for an upfront licence fee of £15 million but in a long-term arrangement for the reasons he set out, and the primary motivation behind obtaining the SG loans was to raise enough money for Gala to make an impact and not to inflate the loss.

(3) We have set out in section 4 why we do not accept that Gala has shown that, had the transactions been solely about achieving a tax advantage, this could have been achieved much more simply, without the effort that Gala went to.

(4) It is apparent from the discussion above, why we do not accept Mr Yusef's evidence that the actual Gross Receipts fell within the 25-30% margin of error in relation to a £1 billion estimate and was a good result for Gala albeit it was not what Gala had initially hoped for.

(5) Mr Vallat noted that Gala negotiated that under the waterfall Sony would recoup some of its expenditure on distribution expenses only under the eighth provision. However, as explained above, we cannot see realistically what could

fall within the eighth provision which would not be captured within the fifth provision.

(6) Mr Vallat said that Gala aimed for a 30:70 profit share but this was only achieved in a limited fashion in the first iteration of the deal. It is plain that in fact there was no 30:70 split of Gross Receipts at any point in the waterfall in any fashion.

Cross-collateralisation under the waterfall

338. As regards "cross collateralisation" under the waterfall:

(1) Mr Yusef agreed that the waterfall is cross-collateralised in the sense that if Gala was involved in 2 films and one was successful and the other unsuccessful, Gala's share of any Gross Receipts would be reduced by virtue of the less successful film. He noted that it "works the other way too, of course".

(2) It was put to Mr Yusef that: If films, A, B and C, each cost 100 and generate 200, 10 and 10 of Gross Receipts respectively (a) if there is a separate waterfall for each film, A would receive 100 of Gross Receipts but B and C would receive nothing, and (b) if there is a single waterfall with cross-collateralisation, no money would come through the waterfall at all as there is aggregate expenditure of 300 and aggregate Gross Receipts of 120. He said that is not how it works, counsel had given "a very advantageous example" and it could also be the opposite and:

> "The objective of cross-collateralisation is to use the profits of one to subsidize the losses of the other. But also, the objective is to maximise profits over a portfolio of films so that you're not dependent on the performance of one to get results. This is a very speculative business. Even the most fancied of films can often, because they also tend to be very expensive...end up not making the kind of profits that one would expect…the whole concept of cross-collateralisation is the reason why studios are profitable. If they had to put all of their money on each occasion on the performance of each of the films that they make, their profitability would be less assured. So what we were trying to do was exactly that; it was spread our bets. That is a prudent thing to do. It is also...an industry accepted way of investing in film distribution. We didn't invent this concept. It's something that we simply followed."

(3) He added that counsel's example is arithmetically correct but there would be other circumstances where that example would not work and:

> "cross-collateralisation does not always have the result that you are claiming. It's not a given fact that every single circumstance where you have a slate of films it is bound to work in the way you have suggested."

(4) It was put to him that you do not spread your bets by aggregating expenditure and performance but by having separate waterfalls and that would be the commercially sensible thing to do. He said that in his experience it would be "very, very rare....to have a slate of films where the investors would...uncross-collateralise" and it would not be sound. He had never come across it and most people in the film industry would say, from a finance point of view, that it makes more sense to aggregate or cross-collateralise not just expenses but also profit potential. In the end, over time, the experience in the industry has been that that is a sounder way to invest in a portfolio than in a single picture enterprise.

(5) He did not agree "as strongly as it is possible for me to do so" that if there was a serious interest in making profit from film receipts, cross collateralisation would not have been a feature of the arrangements. He said that (a) it would not have been normal or wise, to enter into a single picture programme at any level, (b) the portfolio method of investment in film, which is a highly speculative

business, is definitely the standard method of operation, and (c) anybody who sought to invest on a single picture programme would not be in a serious pursuit of profit, because it is not normal. This is not what happens in the industry. What Gala did was completely in conformity, in terms of a methodology of investment, with what anybody else would do in similar circumstances.

(6) He agreed that he did not suggest a single picture programme but said that was for a good reason as he had already set out. He added that he would have had less trouble getting the deal across the table, from a studio point of view. They would have been happy with that "because over a period of time and over a slate, that would have been better for them. Worse for us; worse for Gala."

339. We accept that, as Mr Vallat submitted, the tribunal has no evidence to support a finding that Sony or any other studio would accept a non-collateralised deal, as regards the sharing of Gross Receipts from the transaction films, of the kind HMRC put to Mr Yusef would be preferable. However, we do not consider that Mr Yusef's evidence on this point of itself takes matters any further forwards. We can see that there may be a commercial rationale for an entity, which purports to carry on a film distribution business, to agree to receive a share of Gross Receipts from the relevant films computed, in effect, by reference to the overall receipts less the overall distribution expenses for all of the films, where that entity has a meaningful role in the distribution of the films and in determining what expenses should be incurred in relation to each film, and, hence, the overall level of the expenses. However, that is plainly not the case here (see, in particular, sections 9, 13 and 14).

Section 12 - Review of the Plans in December 2003

Evidence of Mr Ackerman

340. Mr Ackerman was questioned about his comment in his witness statement that: "Mr Yusef required my expert input as to which would be the right slate and which films to cherry pick" and that he was required to review and assess the Initial Plans for the selected films:

(1) It was put to him that (a) advising on film selection and reviewing the Initial Plans was not part of LBPC's contractual obligations (and he had agreed the LBPC agreement accurately reflected his obligations) and (b) in any event, LBPC did not do this pursuant to the LBPC agreement as regards the first transaction films, given that it was executed only one day prior to the execution of the relevant LAs and the DA and that the DA specified that the Initial Plans had to be agreed before the LAs were granted. He seemed to agree that is correct but said that, during the period from the late summer 2003 until 1 December 2003, he did "review a substantial number of films...and made recommendations to Invicta as to which ones would be potentially good investments and which would not", and he thought that there is ample documentation to that effect and "in entering into any investment agreement or trade with a studio it would be very unusual to not see...an initial marketing plan or distribution plan. Distribution is a core part of trading in media, and it is a dynamic side of media business. It changes in realtime with the marketplace".

(2) He added that he believed that the relevant provisions in the LBPC agreement "speak to my activities on films other than" the 3 first transaction films listed in that agreement and he read it as him providing services for the additional films as they were clearly part of the overall trading activity that was involved with the parties involved (Invicta, Gala and Sony). He agreed that the LBPC agreement runs from the day before the first transaction films were signed up.

341. In each of the December letters, Mr Ackerman said the following:

"I have now reviewed SPE's initial media marketing plans for the release of [name of transaction film], I believe this marketing plan demonstrates optimal planning by the studio in all sectors of the advertising and marketing process. I believe the marketing plan indicates SPE's strong commitment for the commercial success of the film. I recommend Gala Partners approve the initial marketing plan."

342. The letters for the first transaction films were dated 5 December (Big Fish), 8 December (You Got Served), 12 December (Something's Gotta Give), and 14 December 2003 (50 First Dates) and for the second transaction films, 1 December (Secret Window) and 15 December 2003 (Breakin' All The Rules).

343. Mr Ackerman said the following in his witness statement as regards his review of the Initial Plans and the December letters:

(1) The December letters were sent following his review of Sony's Initial Plans which are the final pre-release plans to allocate distribution expenditure between locations and types of data intended to best capture the target audience for the film based on significant research by the studio and using data in respect of suitable comparators. Following that Initial Plan, "there will be a series of adjustments in real time to deal with market issues and looking at boosting spend in certain areas and diminishing it in others". Such adjustments would differ greatly depending on the film and competition in the market. The Initial Plans that were developed were "nevertheless very sophisticated and well thought through so changes would typically be as a result of market factors".

(2) In his conclusions in the letters he was looking at the deployment of the media spend across various different categories and considering the chances of commercial success in light of this in the marketplace. Whilst this opinion is subjective it is "underpinned by a considerable amount of data and applying the wealth of my experience in the film industry". He agreed at the hearing that he had not produced this data with his witness statement. Whilst the letters are in the same format, they are more of a formal record and were sent following a number of discussions with Mr Yusef and Mr Bamford regarding the content of the Initial Plans following his reviews and meetings with Sony. He also sent them key documents, such as the Initial Plans, so they would have had the opportunity to ask him questions on this prior to the letter.

(3) He exhibited what he described as a "Greenlight Budget" for You Got Served which he said forms part of an example of Sony's Initial Plans. This is essentially "the final go-ahead for the marketing spend for the film, setting out the amount of money that the studio feels is appropriate for marketing the movie to achieve the desired revenue results. These documents will generally provide broad details of the film.., the target release revenue and detail the estimated spend for P&A". He would have reviewed equivalent documents and information for each of the films.

(4) He noted that:

(a) The "Greenlight Budget" compares the budget for You Got Served against that for Breakup Handbook and Two Can Play That Game, which Sony had also marketed and released or were planning to release in the same genre.

(b) The budget proposed that a significant amount of the spend would be incurred before the film was released, as is very common, to raise public awareness. Research would typically be used to look at where the film would get the most awareness based on genre and competition on release.

(c) Basic expenses are broken down into fairly granular level of detail and include a number of general overheads such as for print creation and

production, website design and production research. The media spend is not broken down into this level of detail as the specific allocation depends on the advertising space available in the marketplace which would be purchased by McCann Erickson. Allocation at this level of granularity for media spend would be considered at various meetings and calls with Sony at a later stage to update and refine the marketing plans.

(d) With his experience of looking at such budgets he could easily identify the component parts of the budget to evaluate the strength for Gala and identify gaps where more information would be required. He attended frequent meetings with Mr Smith and his marketing team to discuss the Initial Plans and the comments he had on them and then reported back on these meetings in calls he had with Invicta.

344. Mr Ackerman was questioned about the fact that the December letters relating to the first transaction films were all dated after the relevant LAs and DA were signed on closing of the first transaction:

(1) He said that (a) the letter of 5 December 2003 relating to Big Fish was "written following multiple meetings with the Sony marketing team" and during those meetings, which took place probably a month or even 2 months preceding this letter, "there were multiple variations to the marketing plan for this film" that he was consulted on by Sony, (b) he also had established by that point an independent relationship with McCann Erickson, who was the media buyer for Sony, and (c) the letter is written on the basis of having had a number of phone conversations with both Mr Yusef and Mr Bamford about those variations in different plans:

> "The data and the granular activity of those marketing plans, it was my responsibility to identify and point that out to them, which I would have done in multiple calls with them and which I would also discuss with the Sony team."

(2) He added that he considered that it was a "unique" feature of the deal with Sony (as compared to trading with another studio) that:

> "the head of distribution and the head of business affairs invited me to participate as a member of their distribution team and their meetings. I was free to comment and to advise and participate in discussions that were not made by one person. They were made by a team of people, of which I participated on, and which would involve, as I said before a dynamic market. As a film comes close to a theatrical release, many factors are involved in the media by the advertising plans, and they change sometimes week by week and day-to
> -day during the initial release of the picture. All of that would have been covered in my work prior to issuing a letter like this."

(3) He agreed that the LA for "Big Fish" was entered into on 2 December before he sent his letter on 5 December 2003. It was put to him that as approval of the Initial Plan was a pre-condition of SPE entering into that agreement, necessarily that approval had already been given before he wrote this letter. He said that such a requirement is customary in entering into any engagement with a studio and one:

> "would want to see what the very basic initial plan was, and... the marketplace is extremely dynamic and changes week to week and day by day, and it is those variations that determine the success or failure of a film as it is placed in the distribution network a studio has."

(4) When it was put to him that this letter is necessarily immaterial to Gala signing up to the agreement, he said that he provided it:

"on the basis of having done the work that I was asked to do with Sony and provide an opinion. We did so as soon as we could. As to the timing of Gala's commitments or Invicta's commitments with Gala here, I can't comment on what the situation was here in the UK."

(5) He said that the December letter relating to 50 First Dates was again referencing the work he would have done in the preceding month or 2 with the Sony marketing team, and "this would be referring to a marketing plan that has now changed very significantly from the initial marketing plan, and this would be a letter on my behalf recommending to London that the changes I have monitored and participated in are worthwhile…" He said that he used the term "initial marketing plan" just then as "the very generalised first entry level concept Sony would have provided when he first looked at the screenplays and:

"We looked at the cast, the budget, the financial paradigm of each movie. The initial marketing plan that is referred to in this letter from me on December 14th would be referring to the plan that had been developed since that very first initiation by Sony....However, this initial marketing plan [referred to in the December letter] would be….a very considerable number of iterations from what we first looked at, and this word "initial" plan would refer to what happens next, as the movie now goes into a theatrical release activity..."

(6) He added that Mr Yusef and Mr Bamford had been kept informed by him in several consecutive months prior to this letter being issued of his multiple meetings with the Sony marketing team and noted that:

"we would have had more than bi-weekly, probably 4 times a week, phone conversations as to what had been discussed in each of those meetings....I would usually have a meeting either around 10.00 in the morning at Sony or..; around 4.00 in the afternoon. Those meetings would be 2 to sometimes 4 times a week and I usually would call either Mr Bamford or Mr Yusef the following day to discuss with them what had been addressed at those meetings. Therefore, this letter, while it appears extremely brief, has background to it both in our files, in the business that we were conducting at the time."

(7) He did not agree that the letters relating to the first transaction films are of no practical import. He said that they "followed extensive work and extensive communication and extensive documentation to multiple different variants of the marketing plan with the Sony marketing team". When pressed, he said:

"Again I find that statement difficult to accept. In terms of the dates, I see what you are alluding to, but in terms of the background of these letters, which needs to be taken into account, I beg to differ in that there was again extensive activity in connection with the marketing plans and with the studio prior to these letters being signed. So Mr Yusef and Mr Bamford would have been intimately aware of the same details in the various workups of the marketing plan by Sony from the period following our initial receipt of screenplays to the date of this letter. I am certain that all of that information and data was taken into consideration by people here in London when they entered into their agreements with parties here."

(8) When it was put to him that the letters in relation to the first transaction films were of no consequence and were "window dressing", he said that he strongly disagreed and:

"These letters were provided as soon as was feasibly possible based, as I have said previously, on my work with the Distribution Department at Sony and the many iterations that were flowing from those meetings, all of which I shared on a bi-weekly, four times weekly basis with Mr Bamford and Mr Yusef. They are extensive, voluminous files documenting different changes in radio, media buying. There is a process in which I am involved, as I mentioned before, with

McCann Erickson, to make sure that the accounting that Sony is using in terms of the cost of different media buying is being adhered to, and most people never get that level of access in a studio's distribution and financial systems.....They are of consequence, because they follow an extensive amount of work on my behalf with the studio and I am only issuing a letter at which point I feel that the studio has said "We now have the plan, the optimal plan and we are moving forward". That's not to be confused with a decision that has already been made to distribute the movie, but the refinements to create a profitable enterprise with each film in question has reached a point where they feel they are ready to exploit the property."

345. When asked to point to an example of a Plan, he said he could not identify them in the bundles but the marketing plans in the files would show different iterations of expenditure:

"in different categories of media where the studio would be researching where to achieve optimal spending. It might be more in radio in Chicago and less in print in Dallas. It might be more in advertising, billboard advertising in Brooklyn than in Manhattan. That would depend upon the genre of film, the timing in the market, the competition in the marketplace, many, many different factors again in a very dynamic market. The dynamism I refer to is not just Sony's..."

346. As regards the "Greenlight Budget:

(1) It was put to him that this is simply an internal communication from May 2003 in which there is a statement that the media plan and basics for this release will be similar to that of Breakup Handbook. When asked where these items can be found, he said they would have been in the extensive filing in the offices in Los Angeles and that the iterations of the media plan leading up to when the film is released by the studio "are telephone book size documents of data and financial planning". All of that was part of the filing system that was established in LBPC's offices and he went as far as possible, with consultation from Sony, to duplicate their filing system so that when he was in conversations with their team, it was easy for him to refer to an iteration quickly. After he finished his contract with Invicta he "continued to store those files for Invicta for many years and it was in 2018 I believe that we shipped all of those files and all the data that was part of those files to London at the request of Mr Yusef".

(2) When it was put to him that the budget is not a Plan, he said that it is the "framework of the marketing plan" and that in referring to a "framework" he was looking at the comparative analysis referred to in the correspondence from Ms Cathy Schengen of 22 May 2003. She would have agreed with the head of marketing, Mr Smith, a "comparative analysis in marketing between these films, be that for genre, budget. It could be for a number of different reasons. They are making an allocation that again will then change as things go forward in realtime….".

(3) He added that the difficulty is "you are looking for a definitive document that is a single marketing plan" whereas his understanding of a Plan based on his involvement with the marketing department is that:

"that is a plan that is evolving over time, again because of the dynamic nature of the market, and I would say probably on this film alone there was probably several boxes of files based on McCann Erickson data expenditures, shifting decisions based on artwork, shifting decisions based on other factors in terms of messaging, be that in whatever media might have been the case. At the end of the day all of that material together would support this framework agreement, which is the departing point and driving forward in realtime. At the

time at which I would have written my letter in December, I would have had access to a lot of the dynamic nature of that material."

(4) He was asked why he said on a number of occasions that he *would have* done something or something *would have* happened. He said he used the word "would" as meaning "I would have. In other words, meaning it did happen".

347. It was put to Mr Ackerman that the address given in the December letters was the office that was not in fact leased until later in 2004 and, as he said in his witness statement, he was keen for tax reasons to use this address. He said it was agreed with the landlord that this address could be used as the mail drop for LBPC and that his personal accountant did not want him to run a business out of his personal home, nor did Mr Yusef. It was put to him this was a pretence, and he was looking to avoid the tax which would be due if the company's affairs were being carried on from his home which they were, as the address given in the LBPC agreement is his home address. He initially disagreed and said that shortly after that agreement was signed, he had identified the building as an office for LBPC (maybe 1 or 2 weeks later) and had a discussion with the landlord and Mr Yusef and Mr Bamford agreed it was appropriate and the landlord agreed to hold them so that they could be used as a maildrop. He added that (1) his personal accountant wanted him to continue as much as possible to practise business off the premises from his own house, and (2) that has nothing to do with tax issues regarding LBPC itself: "It had to do with the use of my own personal premises….There is also liability when you operate a business out of your own home my accountant did not want me to incur.." He thought that when this address was being used as the mail drop "we had a reasonable assessment that we would be able to acquire the lease for the premises and, in fact, we did as soon as it vacated". He then agreed that he meant what he said in his statement that he was keen for tax reasons to use this address.

Evidence of Mr Yusef

348. Mr Yusef gave the following evidence on the timing of the December letters:

(1) In examination in chief he said he wanted to clarify that (a) there is a timing issue, but (b) Mr Ackerman had already provided an analysis of the relevant points before the documents were executed and after the execution of the documents, "we refreshed the analysis in order to bring the analysis up-to-date" and "make sure we were still happy with it".

(2) In cross-examination, he insisted that the approval of the Initial Plans would have been given by 2 December 2003 because Mr Ackerman "will have done the work before that date and would have advised us accordingly". So whilst the "paperwork might not match we would not have entered into that document for that film unless the work that I know for a fact that he was doing had actually been done". He said, speaking as the business mind of Gala it is "inconceivable" that:

> "we would have received the letter on the 15th in relation to something that we say that we approved a week before, unless we actually had a basis on which to do that. We wouldn't have just approved those documents without having had the benefit of Mr Ackerman's advice prior to that date…, he did a lot of meaningful work. It wasn't window-dressing, as you have suggested….I do think that the work that was done was certainly done before we entered into those agreements. The documents don't reflect that, but I do not believe for a moment that we would have entered into the [DA] blind, without any reference to the marketing plans, because we spent so much time on them. The documents don't reflect the work that was actually done in terms of the dates.

I accept there's a discrepancy of the dates but I don't accept...that the work could not have been done prior to the 2nd..."

(3) In re-examination he said that these letters were, as far as he and Mr Ackerman were concerned "a recording or memorialisation of what we actually discussed or agreed prior to that time". So to the extent that they post-dated 2 December they were "always a recording of what was actually agreed prior to closing. It is just inconceivable and not possible for us to simply on the day pitch up to the closing and…agree not just on a slate but all the other aspects that Mr Ackerman was involved with, without having had the prior discussions and agreement". So in each case:

"we knew what Mr Ackerman's recommendations would be, and the document is simply a recording of what was actually agreed prior to whatever date it may be. So the date itself is not the first date that we were made aware of his recommendation in relation to whichever part of the slate that the letter refers to."

Conclusions

349. We accept Mr Ackerman's evidence that, as he described, from around the time when he received the screenplays onwards (which was no later than 17 November 2003), (1) he saw various iterations of Sony's Plans in respect of the transaction films, (2) he was present at discussions in relation to those Plans and monitored their progress, (3) he provided Invicta with information on those Plans as they evolved, and (4) he provided Gala with the December letters at the point he felt Sony had said they had the optimal plan and were moving forward.

350. We do not consider that Gala has demonstrated that Mr Ackerman's activities in the run up to the production of the December letters had any impact on the formulation of Sony's Plans or that Invicta/Gala gave consideration to, or had internal discussion in relation to, the information which Mr Ackerman provided to Invicta. Mr Ackerman suggested that his activities went beyond monitoring what Sony was doing in relation to the Plans in that (1) in his witness statement, he said "he could easily identify the component parts of the budget to evaluate the strength for Gala and identify gaps where more information would be required" and that he attended meetings with Sony "to discuss the initial plans and the comments he had on them", and (2) at the hearing, he stressed that there was a lot of work involved in what he did in the lead up to producing the December letters, said that he was free to comment on the Plans at the meetings with Sony and suggested that he "participated" in those meetings. However, these comments are all framed in very general terms and neither Mr Ackerman nor Mr Yusef referred to or produced, any example where (a) Mr Ackerman had any particular input on any of the Plans, which was considered by or taken on board by Sony, or (b) he raised any particular concern or issue with Invicta, which was then taken forward either in internal discussions at Invicta, and/or between Invicta and Gala, and/or in discussions with Sony. Nor is there any documentary evidence that is the case. We do not accept that Mr Yusef/Invicta considered information and data provided by Mr Ackerman on the basis of his statement that he was certain it was taken into consideration by people in London when they entered into their agreements. It appears this is speculation on Mr Ackerman's part; here and elsewhere in his evidence he stated that he had no involvement in the transaction side of things and of the timing of when the agreements were entered into.

351. The evidence does not justify a finding that Mr Ackerman recommended the approval of the form of Initial Plans Sony had produced when Gala entered into the first transaction on 2 December 2003. Mr Yusef said that Mr Ackerman had recommended approval of the relevant Plans prior to 2 December 2003 and that opinion was then

refreshed after that date. However, Mr Ackerman, did not suggest that he had provided any such recommendation, whether orally or in writing, prior to the actual date of the relevant December letter. He emphasised that he did a lot of work to get to the point of issuing each letter and that he kept Invicta informed of discussions on the Initial Plans in their various iterations. However, he was very clear that he provided the letters "as soon as was feasibly possible" and that he only issued each letter when he felt that the studio had said: "We now have the plan, the optimal plan and we are moving forward". These comments plainly suggest that Mr Ackerman did not feel able to make the recommendation in relation to the Plan for each transaction film until the point at which he sent the letter in relation to that film - hence, the letters for each film had different dates. We consider the evidence of Mr Ackerman to be more reliable than that of Mr Yusef, given there are other aspects of Mr Yusef's evidence which cast doubt on his overall credibility, and that Mr Ackerman was the person who discussed the Plans with Sony.

352. Therefore, (1) it is undisputed that Invicta/Gala were prepared to enter into the first transaction without having received any written confirmation from Mr Ackerman of his views on whether Gala should approve the Initial Plans then in place for the first transaction films, and (2) in our view, it is reasonable to infer from the evidence that Invicta/Gala were prepared to do so without receiving any such oral confirmation from Mr Ackerman albeit that they were provided with information on the relevant Plans as matters progressed.

Section 13 - Second closing

Secret Window letter

353. In the Secret Window letter of 20 January 2004 Mr Ackerman said the following as regards Gala's contribution to the distribution expenses for Secret Window:

> "I have now fully analysed SP's P&A most recent campaign strategy and budget proposal for their upcoming film "Secret Window". The film is scheduled for release on 12th March 2004. This thriller genre film stars Johnny Depp. Comparative films for your information would be What Lies Beneath, Identity, Panic Room, Along Came a Spider...Having seen the film and looked at the overall competition in the marketplace in the upcoming quarter in question *I would recommend that Gala Film Partners consider limiting its P&A spend on this film.* While SP have already long since committed their media allocation for this film and while Gala has approved such early P&A expenditures, including a previously allocated major spend in connection with the Super Bowl game, one of the most expensive, high profile and high effective campaign points in the system, I am nevertheless concerned that the campaign proposal exceeds the film's commercial potential. I also note that some of their latter "Secret Window" campaign activity will fall after our own deadlines [Mr Ackerman confirmed at the hearing that he meant after the end of the 2003/04 tax year]. I *would therefore suggest that Gala consider curtailing its spend to approximately 25 to $27 million and let SPE carry the balance on their proposed budget total.* I note that the current SPE approved pre-opening budget stands at $27 million odd. I note that per SPE SW approved budget, $11 million odd will have already been spent by 1st February. This would represent a little less than half of the revised Gala commitment I am suggesting."
>
> (Emphasis added.)

354. In his witness statement, Mr Ackerman (1) described this letter as one specific occasion when he was "concerned that the media plan proposed by Sony was not consistent with the commercial potential for the film", and (2) said that Gala chose its expenditure in accordance with that recommendation. Mr Yusef described the letter as containing a recommendation from Mr Ackerman for Gala to limit its spend to approximately $25m - $27m on Secret Window (with Sony carrying the balance should

it choose to do so) as he was concerned that the marketing plans exceeded the film's commercial potential and that "we agreed with Mr Ackerman's recommendation and did not agree for Gala to incur the additional expenditure".

355. We note that (1) Mr Ackerman provided this letter when he had described Sony's Initial Plan for Secret Window as "optimal" only the month before, and (2) his/LBPC's contractual remit did not include making recommendations as to how much Gala ought to contribute to the distribution expenses for the transaction films and there is no evidence that as regards the other transaction films Invicta/Gala asked Mr Ackerman to do so or that he did so.

356. It was put to Mr Ackerman that he did not give any reason in the letter for his view that Sony's world leading marketing team had got the film's commercial potential wrong and that that was information that Mr Yusef would have wanted to know. He said he would have discussed that with Mr Yusef probably by phone. It was put to him that the key points apparently never find their way into the letters of advice:

(1) He said that "the commercial potential was tracking weaker than Sony I think had been hoping for" and he would have made that assessment in his research work in talking to parties not only at Sony but also outside and independent of Sony including agencies. He thought that it might have included Mr Depp's own agent and their opinion about the film and how much support Mr Depp would give to the Plans for the film and he would have had the opinion of other professionals in the industry that he might have spoken to who knew and heard what the potential of the film was. So the phrase "weakening commercial potential of the film" incorporates "all of those different types of research into making an assessment like this…there are many reasons that a film's commercial potential can change as it is being prepared for the marketplace.."

(2) He added that in the letter he was trying to be effective in his communication to Mr Yusef and Mr Bamford, and he believed they both are well aware of what is involved in the phrase "commercial potential" or "weakening commercial potential", and they certainly would have been aware of that based on the conversations he had with them.

357. In re-examination he explained that by "tracking", he means following all of the media data assembled by the Sony marketing team from numerous different outlets, such as word of mouth, print advertising and "the testing in realtime on a dynamic basis in different cities….done by people working on behalf of Sony speaking directly to consumers, getting their response to an advertisement, people coming out of the theatre or people anticipating going to a theatre". He added that it is a very extensive form of following the potential of a film as it is building for a theatrical release and also, during a theatrical release, following the data as a way to improve results. He added that once the team have the tracking data they would sit and analyse those points and certain team members would be responsible for presenting specific numbers and percentages analyses to the director of marketing. He then would share that with the team and Mr Ackerman and there would be discussion as to decisions up or down the scale in terms of potential response, expenditures and creative solutions. We accept Mr Ackerman's explanation of the terms he used in the letter.

358. Mr Ackerman agreed that he had not made any recommendation in relation to how much Gala should contribute to the distribution expenditure on Secret Window in his previous letters (such as in his letter of 1 December 2003). When it was put to him that was because it was not part of his remit to make such recommendations, he said this was not referenced in the LBPC agreement but:

> "it would be curious if I was sitting at Sony digesting, volunteering and participating in all of the financial planning with regard to the distribution of these movies and having no financial opinion whatsoever. There is documentation and many, many phone calls and discussions…between myself and Mr Yusef and Mr Bamford as to my interpretation of the financial data that we were receiving on a dynamic basis from Sony and McCann Erickson."

359. When it was put to Mr Ackerman that he did not know the financial arrangements of Gala in terms of precisely what they would get through the waterfall and that was not his remit, he said:

(1) He would have seen the waterfall by the time it was agreed, he participated in discussions as it was being negotiated, he was not party to all of the calls between London and Los Angeles on the finalisation of the waterfall but the DA would have been included in the documentation that was kept in the office, and he would have looked at it.

(2) He was focused on the films and on trying to ensure that the relationship between Sony and Gala generated profit for both parties, and was tasked with advising Mr Yusef, acting on behalf of Gala, as to decisions on expenditure. He does not profess to know more about distribution specifics than a head of distribution like Mr Smith. However, he participated in meetings that he ran and was invited and authorised by Sony to make comments and contributions and changes in the various plans:

> "So in any given film there would be put multiple plans. Some had significant variations, others less varied, but again a dynamic market based on pricing, based on the performance of other studio films at the time, all of which were being assessed from a financial point of view, as the point here was to make money. So the financial aspect of the film business is what ultimately really drives the business."

(3) He confirmed that he was not involved in financial modelling in London over what Gala would get through the waterfall based on certain premises. This evidence accords with his earlier evidence on the limits of his role compared with that of HL.

360. Mr Ackerman seemed to agree that Gala had not approved distribution expenditure on "Secret Window" before it received the letter given the LA relating to Secret Window was entered into only in February 2004. It was put to him, in effect, that (a) his recommendation in the letter is about limiting Gala's expenditure on this film but there was no prior agreement or suggestion that Gala would otherwise commit to a figure higher than \$25 to \$27 million, and (b) therefore, the letter is not concerned with proposed *variations* to an Initial Plan, as Mr Ackerman had suggested, but about a sum of money:

(1) He initially said that any variation of an expenditure plan necessarily involves different monetary amounts, and in referring in the letter to monetary sums he was referring "to multiple plans that have been worked on with Sony, and where I become concerned that perhaps those plans are becoming more risky than originally hoped due to the troubled position of this particular film going into the market".

(2) He accepted that the premise of the letter is that but for his recommendation Gala would commit to a higher sum but added that the letter also reflects "a standard and frequent occurrence" in the film industry about which he was voicing concern in the letter that:

> "often a studio if they have a film which is not a rip-roaring success out of the gate or that has tracking that is off the charts and they are...experts in that

> tracking, different distribution teams will make different types of educated decisions which are calculated risk. Those decisions may involve spending over and above their original marketing budget in order and with the belief of the executive or the team that by pushing more money into this film and creating more exposure, they will ride out and be able to lift the film. That is borne out again and again as a very standard occurrence in the motion picture industry. Sometimes it succeeds and other times it fails, and here in this letter I am recommending to Gala that whatever may go forward not to get drawn into that potential process, to try to cap its involvement."

Mr Ackerman did not here or elsewhere give any adequate explanation of why he thought it mattered precisely what level of Initial Expenditure Gala committed to Secret Window.

361. Mr Yusef was asked similar questions to those set out above and it was put to him that the letter is about setting how much the so-called Gala expenditure was to be for Secret Window but the documents relating to that film were not entered into for another fortnight. He said:

(1) Much of the detail would have been discussed and agreed prior to the relevant date and "these numbers don't just get created out of thin air and in isolation" but are the subject of several meetings and conference calls and dates have to be considered:

> "within the context of that commercial reality. Numbers do not just get magicked up at the last minute...and very often the letters and the agreements are formalisations of what has been understood and agreed between the parties over a relatively long period of time."

(2) He agreed there is no document evidencing this but said the transaction documents could not have been executed unless the parties had a settled understanding of what their contents would be; the material terms were not agreed within a day or so of them being entered into. There was an ongoing, moving understanding of what the deal between the parties would be, but most importantly, Mr Ackerman as well as other members of the team would have known (a) the gross amount of expenditure contemplated in the Plans which he worked on with Invicta, which must have been approved and arrived at before the formal exchange of the DA because it is not a small incidental matter, and (b) the portion that Gala committed to in the formal agreements was a matter which was settled long before those agreements were entered into. So, in making recommendations in this letter, Mr Ackerman would have understood the amount of global and individual commitment.

(3) He added that you cannot look at the date of the agreement in isolation; in order to "agree a fundamental point such as this it is necessarily the case that the parties would have reached that understanding prior to that date" given it was not just an incidental point. He said that it was the subject of several conference calls and personal meetings, some of which he attended and some of which Mr Ackerman attended where these material issues were discussed and the evidence for this lies in what actually happened:

> "The way it works is that the decisions were made over several meetings and over several conference calls….some of which Mr Ackerman attended. Others it was meetings between me, Mr Bamford and…David Davis at [HL]… and all of those were memorialised not in a minute but in the agreement that was eventually signed."

(4) He said that the issues that came up for discussion at the time were (a) "whether or not additional expenditure should be incurred not just in relation to this film but any other films that may come within the slate" which would require

additional funding in Gala, and (b) how much should be allocated to this film as opposed to other films. He added that they made the decision, "not to put all our eggs in one basket, as it were" so this issue of how much to spend on this film was a live issue.

362. We accept that Sony's Plans may have been constantly subject to change and that, following the first closing, Mr Ackerman reviewed and monitored the evolving Plans. For the reasons set out below, we do not accept that, as Mr Yusef seemed to suggest, Gala carried out an extensive exercise to determine what Initial Expenditure should be attributed to Secret Window or any of the other transaction films, or that to the extent Invicta/Gala did have discussions with Mr Ackerman relating to, or gave consideration to the level of, the Initial Expenditure to be attributed to Secret Window, those discussions had any meaningful commercial impact.

363. Mr Ackerman was asked if he meant in the letter that Gala should not contribute more than $27 million to expenditure on Secret Window and that it should contribute additional funds to the expenditure on a different film or do nothing with the funds for the time being. He said, in effect, that he was saying simply "limit your spend" or in co-spending with Sony "don't go above a certain level" and perhaps the fault was that he did not mention for clarity's sake the amount that Sony was anticipating spending, or which would increase or decrease according to the given situation or may increase because Gala decided not to spend. It was not his business, unless instructed otherwise, to analyse an alternative investment and he was not instructed to do so.

364. HMRC questioned the basis for Mr Ackerman's comment in his witness statement that his advice on Secret Window "ensured that Gala's commercial interests were safeguarded and our potential upside was maximised". It was put to him and Mr Yusef that (a) the Initial Expenditure specified in the LAs entered into on 3 February 2004 was $26,778,684.67 in relation to Secret Window and $100,000 in relation to Breakin' All the Rules, and (b) it is clear from this and the fact that Gala had no money left after the second transaction, that Gala did not take a decision to hold money back but put 99.6% of the funds they had into Secret Window and so either did not understand his advice or decided not to follow it.

(1) Mr Ackerman said:

(a) Gala were not obligated to take his advice and, as he was not a decision maker in whether that advice was followed by London, could not speak to what Gala decided to do or not.

(b) Breakin' All the Rules, was a Screen Gems "very small art house release" which would have had considerably less commercial potential than Secret Window. So ploughing funds into that film would have actually increased the potential losses. That could have been part of Gala's decision but that was speculation.

(c) He believed Gala acted in accordance with his recommendation: While they may have spent somewhat over and above what he had recommended, he thought the letter "speaks about not going deeper into a risky film and limiting expenditure". He reiterated that he was concerned that, because of Johnny Depp and his star stature and under pressure with his managers and agents, Sony would be "pulled deeper into trying to pull the film into commercial success".

(d) When he made this witness statement, some 3 years ago, it was his recollection that Gala had limited their investment into Secret Window. He remembers distinctly that they were not going to go forward certainly and try to raise more money to invest deeper in that film.

(2) Mr Yusef said the point was that "the discussions were about whether or not we should be, as was indicated, finding a way to spend more". He said that there was talk about raising more money and it was a question of whether Gala should increase the amount of expenditure that was being suggested at the time. His recollection is that Sony's concern was to look at whether more should be spent, not less. Gala's position was based on the advice of Mr Ackerman that the picture was unlikely to perform in the way that everybody had expected. So "it's not a question of whether we should have spent 26.9 or not. It was a question of whether we should increase the amount of expenditure that was being suggested at the time".

365. It was put to Mr Ackerman that, as Gala's right to receive a share of Gross Receipts from the transaction films depended on the performance of all of them, the notional allocation of expenditure between different films made no difference at all to Gala, and his letter, therefore, makes no sense and his advice was not followed:

(1) He said that he was aware that the slate was aggregated or cross-collateralised. That is a standard practice in slate financing with studios, and:

> "the commercial performance of individual films would have an impact on the results of such cross collateralisation. If you invested in films that were all losers, you would do very badly. If you invested in films that were all winners, you would be better than making 6 Titanics. If you invested in a slate that was a mixed bag, as is generally the case with the motion picture industry, you would have some that performed well and that carried others that performed less well, and that would be determined in the cross-collateralisation, not to be confused with a waterfall structure, which is separate from cross-collateralisation, or an additional component of a commercial venture with a studio partner."

(2) He suggested that the notional allocation made a difference "in the end result" but did not give any clear or coherent explanation as to why that is the case. He commented that:

(a) "the movies did not perform as we had hoped and as an aggregate generated around some 730 or some millions of dollars shy of what we had initially hoped for at around 1 billion, 1.2 billion" and said "there are certainly differences that result from loss as opposed to a return in terms of profit",

(b) Sony had "an option to spend deeper" which "would enable Sony to....take a deeper recoupment in terms of money they spent" and would potentially set a partner like Gala back; that is part of what a cross-collateralisation and dynamic trading relationship is, where if Gala decide not to invest the full amount, "Sony did not want to be tied to a reduced distribution situation as the distributor with the potential that they could then spend that variance if that was their choice", and

(c) the process of deciding whether to spend more or less money "in realtime based on real market" can be described as a form of spot trading, whereby Sony would look to leverage and maximise commercial results: They could be right or wrong in some of their campaign assessments or expenditures. For example, a television ad may fail and they may decide to change the ad and do a new campaign or to change a poster and attract a specific segment of the population who they feel will buy more tickets: "These are all issues that actually do have real impact and create real change. In any trading with a studio, whatever fund structure you may have, there will be changes brought about constantly in that relationship."

(3) He said Gala spent more on the film than he recommended but the advice was followed in that “they did not commit to going out to raise more money and go deeper into supporting a film in partnership with Sony that I had said “don't go there””. He said he wrote the letter for the reasons set out in it and it was his remit and responsibility towards Gala and directly towards Invicta to provide commercial assessments on a picture-by-picture basis with a view to trying to maximise the investments that Gala was making in these pictures. He thought “we did a good job of that” and believed:

> “Gala’s P&A business by nature is a commercial enterprise, it is last money in, first money out....So if you want to compare it to an investment in production where you would have a far longer tail and a far greater number of variables to assess on an ongoing basis, yes, you would have a greater share of profits because you are in a longer stream, but the actual cost of money would be far greater in the scheme of things. In the P&A business you have the advantage of seeing the product, seeing the scripts, knowing where the talent is in realtime in terms of reputation and star appeal, and you are able to participate in this case, which was exceptional at Sony, to a very significant degree in the marketing plans and the making of those marketing plans, and then in terms of the joint expenditure supporting those plans.”

(4) When it was put to Mr Ackerman that the idea of Gala “going deeper” and raising more money is an invention, he said he thought initially Gala had hoped to raise £250 million but raised less. So his original support team proposal was probably made on the basis of £250 million expenditure but when it was clear that Gala would invest less and was being more cautious, “we downsized the team accordingly. That saved overheads and was what both Mr Yusef and Mr Bamford wanted”. He was aware through the trajectory of the process that Gala hoped to raise additional funds but did not know if that would have been done through Gala or another LLP. When he wrote this letter he did not know one way or the other whether Gala would or would not be raising further funds.

366. Mr Yusef was asked similar questions as regards the operation of the waterfall:

(1) He did not agree that Gala’s rights under the waterfall worked on the basis that all of Gala’s so-called expenditure was aggregated: (a) In each case, there was an agreement on how much would be spent on (i) the licence for a film and (ii) the expenditure for that specific film, and (b) the gross receipts and the gross distribution expenses are cross-collateralised so that the expenses relating to one film which are not recouped from receipts for that film, could be relieved as expenses of gross receipts from the other films.

(2) He disagreed with the proposition that the notional allocation of expenditure between films, as he described it, is an empty exercise. He did not accept that whether Gala allocated less expenditure to Secret Window and more to Breakin’ All the Rules” would not have made any difference at all to Gala as all of the expenditure allocated to all of the films was aggregated for the purposes of calculating Gala’s entitlement under the waterfall. He did not, however, give any reason for his view which makes any sense in the context of how the Gala arrangements operate. He said that:

(a) Such an allocation is a “perfectly standard accounting and gross receipts procedure in all studio movies where there is a slate involved” and it is very important.

(b) The allocation does make a difference because “at the end of the day... neither Gala nor Sony are in the business of spending money. That is not the business. The business of incurring expenditure is to enhance the gross receipts

of each of the films”. It is not an empty gesture to be concerned with the expenses incurred in relation to each individual film, “because overall we want to make sure that each of the films has the maximum capacity to earn as much as possible. So you are concerned about how much each individual film in the slate should be spent on.” He made similar comments later as set out below.

(3) He seemed to agree that if Gala reduced its contribution to distribution expenses, Sony would just pay the remainder and, under the waterfall, would recoup that from the Gross Receipts before Gala got anything. He said that is not something Gala would want to happen but agreed that this was not within his control. He added:

> “but before that happens the important stage is that we would have the right to spend the money and if we had made an informed decision not to, then and only then would the right to spend the money fall on Sony…They even had the right, if I recall, of termination in such circumstances if the issue was substantial or material, but before that could happen we would have the right to spend the money as contemplated. It wasn’t in their gift in that sense.”

He added that Sony’s rights in this respect only arise in very specific circumstances and “was conditional on either Gala not agreeing to spend it or not in fact spending it”. He agreed that Mr Ackerman recommendation was that Gala should let Sony “carry the balance”.

(4) It was put to him that Mr Ackerman’s advice did not ensure that Gala’s potential upside was maximised because of the way the waterfall works and his advice was a nonsense and Mr Yusef knew it was. He said that was not the case and:

> “we had considered it very carefully at the time. We took his points very seriously. We discussed it at length both within Invicta and also with him, and he could have just as easily have asked us to spend more or recommend more. At the time I recall that Sony was toying with the idea of spending more, I think largely because of the artistic elements that were involved, but the feedback that we got quite clearly from Mr Ackerman was that this film was not going to perform, or was unlikely to perform, as was originally contemplated, and that’s what I took away from that encounter.”

367. It was put to Mr Ackerman and Mr Yusef that the letter makes no sense because the amount of the Initial Expenditure was not based on any commercial decision but on a formula; essentially it was the sum of the total SG loans:

(1) Mr Yusef accepted that was how the Initial Expenditure was computed but said that it was important for Gala to ensure that there was enough money to service all of the transaction films. He said that there was a finite amount of expenditure available and that is where the formula comes from, but in terms of allocation:

> “we needed to be sure that there would be enough money there at the end of the day that all 6 films could be serviced from the limited amount of money that we had…originally, we anticipated or hoped that we would be able to raise 250 million. As it turned out we had less. So at the time it was important to us that we made sure that we had money for all of the films, not just one. So that’s the reason behind the decision as to how much was incurred in relation to each of the films.”

He described that as the overriding consideration and stressed that (a) “it did matter how much we put into each picture, and it theoretically could have been possible that we decided to spend more money on this than the amount that was originally allocated or designated”, and (b) he spoke to Mr Ackerman at least

twice a day, sometimes more, "about the very things we are now talking about and more…We discussed business in great detail and at length".

(2) Mr Ackerman said he was not involved in the structure of what was agreed between Gala's partners and management. He was focused entirely on the commercial integrity or lack thereof of the films, and it was not his job to assess through a financial model operated in London by Mr Bamford as to the dynamic side of Gala's investments. He was looking at the commercial performance, recommending which films he felt would have a stronger performance with a view to profit and where he saw changes and discrepancies, or in the case of Secret Window where he saw a weakness, and he was saying in the letter: "Try to limit your investment from going deeper if indeed Sony were to go deeper".

368. Mr Ackerman was asked why he wrote the letter given he said he would not advise on investments unless instructed to do so. He said that he wrote it based on the same process that applied to the other transaction films, whereby he participated in meetings with Sony, negotiated in those meetings based on different campaign expenditures and then provided a record/an opinion on that to keep Mr Yusef and Mr Bamford informed, and where he saw issues, voiced an opinion. His recollection is that he was not specifically asked to write that letter. He looked at the tracking data and performance regarding Secret Window and arrived at a position in his assessment where he thought there was reason to limit the amount of expenditure if one could. That was "the be all and end all of my recommendation".

369. It was put to Mr Ackerman that there are no other such letters anywhere in the bundles and the letter was window dressing, pretending a commercial decision was being made when there was no such decision to make. He disagreed:

> "It was not my job to write a letter that was addressing the structure in London. It was my job to write an opinion and... to assess in realtime what was happening with Sony and what adjustments were being made on multiple films involved in the slate, and this was one case where I saw distinct potential problems in the roll out of this film that I felt were problems that were not fully recognised by the Sony team at the time".

370. In re-examination Mr Ackerman said that the letter came about as, in discussions at meetings at Sony concerning Secret Window, it became very apparent to him that the film had problems. Sony was aware of a less than, "stellar word of mouth for the film in the marketplace" and were looking at ways to overcome that prior to the release. They were talking about spending significantly more amounts of money than had originally been contemplated. In his letter, he was responding to those discussions and flagged to the Invicta team that he "would not recommend that one follow with Sony into a significantly higher expenditure, if indeed that was what they would do". He thought that Sony was under some pressure from Mr Depp and his business managers. As to the timing of the Gala expenditure, he did not recall other than he certainly had anticipated that Invicta would continue with additional stages of investment perhaps through new funds or additional Gala type structured funds, and certainly in the months leading up to that time it was hoped by both Sony and himself, and, he believed, Mr Yusef, that the relationship with Sony would continue on an investment and trading basis, although it might be through different vehicles.

371. Mr Yusef seemed to agree that there was no written reply to this letter from Invicta in which Invicta asked what Gala should do with the relevant funds instead. He said that at the time he and Mr Ackerman were speaking probably twice a day and on the day that the letter came out, it would be the top of the agenda of things they would have discussed; that was the response from Invicta. He said that "we were in the throes of a very, very fast-moving situation at the time, and it would have been perfectly within

the confines of how one runs a business like this that those kinds of responses would be oral and not necessarily minuted".

372. It was put to Mr Yusef that the letter is pure window dressing as it makes no sense in the context of the structure. He said that was not the case and Mr Ackerman was not asked to write the letter:

> "I didn't know the letter was coming until it actually came in that form. I did know that there were discussions taking place between Sony and him regarding, amongst many other things, Secret Window. I did know that he was going to make a recommendation, but the actual contents of the letter, which was what we discussed subsequent to me receiving it, was not something that I asked him to write or....encouraged him to write, and it was only the next day or that evening, if it came within our working day, I am certain and I am confident that we did discuss it at length, and the underlying points that he's making, which is an earnestly held view about the performance potential of that picture is something we would have discussed at length."

373. In our view, neither Mr Ackerman nor Mr Yusef provided any sensible explanation as to why Mr Ackerman's recommendation in the Secret Window letter was of any commercial use to Gala. For the reasons set out below, we do not accept Mr Vallat's submission that this letter provides evidence of Mr Ackerman providing useful commercial input to Gala in relation to its activities under the Gala arrangements.

374. Under the Option, Gala agreed that (1) no less than 91.5% of the contributions would be advanced to the expenditure account and applied towards payment of Gala Expenses for the transaction films, (2) the Gala Expenses funded by the Initial Expenditure would be no less than, £82,350,000, and (3) and the licence fees would be 13.5% of the contributions subject to the proviso that if SPE had not, prior to 28 January 2004, included sufficient films within the terms of the Option to enable Gala to fully utilise the specified funds, these sums were to be proportionately reduced. Therefore, the individual amounts of Initial Expenditure which Gala could agree to provide under the LAs relating to the films Gala chose to invest in simply had to add up in total to the specified proportion of the contributions and comprise a sum no less than the specified amount. The Option also provided that Gala would review the Plans and notify SPE of the individual amounts of Initial Expenditure it wished to provide in relation to each film and that those sums would then be specified in the relevant individual LA.

375. Against that background, Mr Ackerman's recommendation that Gala should limit the Initial Expenditure relating to Secret Window makes no sense. Gala had to put an amount equal to 91.5% of the contributions into the expenditure account. As HMRC pointed out in cross-examination, in fact, nearly all of the sums required/available to be put into the expenditure account on the second closing was allocated to Secret Window (over $26 million) and only $100,000 was allocated to the other second transaction film. It was only when this was pointed out that Mr Ackerman said that the letter spoke of Gala not going deeper into a risky film and that he thought Gala did not go deeper in the sense that they did not try to raise more money to invest further in this film. He later confirmed, however, that he did not know when he wrote this letter whether or not Gala proposed to raise more funds and there is nothing in the other evidence to suggest that was proposed. In any event, the same points made here and below would apply in relation to any such further funds.

376. We can see that on Gala's case, it was important for Gala to provide funds to meet approved Gala Expenses to be incurred on each film. Gala's case is, essentially that the purpose and effect of the Gala arrangements was to enable Gala to exploit distribution rights in relation to films it selected (so it says, on the basis of their prospects of commercial success) by receiving a share of Gross Receipts from those films. On Gala's

analysis, the provision of funds to meet Gala Expenses to be incurred on each selected film provides part of the rationale (along with its other asserted input into the distribution process) for SPR agreeing to give it a share of the Gross Receipts from that film. In that context, therefore, we can see that, viewing matters purely through the lens of Gala's case, Mr Yusef has a point that Gala had a finite amount of funds available to put into the expenditure account which needed to be allocated between the selected films.

377. However, whilst Mr Yusef's point makes some sense in theory, it falls down in actuality because, under the terms of the deal with Sony, the reality is that precisely how much Initial Expenditure was allocated to each film could have no commercial effect on Gala's position. Under the terms of the DA, Gala's prospects of receiving a share of Gross Receipts under the waterfall would be precisely the same however it chose to allocate the Initial Expenditure between the transaction films:

(1) As set out in section 11, the waterfall operates (a) by reference to the aggregate sums of (i) Gross Receipts realised from, and (ii) distribution expenditure and other costs incurred on, all of the transaction films, and (b) on the basis that Sony was entitled to a share of the total Gross Receipts equal to the total distribution expenses specified in the fifth provision in the waterfall, in priority to Gala's entitlement to a share of the total Gross Receipts equal to the total approved Gala Expenses under the sixth provision in the waterfall. We note that there is a notional category of distribution expenses which Sony was entitled to recoup only lower down the waterfall (under the eighth provision) but, for the reasons already set out, we cannot see realistically what could fall in that category that would not already be captured under the fifth provision.

(2) Under the terms of the DA, if SPR wished to incur Gala Expenses which Gala did not wish to provide funds for or, to incur other distribution expenses, it could simply do so (see section 9) and could recoup the cost under the fifth provision in the waterfall (see section 11). Gala had no contractual right to prevent SPR incurring such sums. Mr Ackerman did not suggest that he was seeking to prevent SPR itself from incurring further expenditure on Secret Window.

(3) Therefore, if the total distribution expenditure on all of the transaction films was 140, of which Gala notionally contributed 60 (as monies in the expenditure account) and Sony contributed 80 (using resources other than those in the expenditure account), Sony would be entitled to recoup its 80 under the fifth provision in the waterfall, in priority to Gala's ability to recoup 60 under the sixth provision in the waterfall. If Gala decided to limit its notional contribution to 40, then Sony could simply fund an additional 20 of expenditure so its contribution would be 100, and recoup all of that 100 under the fifth provision in the waterfall in priority to Gala recovering 40. Plainly, in that context, it cannot make any difference to Gala's position under the waterfall whether it decided to allocate 10 of its total notional contribution of 60 to each of the 6 transaction films or 30 to one film and the remainder between the rest or in some other proportion.

378. Mr Ackerman made no relevant comments in response to HMRC's challenge to his comment that his advice in the Secret Window letter ensured that Gala's commercial interests were safeguarded and its potential upside was maximised, as made on the basis of how the DA operates. This could be, at least in part, because Mr Ackerman had a limited understanding of the contractual arrangements; he said a number of times that he was not concerned with the structure in London. However, in our view, that does not provide a full explanation, given that Mr Ackerman was plainly aware that Sony could utilise other resources to pay for Gala Expenses which Gala did not want to provide funds for (and/or could incur other distribution expenses). In light of that, it is

reasonable to infer that he must have been aware that any limitation on what Gala put in the expenditure account as regards Secret Window would not of itself necessarily decrease the overall expenditure on that film.

379. Mr Yusef was insistent that the allocation of Initial Expenditure between the transaction films makes a difference because "neither Gala nor Sony are in the business of spending money", rather the "business of incurring expenditure is to enhance the gross receipts of each of the films" and "overall we want to make sure that each of the films has the maximum capacity to earn as much as possible" and the concern is "about how much each individual film in the slate should be spent on". These comments would make sense if Gala had the ability to control, limit or, provide meaningful input into, the overall spending on the distribution of the transaction films but clearly it did not (see, in particular, sections 9 and 14). Moreover, Mr Yusef's comments that Gala would not want Sony to pay Gala Expenses which Gala did not want to cover and that Sony could only do so on following the process in the DA are not to the point. The point of relevance here is that, under the DA, SPR could simply incur distribution expenses including Gala Expenses, using funds other than those in the expenditure account if Gala was not required to, or chose not to, put funds into the expenditure account in respect of the relevant cost.

380. Overall, given Mr Yusef's role in this transaction (1) we find it implausible that he was not aware when the Secret Window letter was issued that it makes no sense due to the way in which the Gala arrangements operate, and (2) we do not accept that he/Invicta/Gala considered the Secret Window letter very carefully and took Mr Ackerman's points very seriously.

Members' meetings and provision of information to members

381. Mr Goffman of Sony sent Gala a full set of documents relating to the second transaction films on 23 January 2004 including (1) for Secret Window, a Plan dated 7 January 2004, a summary cost report for the period ended 10 January 2004, a project status report, a synopsis, details of the cast, screenplay and documents evidencing title to the film, and (2) the same documents for Breaking All the Rules except that there was no Plan. Invicta wrote to investors on Wednesday, 28 January 2004 reminding them that there was to be a meeting on 2 February 2004. The letter states that (a) the 2004 HL letter was not enclosed but was to be forwarded shortly, (b) the transaction documents were enclosed, (c) the film files for one of the films were enclosed and the files for the other were to be forwarded shortly, and (d) the acknowledgment was enclosed in the same form as that sent to investors in the first closing but with a space for the investor to insert the date.

382. Mr Yusef was taken to Mr Summers' acknowledgement which was dated 29 January 2004. It was put to him that Mr Summers signed this notwithstanding that he had not then received the 2004 HL letter and one of the film files, as shown by the letter of 28 January 2004. Mr Yusef gave unclear and inconsistent responses to this line of questioning, which conflict with what he said in his witness statement, and which appear to be based on his view as to what ought to have happened rather than actual recollection, and on speculation about Mr Summers' actions. We note that, as set out below, Mr Summers' evidence was that he did not receive the 2004 HL letter until after he signed the acknowledgement:

(1) Mr Yusef initially asserted that Mr Summers would have received the 2004 HL letter prior to him signing the acknowledgment. He noted that it could have been sent to him on 28 January 2004 by e-mail and it could have been sent to Mr Summers the next morning and then said: "That's almost certainly what happened." He recalls Mr Summers saying that he had a box of film files and that

he had a lengthy discussion with his wife about them. When pressed, he suggested the letter of 28 January 2004 is not accurate but then said he could not comment on its accuracy but was going on the fact that the acknowledgment signed by Mr Summers presumes that he had the film files, as he knows to be the case because Mr Summers told Mr Yusef he had them.

(2) It was put to him that it cannot be right that Mr Summers had the 2004 HL letter when he signed the acknowledgment because the 2004 HL letter is dated 30 January 2004:

(a) He said that there is a process involved:

> "We don't just get a letter out of the blue from [HL]. There will be discussions….by the time we got to the 29th, or even later than that, we will have a fairly well formed version of the letter that's going to go out. So whether it's the signed version or,…the version to be signed, something would have gone out to the individuals at the relevant date. If Mr Summers is saying he had it, he probably had a fairly late version of the letter which eventually will have been signed."

(b) When pressed he said he could not be certain as regards the 2004 HL letter but it is certain that Mr Summers received all the film files before he committed to this project and the communications from HL would have been sent by fax or e-mail. He remembers that the film file went by courier. He added that he could not see why Mr Summers would sign a letter saying he had received something when he had not. There is no reason for him to do that. It is illogical.

(3) It was put to him that the acknowledgement does not reflect reality. He initially said he could not comment. When pressed he said, in effect, that he could not say after 19 years exactly what the situation is but can only go on what the acknowledgement says and can only guess that Mr Summers would have received the final version of the 2004 HL letter - there were various versions of that around over quite a period of time and there was not that much variation between those and the final one.

(4) It was put to him that in his witness statement he said that Gala did not receive the 2004 HL letter until 30 January 2004:

(a) He said that after 19 years, it is quite possible his dates may have slipped by a day or 2 but he knows that Mr Summers would have received the additional film file by courier prior to 29 January 2004. It is not irrational and he sincerely believes that, at the appropriate time, Mr Summers had a draft or an executed version of the 2004 HL letter on which he could form a view.

(b) He made the comment in his statement because there is some evidence to suggest that the 2004 HL letter came on 30 January 2004 but that is not to say that a draft was not available. He added that he was quite certain that whether Invicta had the final signed or agreed version on 29 or 30 January 2004 "it's perfectly possible that we would have made available, not just to Mr Summers but to others…the agreed version that just required Board approval and signature from [HL] that process to get an agreed version of a document…signed…and Board approved within 24 hours is not inconceivable" and that "We couldn't have magicked up the document in agreed form from the 29th to the 30th in 24 hours. It existed in the agreed form" before that. When pressed further he said that what he received on 30 January clearly was the signed version but that was not the first time that Invicta saw this report; they had an agreed version of that for some time.

(5) He agreed there is no evidence of a draft of the 2004 HL letter in the bundle. He said that (a) the evidence of a member receiving a draft/agreed version is provided by Mr Summers signing the acknowledgement. He is quite a senior guy who would not write something that he did not think to be true and he must work on that basis, and (b), when pressed, the evidence lies in the logic of the transaction. There is no way that, on 29 January 2004, HL would just decide that this is the approved version. They would have to get the version approved by Invicta, Sony and the board. That document would have existed in signature form long before the 30th. That has to be the case; it is just the way these things work. It is not possible they could just magic up that document in one day in a form that is approved by their board. When it was put to him he had not put any of this in his witness statement, he said it took months in 2018 to prepare the statement and there are many things that went on in that transaction that just do not come across but he could not possibly put in everything that happened 19 years later.

383. Mr Yusef said that he did not know if the existing members received the 2004 HL letter but they would have been sent the film files for the second transaction films. He said they were not sent the transaction documents for the second transaction because they were identical to the ones that they received for the first transaction, and they were not sent the draft documentation amending the previous documentation for the first transaction. We do not accept Mr Yusef's evidence that there were multiple versions of the 2004 HL letter or that any version of it was sent to Mr Summers or other investors before they signed the acknowledgement. This is implausible in light of the difficulties with Mr Yusef's evidence on this set out above, Mr Summers' evidence on this, and the fact that the similarity of the 2004 HL letter to the earlier 2003 HL letter of itself renders it unlikely that multiple versions were produced.

384. As regards the meetings:

(1) The minutes of the first meeting held on 2 February 2004 show 17 persons in attendance and those for the second meeting, at which the transactions were approved, show 9 persons as present (including Mr Bamford) and 11 persons in attendance. Mr Yusef said that both existing and prospective members would have had the film files by courier before the meeting.

(2) As regards the timing of the meetings (at 12.00pm and 12.15pm) Mr Yusef said it was not uncommon that meetings do not happen precisely when they are scheduled to "just because of the physical business of getting through the business. It doesn't always run to clockwork."

(3) It was put to Mr Yusef that only 11 members attended the second meeting. He noted that there are in attendance people who would have had powers of attorney as agents or advisers of those members who were not there such as Mr Pritchard. He listed 4 persons shown as present who were existing members. He said it is not true that the reason for the low attendance and why it does not matter that the majority of the members did not get the documents is because this is all about the generation of massive purported losses and there is no serious focus on slate profitability.

2004 HL letter and conclusions on HL letters

385. Mr Yusef was taken to the 2004 HL letter which is identical to the 2003 HL letter except that it includes 11 rather than 9 films of which 2 (Secret Window and Breakin' All the Rules) were not referred to in the earlier letter and it does not refer to one film (Mona Lisa Smile), which was referred to in the earlier letter. HMRC put to Mr Yusef that (a) their case is that this letter is flawed for the same reasons as they put to him in relation to the earlier letter and (b) it is even more divorced from reality than the earlier

letter because it says that the transactions films may include the 11 listed and does not take account of the fact that Gala had already transacted in relation to 4 films and was on the cusp of signing up to 2 more, and (c) it does not take that into account because HL did not have this information. He said:

(1) By this time HL would have known which of the films Invicta/Gala were targeting and it was left in a loose position because the situation was fast moving:

> "We were looking at more than the 6 films that we acquired…the situation was fast moving, but…at the relevant time [HL], Justin Ackerman and we in turn by the time we received the film file,…everybody would have known which of the films we were going to include in the slate…this document was intended by all parties to be as fluid as possible, because the situation was changing daily. Release dates were changing daily. For example, I recall that one of the films, "Bad Boys 2", that fell out simply because….it fell foul of our definitions of which films we could include, because it had already been released and more than 30% of the expenditure had been incurred. So the situation was very, very fast-moving…but certainly in terms of the bundle of documents that [HL] would have needed from Sony, they had them, and altogether between Sony, ourselves and [HL] we were working to solidify which of the films that were actually going to be acquired so that they could make this opinion…we had actually included all of the films we ended up acquiring."

(2) When pressed, Mr Yusef added:

> "everybody in the triangle knew which films we were targeting…I remember that I was on the calls pretty much on a nightly basis and the situation moved from one day to the next. That's the way the movie business at this level functions, not for this deal but for all deals. The variables were many. It isn't because they didn't know. They had access to all of the information that Justin Ackerman would have had, that I would have had, either directly physically by fax or I would have made -- it would have been made known to me by Justin Ackerman over the phone…they knew 4 of the slate, because they would have known we had already signed them. The 2 others were still in a state of flux, but at the end of the day all of the films that we ended up with were in the frame for them to include in their assessment as to whether or not the slate would be profitable. They had the opportunity to look at the 6 films, 4 of which they knew for certain, 2 that were in the frame. The only reason why those 2 were still speculative is because there was the possibility that right up to the last minute that we could substitute one against the other. They would have known that."

386. It was put to Mr Yusef that the 2004 HL letter is an absolute embarrassment and astonishing in the context of such a high value transaction given that it comprises one sentence as regards slate profitability in a letter identically worded to the prior letter which is fundamentally flawed in the same way and factually incorrect. He disagreed and said the letter represents the culmination of the work that HL did and they would not have written it unless they had gone into the absolute detail that was required in order for them to make a very succinct appraisal of whether or not, bearing in mind the waterfall, the gross receipts of the picture could exceed a certain sum:

> "That sum was known to everybody. It might have taken counsel 2 weeks to come to the conclusion that it did, but to everybody that was involved in the transaction they were very clear as to what needed to happen...[HL] is not an embarrassing company. It is one of the 3 top people. They are not in the business of handing out letters like confetti…..I stood by it then and I stand by it now…..it was reasonable to believe that the slate of movies that we finally selected and did engage with were capable of achieving a profit to Gala…that sentence is more than enough, bearing in mind what I have just said."

387. It was put to Mr Yusef that the timing is absolutely extraordinary as the letter is dated the last working day before a meeting where Gala had to take critical decisions on whether to spend millions of pounds, which left no proper time for careful consideration. He said that during the last week prior to closing a deal of this size and this complexity "we were working round the clock" and he was working London and Los Angeles hours. It was not a 9 to 5 experience at all. Moreover, he was dealing with all of the prospective members on a daily basis as well. So the timetable has to be seen "in the context of what we were seeking to do and did achieve during that period".

388. We have concluded that the HL letters do not provide evidence that Mr Yusef/Invicta/Gala or the Referrers were concerned with the likely level of Gross Receipts generated by the transaction films and/or whether Gala's share of such Gross Receipts would generate a profit for it, or for the members on their investment, and/or that an extensive exercise was carried out to assess that. It is clear from the terms of the HL letters that HL was not in a position to make any realistic assessment of these matters. Overall, HL's single sentence opinion, as couched, perhaps not surprisingly in light of the points made below, in broad, generalised terms, is devoid of any real meaning for an entity such as Gala or an investor in Gala, who is seriously interested in its/his prospects of making a profit/return through the receipt of Gross Receipts from the films which are the subject of the purported activity of film distribution.

389. In our view, as HMRC submitted, the fundamental problem with the letters, is that HL expressly made whatever appraisal they carried out by reference to "the Slate" including but expressly stated not to be limited to a list of films which it stated "may" be included in the arrangements which (a) includes films which were not transaction films and (b) in the case of the 2003 letter, does not include 1 of the first transaction films:

(1) In the 2003 HL letter, HL referred to 9 films, only 3 of which were transaction films; Big Fish, a first transaction film, and Secret Window and Breakin' All the Rules, the second transaction films, were not included.

(2) In the 2004 HL letter, HL referred to 11 films in total including the transaction films and one film (Mona Lisa Smile) which was not included in the 2003 HL letter.

390. The terms of the letters clearly indicate, therefore, that when HL wrote both letters, HL did not know which or how many of the films it listed in the letter would be subject to the Gala arrangements or whether other films, which were not listed, would be the subject of the arrangements. Mr Vallat said that the tribunal should accept Mr Yusef's evidence that HL was aware of the specific films and his description of the level of activity at the time the transactions were closed. However:

(1) Our view is that Mr Yusef's evidence that HL was aware of the specific films involved certainly at the time of the second transaction lacks credibility in light of the plain terms of the HL letters. Moreover, he and the other witnesses were at pains to stress that HL is a highly reputable firm. One would not expect such a firm to refer to 6 films in the 2003 HL letter and 5 films in the 2004 HL letter as films which "may be" included in the arrangements on which they were asked to opine, if they knew when they wrote the relevant letter that those films were not in fact to be included.

(2) Given his references to the fast-moving situation and how everyone was working around the clock at this time, Mr Yusef could be taken to mean that HL formed an updated view which is not reflected in the HL letters. However, if that is what he meant, that also lacks credibility given that he did not mention that in

his witness statement and no written updated opinion was provided to the members/prospective members.

391. It is apparent also from the terms of the letters that HL did not know (1) how much capital would be contributed to Gala but only that it would be between £80 and £250 million. Therefore, as Mr Yusef accepted, HL did not know the level of Gala's Initial Expenditure, and (2) it is not apparent that HL knew what particular Participations there would be in relation to each film. Mr Yusef said that HL would have known the Participations from the extensive information which he asserts Sony made available to HL and that it did not matter that HL did not know the level of Initial Expenditure because (a) HL would have known the estimated overall distribution expenses from the information given to it by Sony, and (b) Sony and Gala are both entitled to recover their respective share of the expenses from Gross Receipts albeit at different stages of the waterfall. Mr Vallat said that Mr Yusef's evidence should be accepted and that the tribunal should be slow to assume that a firm such as HL would give advice without a proper foundation.

392. However, (1) we find it very surprising that a reputable firm, such as HL, would specifically make reference in its letters to only 2 documents, the LA and the term sheet, if the firm was in fact given access by Sony to written material on the scale Mr Yusef asserts, and (2), in any event, if HL did have an idea of the likely overall distribution expenses relating to each film and the Participations, the problem is again that HL did not know which particular films were in point and hence which sets of expenses were relevant. We do not mean to suggest that HL are disreputable or did not act professionally. They could only act on the information they were given (hence, the limitations included in their letters) and, within whatever remit they were given, which is presumably reflected in the broad, generalised single sentence opinion they gave.

393. Moreover, in our view, as HMRC submitted, HL's single sentence opinion raises more questions than it answers. HL state that there is "a reasonable expectation of profit from the capital introduced by Gala….during the first cycle" and of "further profits after the expiration of the term" but do not state (1) whether they mean profit could reasonably be expected to arise during the specified periods for Gala or for the members or both, (2) what level of profits could reasonably be expected, and (3) precisely when, during the period referred to, any profit point may reasonably be expected to be reached. HL state, in effect, that their assessment is made by reference to "economic performance of the Slate, along with the guaranteed payments due under the Term Sheet" but do not specify to what extent they consider the "profit" which they consider could reasonably be expected would be generated by the Minimum Sums or through Gross Receipts.

394. We do not accept that any of the other points made by Gala in relation to the evidence on the HL letters detract from our findings set out above. In summary, Mr Vallat said that:

(1) HL were not giving a "dollars and cents" precise prediction of the likely Gross Receipts and profitability of each film but rather were just giving a bottom-line position as a general indication of how things stand, namely, that this deal gave a reasonable expectation of profit, and they do that in a perfectly explicable way. The fact that they do not include all their workings in the letter does not mean that the stated position is unreliable or inexplicable. The evidence was that the letters did not properly reflect the amount of work that HL would have done in order to reach their conclusion.

(2) HMRC's criticisms of the HL letters for not referring only to the specific transaction films does not recognise that Gala considered all the films on the slate

and refers to those which *may* be included in those that Gala might acquire. It makes sense that the composition of the slate was less important given that HL was commenting on the deal and on the overall package rather than giving detailed comments on individual films.

(3) The fact that HL did not refer to Big Fish in the 2003 HL Letter was discussed at the meeting in November 2003 and the members decided to go ahead with that film.

(4) Mr Yusef was clear that HL's opinion on the profitability of the slate was critical to Gala. If HL was wrong, in a sense that does not matter; the important thing is that Gala had every reason to believe that it was possible to make a profit.

395. We accept that the fact that HL may not have included all their workings and specifically reflected the work that took place behind the scenes in the HL letters does not necessarily of itself undermine the value of the opinion expressed in them. However, we do not accept that the fundamental issue with the scope of the HL letters identified above can be explained away by this and/or by Mr Vallat's other points. We cannot see how a serious, realistic appraisal of the deal or the overall package and of its bottom line position can be based on anything other than an assessment of both (a) the prospects of *the particular transaction films* generating Gross Receipts, and (b) whether and to what extent Gala was entitled to Gross Receipts expected or estimated to be generated *from those particular films under the actual deal terms*.

396. We do not accept HMRC's submission that, given the difficulties HL faced and the terms of the HL letters, logically HL must have been looking only at scenario 1 and so, basing its view entirely on the receipt of the Minimum Sums, without any assessment of the Gross Receipts position. As Mr Vallat said, it would be very surprising if a reputable firm such as HL had in fact only looked at scenario 1 given (1) HL said in the HL letters that it was assessing profitability by reference to the economic performance of the Slate (as they expressly stated as assessed by comparison with other films) as well as taking account of the Minimum Sums, (2) the opinion related to the period after the first cycle which scenario 1 does not materially address. We consider, therefore, that it is likely that HL considered what Gross Receipts "the Slate" may generate but that still leaves all the problems with the HL letters identified above.

397. Finally, we note that Mr Ackerman was very clear that his role was distinct from that of HL. His role was confined to looking at the transaction films' prospects of success in terms of generating Gross Receipts. His role was not to assess the likelihood of Gala receiving a share of such receipts or what level of share it may receive under the terms of the waterfall. Mr Yusef's suggestion in his witness statement that Mr Ackerman reached a view in relation to the profitability of Gala, which he repeated at the hearing, is not correct as he eventually accepted. Therefore, whilst we accept that Mr Ackerman provided input on the likely commercial success of the transaction films, we do not find that he had any input into what level of Gross Receipts needed to come through the waterfall for either Gala or the members to make a profit.

Evidence of Mr Summers

398. Mr Summers said the following in his witness statement:

(1) He signed the pack of documents relating to his admission to Gala on 15 January 2004 and they were received by Gala on 20 January 2004.

(2) He thought that the 2004 HL letter must have been sent to him on or after 30 January 2004 and that he went through it at the time because he considered it to be important, given it was giving an appraisal of the likelihood of him making a return:

(a) He found that it added further credibility to what he had already seen of the Gala opportunity, because it looked official and legitimate.

(b) He saw that there were some films considered with major blockbuster type star names lined up to star in them (Kate Beckinsale and Jack Nicholson stood out) and thought the conclusion that HL came to was very encouraging.

(c) He noted that Gala had the opportunity to choose the films it purchased thus giving Gala the opportunity to try to pick the best films.

(d) He concluded that credible people within the film industry had high regard for the Gala film investment.

(e) Having already seen the financial projections elsewhere from the scenarios in the IM, he did not expect HL to provide any deeper analysis, because he assumed that there was some cooperation or communication between the various parties. In his opinion, the letter was meant to be an opinion letter rather than a full report with diagrams and detailed analysis. As such, he did not expect it to be anything more than a fairness opinion type of letter, but it still gave him comfort that he might make some money out of his investment.

(3) As regards the other documents:

(a) He did not recall reviewing the transaction documents in any detail as there was a lot of paperwork involved and he very much assumed that people know what they are doing when they set one of these things up, and that the people involved were credible professionals in their relevant field.

(b) He thought he saw all 3 legal opinions but only took a cursory glance through one because he trusted the credibility of the legal professionals involved and the tax mechanics were above his understanding. Really, the opinions that he reviewed simply served to confirm to him the validity of the Gala film investment.

(c) He recalled receiving film scripts but could not now recall which films they were for. He did not review them before deciding to invest as he understood that there were other people involved with the requisite expertise to carry out the review. To this day, he has not read a screenplay and did not consider himself to be in any position to review one and predict the success of a film based on it.

(d) He signed and returned the acknowledgement on 29 January 2004.

(4) He did not attend the meeting held on 2 February 2004, as he understood that it was only held formally to admit members and all the documentation had already been filled in to enable him to join.

(5) As regards his on-going involvement:

(a) At the time, he was not very familiar with how companies and partnerships are run and he did not think he would be actively doing anything such as choosing films or making decisions. He saw his role as providing the capital and participating in the upsides and downsides of it. He was aware that there would be a minimal degree of involvement simply as part of the mechanics of the LLP.

(b) He was not aware of Mr Ackerman or his involvement in Gala, and he did not receive anything that showed his involvement. He understood that Invicta was acting on behalf of Gala as its agent, such that there were things that happened behind the scenes that he did not know about.

(c) He did not expect or have any inclination, to be involved with selecting the films, as he did not have any specific interest in, or experience to judge,

films. Aside from the flurry of activities that took place from when he was first introduced to the Gala opportunity until he filled out the paperwork to join Gala, his involvement in Gala was minimal. He attended a Gala meeting at Invicta's offices and otherwise, apart from receiving regular minutes of meetings and signing proxies when the option arose, he was not actively involved with the partnership.

(6) He now very vaguely remembers the decision being made to extend the time limit for Sony to exercise the option. He would say most of it just passed by in a flood of noise and he frankly had many other much more urgent matters to deal with. This completely slipped his mind at the time, and for some time afterwards.

399. At the hearing, Mr Summers agreed that, when he signed the admission form and related documents, he was not in a position to know what the split of revenues would be or how likely revenues were to arise but said that he did not think that concerned him unduly. It was put to him that he was unconcerned because he had the certainty that the tax relief would produce a return for him come what may. He said: "no":

> "I think it's also that when you work in the financial markets, a lot of transactions proceed in various milestones. You can never know everything. It's impossible to know everything. As a passive investor in an LLP....I am never going to know everything about everything. I outsource trust to people…So there is a natural process of coalescence that comes in when a transaction proceeds…
>
> I was also not too concerned unduly, because I figured I knew enough, but also…there had obviously been a previous closing. So in the financial markets you would always rather go in for the second closing, because other people have already...provided some evidence that you're not thinking of doing something silly..'.

400. When it was put to him that the tax relief gave him comfort that he did not need to know these other things, he said "That's definitely part of it...I probably didn't read all of the [IM], certainly not in the detail that you are quizzing me about" but he remembered reading that Mr Yusef has a wealth of experience in the film industry and thinking to himself "Gosh! This person and these people know what they're doing" and they have been involved in some films he had heard of and in transactions totalling £800 million.

401. Overall the above evidence and that set out below demonstrates that Mr Summers had little interest (if any) in Gala's prospects of receiving Gross Receipts. We note that (1) Mr Summers went ahead with his investment in Gala by signing his acknowledgement before he had received the 2004 HL letter, (2) he did not attend the meetings on 2 February 2004, (3) he seemed to regard the 2004 HL letter as important in demonstrating the "credibility" of the arrangements whilst acknowledging its limitations in providing him, as an investor, with meaningful information, (4) he did not pay much attention to the other documents sent to him prior to those meetings, and (5) took comfort simply from the fact that others had already invested on the first closing and relied on the "experts" involved to deliver a return for him. In more detail:

(1) He confirmed that he would not have had the 2004 HL letter any earlier than 30 January 2004 and agreed he did not have it when he signed the admission form or the acknowledgment on 15 and 29 January 2004 respectively. His only recollection is that he received a large box and there were some film scripts in there.

(2) It was put to him that realistically the HL letter cannot have given him any comfort, as he did not have it when he signed up unconditionally on 29 January 2004. He said it gave him some additional comfort as (a) it referred to actors he

had heard of, and (b) he made his decision to invest in Gala "on the basis of the calibre of the people that were involved and what they were trying to do. This letter on very professional looking notepaper from a top investment bank/financial adviser "certainly is a very good sort of additional item to have" and it certainly made him feel more comfortable about what he was doing.

(3) He was asked if he took the view that the HL letter was about whether he would make a return as opposed to whether Gala would make a profit. He replied that he did not think it was that sophisticated. It was "more an illustration that we were engaged in a business that was credible, had structure and there were real people involved" both in terms of HL, whom he had heard of at the time and some of the actors and actresses. He added that he used to live in Japan between 1997 and 2000 and Sony, at the time, was probably in the top 5 biggest Japanese companies on the stock market and "everything that I read in here as a generalist tells me credible, credible, credible".

(4) He agreed that the HL letter was a very high-level letter and said that it obviously was not referring to his own specific financial outcomes. He thought it is fair to say, as regards any investment in the film industry, an investor would invest in a film that stars well-known actors rather than people you had never heard of.

(5) When it was put to him that the HL letter is not focused on the specifics of the transaction and the relevant films and does not assist with the prospects of the particular films in generating revenues or profits he said it does not address that directly but "just shows that a very well-respected investment bank thinks that what we are doing is sensible and that Sony Pictures is engaged actively with Gala in choosing a slate of movies. I don't think it's meant to be a financial projection, no."

(6) He was not sure when the other materials arrived. He said that he definitely read the basics of the transaction documents, although he would have only done what was required to confirm his participation. He thought to this date he had never read any film scripts. He confirmed what he said in his witness statement on this and commented that generally, at that point, he was dealing with a lot of paperwork every day and was in the habit of dealing with it quite quickly.

(7) It was put to him that he did not review the documents because he did not need to worry about the splits of revenue or the prospects of revenue arising as he had the comfort in his mind that, come what may, the tax relief would produce a return for him. He said he thought that is a partial answer, but that is not all of it. He vaguely recalled there is an element in the IM outlining fees that go to certain groups that are part of the promotion of the investment. He said that those people were effectively paid to handle the transaction, produce the transaction documents, provide the legal opinions, choose the films and manage the structure. So the tax relief was part of it, but he thought the films would be fun, he had never done anything like this before, it seemed credible, other people had done it and other people were being paid to do the relevant work:

> "It really felt like it had some structure and substance. Now did I take a lot of that on trust from a general awareness of what was happening? Yes. Did I spend 500 hours examining every transactional document and cashflow? I admit I did not, but I tend not to do that in any of the investments I do, and…In any investment I make, unless I am managing it myself,...I'm relying upon the people who are involved to do what they say they're going to do and do the best they can for the investors. So, you know, at a certain point I can never

know as much as other people about this, because it's not my speciality. You have to bet that the people who are doing it know what they're doing."

(8) When it was put to him out that there were 2 meetings on 2 February 2004, he said he stood by his comment in his statement; he was assuming that his admission to the partnership, with others, was a relative formality and he imagined that the partnership business would proceed accordingly. It was put to him that he did not attend because he wanted to sign up to the scheme, sit back and eventually the tax relief would roll in. He said he thought the process of Gala would continue, there were many members other than him, there are LLPs or situations he has been involved with that "would not jump through quite as much documentation as this…this is a decent amount of documentation to evidence the activity of an LLP in my eyes." He added that, in reality, he was just one of many people so maybe there was a bit of laziness, but also his own personal presence or not was not going to be the ultimate decision on what Gala did or did not do on that day. He noted that at LLP meetings, quite often most people attend either virtually or by phone.

Section 14 - Ongoing activities

Evidence of Mr Yusef

402. Mr Yusef said in his witness statement that the business of distribution of films is "primarily back-ended" in that a large part of the business activity begins after the signing of the documentation. Once the transactions had been completed "LBPC's substantive work on behalf of Gala and relating to the successful distribution of those films commenced, and there was a significant effort carried out in that regard". He said that the Plans are continually monitored and changed throughout the distribution process to ensure that the expenditure is used to maximum effect to increase the performance of, and therefore revenue generated by, a film. He then went on to describe what he considered LBPC/Mr Ackerman did as part of this process, and to give a description of the only other relevant activities he identified, namely, that (a) Mr Ackerman checked that proposed expenditure was in accordance with what had been agreed, and (b) dealt with invoices for the payment of sums from the expenditure account.

403. Before turning to the detailed evidence, we note that:

(1) As set out above, we do not consider that, under the terms of the DA, Gala had any meaningful contractual right to participate in the distribution process.

(2) Whilst both Mr Yusef and Mr Ackerman gave lengthy comments on their activities in their statements and at the hearing, much of this is vague and unparticularised with a lack of any specific examples of what input Mr Ackerman/LBPC and Invicta had in relation to the distribution of the transaction films or what meaningful consequence any involvement in discussions with Sony had for Sony or Gala.

404. Mr Yusef set out that:

(1) Once LBPC reviewed and approved the Initial Plans in the December letters, LBPC (a) met Sony on at least a weekly basis for an initial discussion in relation to any variations to the original plans and to suggest changes to the Plans; (b) discussed media slots with McCann Erikson, Deluxe Laboratories and Manning Gottlieb OMD. These are advertising agencies based in the US, Canada and UK respectively that handled media buying on behalf of Sony and held accounts with major print publications and television stations; (c) reviewed the amended Plans, as revised following earlier discussions with Sony; (d) reported back to Invicta to either approve (for the most part) or reject (on occasion) the

revised Plans; and (e) reviewed and approved the significant volume of invoices received by Gala to ensure that they were in accordance with the Plans and budgets.

(2) Invicta continued performing tasks on behalf of Gala until the Call Option was exercised. For around 6 months after the transactions were completed, Mr Yusef was completely preoccupied with Gala and estimated that activities for Gala took up around 6 hours, or 80%, of his working day.

(3) Mr Ackerman reported to Invicta on the Initial Plans and on the on-going review process as regards variations to the Initial Plans and regularly reported back to Mr Yusef.

(4) Mr Yusef was in near-daily contact with Mr Ackerman in LA during that first 6 months or so after completion of the first transaction. Typically, on the day of a meeting that Mr Ackerman had with Sony to discuss variations to the Plans (or the day after), there would be a call around 3pm UK time (7am LA time) so that Mr Ackerman could explain what the meeting was about, and a call around 11pm or midnight (2pm or 3pm LA time) for him to report back on the conversations that took place at of the meetings.

(5) Mr Ackerman would go through in some detail any changes that were proposed and why, his responses and suggestions to Sony relating to those changes and what changes had been discussed and agreed in principle. Whilst Mr Ackerman had Gala's authority to propose changes which he considered would better market the films, he required final sign off by Mr Yusef on behalf of Gala before approving any changes with Sony.

(6) Mr Ackerman was required to report back to Sony on his discussions with Mr Yusef at subsequent meetings. Assuming that the amended reports were in accordance with what had been discussed and verbally agreed, the process was that: (a) Mr Ackerman would write to Mr Yusef with a memo or report to confirm what the proposed changes were and provide his comments on them. Invariably (but not always), Mr Ackerman's recommendation would be to approve the variations; (b) Mr Yusef then reviewed the proposed variations to ensure that he was ultimately satisfied with what was being proposed and, as Mr Ackerman and he had already reviewed and verbally agreed the changes, invariably he then confirmed to Mr Ackerman in writing that the proposed amendments to the marketing budgets were agreed; and (c) Mr Ackerman would write to Sony to confirm that the proposed changes to the marketing budgets were agreed by Gala, and Sony would then action the amendments to the Plans.

(7) Mr Yusef exhibited what he put forward as 3 examples of this process. He said that he received over 60 reports or memos from Mr Ackerman in which, following a series of discussions with Sony, he recommended amendments to the Plans. He did not think that these were major amendments. Had that been the case, it would have been evidence of failings on Sony's part in drawing up the Initial Plans (and, therefore, on Gala's (and Invicta's) part in agreeing to a deal with Sony). They were:

> "after all, the most successful studio at this time. However, as is typical in the industry, the marketing plans did require discussion and tweaking as the public's reactions to the films could be assessed, and Gala's role (via Mr Ackerman) was to actively work with the studio to get to a position where both parties were in agreement with the proposed changes and spending commitments to maximise revenue and we were adding our experience to the process."

(8) Invicta would not always agree to unilateral changes proposed by Sony. The Secret Window letter is an example of Mr Ackerman being concerned that the Plans exceeded the film's commercial potential: "I recall that we agreed with Mr Ackerman's recommendation and did not agree for Gala to incur the additional expenditure. Whilst this is the only specific example that he could recall this is not unexpected because: (a) Sony are experts in the field (which is why we selected them) with access to a lot of real-time data and, therefore, "we would not expect to disagree with them often in relation to marketing changes (despite Mr Ackerman's own expertise) and it was a collaborative effort to get things right"; and (b) secondly, although this is the only example in writing, Mr Ackerman would already have taken part in earlier meetings with Sony whereby:

> "I expect that he would have discussed and likely pushed back on suggested amendments which would likely have resulted in changes by Sony that were agreeable to him."

(9) Once any amendments to the Plans had been approved by Gala and the service providers had incurred the expenditure in accordance with those Plans, Mr Ackerman received at the LA office the invoices relating to that expenditure. Thereafter, Mr Ackerman's role was to review the invoices, carry out a reconciliation exercise to ensure that they had been incurred in accordance with the agreed expenditure and report back to Invicta with a request to pay. Mr Buckley and he then carried out a further reconciliation exercise before any money left the relevant bank account of Gala, to satisfy themselves that what was being spent was consistent with what had been agreed.

(10) Sony was also a signatory to the expenditure account to provide Sony with the comfort that the money was in the account and was available before they committed to a significant outlay. Once all was approved, he would authorise Gala to make the payment.

405. The exhibits Mr Yusef referred to are an incomplete record devoid of context from which we derive little assistance. They show merely that (a) Mr Ackerman passed information to Invicta on what Sony was doing in relation to the distribution of the transaction films, (b) on one occasion he made *unspecified* recommendations, which Invicta "approved", (c) on one occasion Invicta "approved" Sony's unspecified recommendations, and (d) on one occasion Invicta "approved" a matter which Mr Ackerman said already fell within the previously approved strategy:

(1) A one-and-a-half-page memo dated 1 March 2004 from Mr Ackerman to Invicta (copied to Gala) in which he said that he had met with Sony that day, gave brief details of earnings, expected earnings and major spending on distribution expenses as regards the first transaction films and said there were no marketing changes to discuss.

(2) (a) A letter dated 17 March 2004 from LBPC to Invicta in which Mr Ackerman said that on 15 March 2004 he sent Invicta a memo in which he made a number of recommendations in connection with SPE's distribution of the first transaction films and asked for Invicta's approval for confirmation to SPE, and (b) letter dated 18 March 2004 from Invicta to LBPC in which Invicta confirmed approval. The memo of 15 March 2004 referred to was not exhibited so we do not know what recommendations were made.

(3) A letter of 19 March 2004 from LBPC to Mr Litt confirming on behalf of Gala that "we are in agreement with the recommendations made by SPE on 1 March 2004 in connection with the distribution expenses for the first transaction films". Again, we do not know what the recommendations were.

(4) (a) A fax dated 5 April 2004 from LPBC to Invicta in which Mr Ackerman said:

> "Please note the attached spending option for Fifty First Dates for the week of March 8 2004. SPE held a savings of $661,000 prior to the weekend of 03/05/04. My analysis of these minor marketing adjustments show that these developments fall within the previously approved distribution and marketing campaign strategy for this film.

(b) A letter dated 7 April 2004 from LBPC to Invicta in which Mr Ackerman asked for approval of recommendations made in the earlier fax.

(c) A letter dated 8 April 2004 from Invicta to LBPC in which Invicta confirmed approval and a letter from LBPC to Sony confirming on behalf of Gala that "we are in agreement with the recommendations made by SPE in the Spending Options on March 5 2004 in connection with distribution expenses for Fifty First Dates".

406. Mr Yusef said that Invicta also had the following activities:

(1) Invicta managed the process of receipt of the SG loans into the account of Gala in respect of each of the separate transactions and arranged for the licence fees to be paid by Gala.

(2) Invicta personnel drew up the necessary accounts and financial statements. Mr Bold of SFP facilitated the accounting process and carried out an "audit" of the business activities of Gala and LBPC.

(3) Invicta remained in contact with members for the duration of Gala. Some members were more actively involved than others. For example, some members simply wanted to know things were going well at every year-end. Others, such as Mr Cadogan and Mr Thacker, were deeply involved and we would often deal with queries they had. Mr Thacker, in particular, was very interested in the process and keen to learn, and would often be influential in terms of explaining and reporting back to the other members.

(4) On behalf of Gala, Invicta also instructed MRI Moores Rowlands (which merged business with Mazars with effect from 16 April 2007) to audit the annual financial statements at the end of each financial year.

407. At the hearing, Mr Yusef gave the following evidence about the role of Mr Ackerman under cross-examination:

(1) He said that Mr Ackerman was engaged by Invicta pursuant to the contract but that Invicta acted as an agent for Gala in doing so (as provided for under the MSA) and it was always understood by the parties that his services were rendered to Invicta, acting on behalf of Gala.

(2) It was put to him that (a) the Secret Window letter does not illustrate that Gala rejected a revision to a previously agreed Plan and (b) there is no documentary evidence of any other such instance. He said that the Secret Window discussion was a rejection of a suggestion that a Plan be varied upwards. He reiterated that the Initial Plan had been agreed at that point because it was the subject of numerous discussions between Invicta and Sony. It was not just produced overnight. The marketing of a film occurs over a number of months and there would have been weeks of discussion prior to 2 December 2003 when the Plan was in formal agreed form. The contract simply memorialises what was actually being agreed by the parties. He said that he used the term "for example" in his witness statement as regards Secret Window as an illustration of the point he was making, namely, that the situation was capable of rejection. He did not

mean that there are hundreds of other examples. He agreed that there was no other example in the evidence provided to the tribunal.

We note that it is plain that the Secret Window letter does not provide an illustration of Gala rejecting a proposed change to a previously agreed Plan (see section 13) and, as Mr Yusef agreed, there is no such other example.

(3) It was put to him that he was speculating in his comment that Mr Ackerman was likely to have pushed back on amendments to the Plans suggested by Sony. He said (a) this comment reflects his understanding of what happened, as based on the daily conversations and the oral reporting that took place after the meetings, (b) much of what occurred in the meetings was based on a collegiate and joint affair, nobody had a "green light power", it was a consensual situation, and "knowing the realtime reporting that I was given, it is more than a presumption or an assumption as to what happened", (c) Mr Ackerman was very active, very well respected and was listened to and Mr Litt, who originally was resistant to Mr Ackerman being involved, remarked on a number of occasions that he "really knows his stuff" and that Mr Smith got on with him. He based his statement on what he understood from Mr Ackerman and Mr Litt. His response, therefore, lacked any specificity as to what actually occurred, he provided no specific example of any "push back" and overall it adds nothing to our understanding of whether and how (if at all) Mr Ackerman contributed to the "collegiate" and "consensual process".

(4) It was put to him that any discussions Invicta had with Mr Ackerman about Plans or amendments to Plans were without consequence, practical import or reality, and there is no evidence to the contrary. He said that he did not accept that for the reasons he had already given,

(5) and that the back-up evidence is:

> "the work that we did prior to the start of the theatrical release of these pictures, the analysis that was made in relation to which pictures out of the overall portfolio of Sony films should be selected to form the slate, the analysis that was undertaken on our behalf by Mr Ackerman, the appraisals that were undertaken on Gala's behalf by [HL], the daily interactions that Mr Ackerman had not only with Sony, but also with the agents that were working to book the slots. There lies the evidence. The degree of work that Mr Ackerman, for example, undertook was not a cursory thing. It's true to say that he was and is a very well-known person within film production as well as film distribution and the work is there to see. It is represented in the fact that there's a huge amount of written material, particularly in the form of the purchase orders, the invoices, all of which were available on many, many occasions to HMRC, and that represents that body of documentation, which….is huge. It is not one or two boxes. Therein lies the evidence. Therein lies the result of all of the work that culminated in the expenditure being incurred and in the invoices being rendered in the name of Gala. That is a complete answer to your question."

We comment elsewhere on the lack of any serious appraisal by Gala/Invicta of Gala's prospects of making a profit from the transactions through the receipt of Gross Receipts and the limitations and/or inadequacies of Mr Ackerman's letters and the HL letters (see sections 3, 6, 12 and 13). Otherwise, the work which Mr Yusef asserts is there to see amounts simply to the invoices which Mr Ackerman reviewed to check that sums leaving the expenditure account related to approved Gala Expenses.

(6) It was put to him that, on a realistic analysis of the facts, Sony marketed and distributed its own films acting on its own behalf, not as agent for Gala, in the same way as it would have done had Gala not been involved. He said that is

not true: Sony could only secure the amount of money that Gala put in and hoped to put in, if Gala was actively involved in that transaction:

> "we demanded, and we got a meaningful engagement at the highest level with the studio, and it wasn't so much what benefit that had to Sony. It was a condition precedent to the deal actually happening. Sony agreed it because they knew they didn't have a choice."

In our view, the terms of the deal with Sony speak for themselves; for all the reasons set out in section 9, Gala did not have meaningful contractual rights to participate in Sony's marketing and distribution of the transaction films. Moreover, as set out in section 2 and 10, we do not accept that Sony entered into these transactions for the purposes of securing funding for its distribution expenses; in fact, it did not receive any such funding.

(7) It was put to him that if Gala or Invicta had contributed anything consequential, substantive in relation to the distribution and marketing of Sony's films, there would be something in writing emanating from Sony. He said: "That is not the way that the film industry at any level works, particularly when dealing with a fast-moving dynamic situation." The fact that the discussions are not documented does not mean they did not take place. He emphasised that it is not possible for the work that was undertaken by Invicta to have occurred overnight. It was the result of many weeks, if not months, of meaningful discussion and agreement by consensus of which Mr Ackerman was part. It is very rare for there to be conflict, particularly where the parties chose each other. There's no written evidence from Sony as to the extent of the work that they did to get themselves comfortable with Mr Ackerman's involvement, but that does not suggest that it did not happen. It's illogical that it would not happen. They were not used to people coming to them in this way. They were entitled to be a little bit apprehensive about it and the fact that they got themselves comfortable without any written minutes or whatever is not surprising, because that's how it works.

We accept that, the fact that there is no written record or communication from Sony does not necessarily mean that there were no meaningful discussions with Sony. However, we find it surprising that a major commercial group such as Sony would not engage in any written or email correspondence with a counterparty at all, if it was relying on that counterparty to provide meaningful input into its distribution and marketing activities.

(8) It was put to him that his comment that Mr Ackerman reached the same conclusion as HL did in their reports is not correct in light of Mr Ackerman's evidence on his role. He said that it was true that Mr Ackerman was not involved in negotiations for the waterfall but he did believe that he had some knowledge of the profitability position, "but more importantly, he had his own access to the same data that HL would have received from the studio….he would have had access to the draft marketing plans in various iterations. He would have had access to the other documentation that he himself referred to. So he could make his own independent judgment independent of HL as to whether these were films that Gala should had been involved with". He meant in his witness statement that Mr Ackerman had access to data that would have allowed him to reach certain conclusions in terms of which film should be selected from a profitability point of view. In terms of a detailed analysis of the profitability of the films as they relate to Gala, "we relied on [HL's] analysis, which would have included an analysis in relation to the waterfall. He then agreed that was not what Mr Ackerman was doing.

408. As regards Mr Ackerman's role in relation to paying invoices:

(1) Mr Yusef said that Mr Ackerman's role in coordinating payments from bank accounts and facilitating payments of invoices is "a natural function" which arises from Gala's activities: "They're partly administrative…we needed to ensure…that the films that the partnership was licensed to exploit were the films that the expenditure that we were paying related to". It was critical as studios have maybe 25 or 30 films a year that they are pushing through their pipeline and often expenses for one film end up quite by accident into another; "It is a huge part of the trade that we are involved with".

(2) He did not agree that all that happened was that the name on the invoice changed from Sony to Gala. He said there was a commitment made by Gala to spend a significant amount of money on films they actually owned for a specific purpose. The actual business of whether the invoice said "Gala" as opposed to "SPR" was not an administrative function but the personification of the correct allocation of expenditure. The administrative function "was to make sure that the expenditure that was referred to was correctly allocated to the party that actually incurred that expenditure. It's very important."

409. Mr Yusef later said that (1) Invicta was engaged as the agent of Gala to conduct a whole range of services to do with Gala's trade, one of which was to engage not just LBPC but a number of agencies and entities to perform numerous services, (2) the services that were rendered "to us by Mr Ackerman and [LBPC] were at all times on behalf of the partnership", (3) the work undertaken by Invicta and Mr Ackerman was of significant consequence, not least of which is that the studio had to perform in the way that was contemplated in the DA: "A factor which is not to be considered insignificant is that Gala had a very, very deep transparent understanding of the minutiae of this transaction in a way that was unique. No other transaction that has been undertaken by high-net-worth individuals coming together in a partnership had achieved that level", and (4) it is noteworthy that this transaction is not "another tired old tax scheme, like Icebreaker, like Ingenious, like a whole slew of transactions that have come to the courts". It predates those transactions and:

> "We weren't a copycat. We were the first. There is a fundamental difference between us, Gala, and Ingenious and Icebreaker....we didn't just enter a whole bunch of transaction documents and then wait for the outcome. We were directly actively involved in the business and trade of film distribution in a way that marks Gala as being fundamentally different from all these other transactions."

We note that Mr Yusef here provided no real explanation of why Invicta's and Mr Ackerman's activities were of significance or what Gala's asserted deep understanding of the minutiae of this transaction achieved for it or Sony.

410. In re-examination, he made the following points as regards Gala's activities:

(1) When asked to explain how the Initial Expenditure was allocated between the transaction films. He said that the amount of money available to Gala was finite and:

> "our desire to ensure that we actually ended up being involved in all of the films...would have governed more than anything else how much was allocated to each of the films. We wanted to make sure that all of them were covered, because, contrary to what has been asserted, cross-collateralisation can work both ways. It can work against you and it can work for you. It is not just a one-way street."

(2) He added that obviously, the starting point was how much initially Sony proposed to allocate in the draft Plans because one of the attractions of being involved with Sony was that they have a very sophisticated distribution apparatus and enjoy great relationships with all of the parties that supply the relevant

services. Mr Ackerman would have been given access to that and it would then be the basis for the discussion at the distribution meetings.

(3) Those distribution meetings, which included at all material times Mr Ackerman, would have consisted not only of people directly involved in the marketing department, but also representatives of the studio across the board who had any interest in the outcome of the movie. It was a high-level meeting of decision makers:

> "for us to have access to that meeting was unique. As far as even today, almost 20 years later, I don't think that there is anybody that has access to those kinds of meetings. During those meetings, no-one person, including Paul Smith, (the head of marketing and a very key and powerful figure in the studio) did not have what they call a green light capability. It was a consensus forum. Mr Ackerman was part of that consensus."

(4) Prior to entering into the DA, "there was significant resistance from the operatives within the distribution company to the idea of somebody else coming along and being involved in that process" given it had never been done before. The sort of information that Mr Ackerman and therefore Invicta had prior to the release of the picture, was "commercially hugely sensitive". There was also resistance to Invicta wanting an appraiser to have access to the same information that Mr Ackerman had access to. But when Invicta suggested HL they agreed to give them prime access to that documentation because HL maybe the year before that, had done a huge transaction where they had access to the kind of information that we were now asking them to have in relation to this slate.

(5) Then, through various meetings, following which the Plan was set, and then thereafter during the distribution process for each film, there would be meetings of 2, 3, sometimes daily meetings, and Mr Ackerman would be involved with those and would have had access to exactly the same information as anybody else in that room. His views were not just given lip service to:

> "I do recall when I sat with Mr Smith and a couple of other of his colleagues, when Justin wasn't there, and I did make some enquiries. It was quite clear from the way they were talking that they didn't treat him as a nuisance. They didn't treat him as anything other than a professional person who was, you know, making a contribution. So that was the process within the distribution..."

Again, the fact that Mr Ackerman was able to attend meetings at Sony, that those meetings were a consensus forum and the assertion that his views were not just listened to adds nothing material to our understanding of what, if anything, Mr Ackerman actually contributed to the distribution process.

(6) So how much was allocated for distribution for each film was a process that started with Sony and was a function of ensuring that the finite aggregate amount was split so that "all of the movies that we had identified would be funded by us in the way that was contemplated". He repeated his views on cross-collateralisation and said it is "definitely preferable, as a financing tool, to invest in a slate or portfolio of films which are cross-collateralised than it is to invest in a single picture by picture process. That is conventional wisdom in the movie business".

(7) The distribution report of 1 March is a breakdown. In effect, it is a note or a minute of a meeting, and it deals with each of the films in question, as a way to update Mr Bamford and Mr Yusef as to where things were going. The norm, however, would be that this kind of discussion would take place almost on a nightly basis, and more often than not, twice a day (as already set out).

411. For the reasons set out in section 13, we do not accept that (1) how much Initial Expenditure was allocated to each particular film affected Gala's commercial position, and/or (2) in these circumstances, there had to be an exercise to work out the allocation to ensure that Gala was involved in all of the films because "cross-collateralisation….can work against you and it can work for you". As set out in section 13, the allocation of Initial Expenditure between the transaction films was meaningless and could not affect Gala's position under the waterfall.

Mr Yusef's evidence on LBPC/Mr Ackerman's role after the termination of the LBPC Agreement

412. Mr Yusef confirmed (as did Mr Ackerman) that Mr Ackerman's role was terminated at the end of December 2005, 6 years before the end of the term of the DA, only 2 years into the first of the 3 cycles and, almost half a year before arrangements with Sony were brought to an end. He did not agree that this makes it clear that he was expecting Sony to exercise the Call Option in a few months' time or that it shows that Mr Ackerman's role had no consequence.

413. As regards the points on the exercise of the Call Option:

(1) He said he was not expecting Sony to exercise the option in 2 years' time and that the reason for terminating Mr Ackerman's role was that "we were very conscious of the financial position". He noted that (a) at the beginning Mr Ackerman worked substantially without a formal agreement, on the understanding there would be such an agreement should the transaction happen - so he did a lot of work then, which is quite common in the industry because the outcome is always uncertain and people "don't tend to engage in formal legal contracts until such time as things are certain", and (b) "we contemplated that this would be the first of many" and by "whatever date that we contracted we were not certain what the situation would be going forward", but, in any event, Mr Ackerman "continued to perform services for us for many months some time after the Sony contract was terminated" because:

> "at the point at which the option was exercised we didn't just shut up shop immediately…We continued with him and the lease for quite some time after that. I can't recall the date, but I have in mind that at least for one more year the offices were going and that Mr Ackerman rendered services in much in the same way that he rendered them outside of the contract in the early part. So what he did substantially wasn't tied to a contract either before or after the date of termination. He continued to do work for us, as I recall."

(2) It was put to him that Mr Ackerman's contract was not renewed because he knew that Sony would be pulling the plug shortly, that was always the intention and that was why he approved a lease on US premises for 1 year rather than 2 – hence, the revised lease ended on 28 February 2006, which was the original first exercise date. He said again that the reason for terminating LBPC's contract was financial:

> "No. The issue right from the very beginning was to control costs as much as possible...when we first started to talk about budgets with Mr Ackerman, the original first pass of the budget was much greater than we wanted it to be, but what he was suggesting was not unreasonable. It was just that some of it was a duplication of what we in London were doing or could do. For example, a lot of the accountancy work could and was done in London."

He added that it was perfectly normal to have a lease which was year on year. "We didn't know that the option would be exercised. It was not in our control" and "the intention of me, Mr Ackerman and Mr Bamford at the time that the lease

would be extended on a year-to-year basis….it wasn't tied to the option because we were not in control of that option."

414. It was put to him that the fact Mr Ackerman had no role, or at the very least, no contract from the end of 2005 demonstrates that his role was not necessary. He said:

> "we would not have recommended the transaction going forwards unless we could find somebody of Mr Ackerman's calibre, and there are many people of Mr Ackerman's calibre that we could have found, but none that I personally could trust…at that time I knew him quite well. It was about 18 to 20 years. We shared the same values, the same experience. I trusted him and that was the reason why he was involved. His role was critical. We wouldn't have done that deal without somebody over there whom we could trust providing us with the real-time data and real-time experience that he provided. He certainly wasn't window dressing…".

415. It was put to him that in Mr Ackerman's witness statement he says the amount he was paid was less than he hoped for. He said that the figure was agreed to on the understanding between them that on an ongoing basis:

> "not only he but we would have the ability to renegotiate our deal, him in relation to his relationship with Invicta and us in relation to our arrangements with Gala. It is for that reason that he agreed that deal. If it was something which he knew or we knew was just going to be a short-term deal, he would either have not agreed to the level of fees that he did agree or he wouldn't have done the transaction. He believed, as did I, that the relationship would endure way beyond that, and certainly that wasn't a foolhardy belief at the time."

416. It was put to him that a serious business entity does not terminate the contract of someone carrying out a critical function. He disagreed because (a) by the time his contract was terminated the height of the distribution activity in relation to the expenditure, the selection of the slate, the expenditure monitoring, the dialogue with the counterpart, most of that, if not all of that, had occurred prior to that date, and (b) it is not preposterous for an entity that's engaged in a trading posture to try to limit its expenditure as much as possible. That's good business. He added that in any event his involvement with Gala did not end there:

> "I still continue to talk to him on a regular basis about Gala. We still harbour the belief and hope that we could continue the business within Gala in a slightly varied way. It took a long time after that to conclude that that was not going to be possible, but I think both what I am saying and what Mr Ackerman was saying is that the contract date doesn't reflect what happened after that."

417. He did not accept that had Mr Ackerman's role been critical, Invicta would not have terminated it mid-flow and it was terminated because his role was superfluous and not substantive:

> "It was substantive, particularly at the point at which the primary activity of the partnership took place...2 to 3 [days a week] is still a substantial element of his time during the height of the distribution process, and certainly there would have been weeks where he would have spent more time rather than less and…it is a matter of fact that the period after the termination date he nevertheless continued to work with us and to continue giving me and therefore the partnership advice on anything that may relate to the business. It was done so…on the understanding, as we had at the outset, that should it all evolve in a different way, that he would be compensated with a new contract that would be higher than the existing one to reflect the changes that took place. That's the basis upon which he got involved...Most people operate without a contract until the day that the money drops...I know that he rendered services to us. He did operate without a contract, but he did so in the hopes that what happened the first time would happen again…Your emphasis on the contractual dates misses the fact that the reality was

> that he had rendered services to the partnership prior to the contractual date and he rendered services to the partnership post the contractual date, and those services were significant and not trivial."

418. It was put to him that this all shows that there is no substance to the idea that Gala's activities amount to marketing and distributing the films and Sony marketed and distributed its own films on its own behalf using its very considerable expertise, its own marketing teams and its media buyers. He said that is not the position but put forward a legal argument rather than any additional factual information in support of his view:

> "It isn't a circular transaction…The rights that are granted to Gala are not simply funnelled down to SPR…you raised issues about the sequel rights, but that agreement would not have made any sense whatsoever unless it was the intention of the parties that Gala would have sequel rights and that the sequel rights would be on substantially the same terms as the rights that they had. The document makes no logic unless that is the case. Even if it was true that the correct interpretation of that contract is that the sequel option terminates after a certain date, even if it was a matter of weeks or months, that option is not a right that is granted to SPR. But more significantly, the term of the rights that are granted to SPR are years shorter than the rights that SPE grants to Gala. Gala ends up retaining as a reserved right those 2 bundles of rights, which is perfectly…what you would expect in the film industry, and at the end of the day Gala's involvement is financially recognised in the direct expenditure of distribution expense in relation to films that it had acquired and it had agreed to distribute and sub-distribute to Sony. That's how I understood it. That's how I believe it was. We paid a lot of money to some very experienced lawyers to reflect the arrangements that I've just stated, but certainly that's my belief at the time and it's my belief now."

419. It was put to him that (1) there is no way that Sony, a leading film studio, would allow Gala, a vehicle set up for the purpose of this tax scheme, anywhere near its meaningful rights, and (2) it would be madness or commercial suicide for such a studio to hand over control and meaningful rights, to a special purpose vehicle run by Invicta plus a collection of bankers who would like to pay less tax. He said that the members of Gala are not all bankers. Some of them are lawyers or barristers although he does not know the occupations of all of them. When it was put to him that the majority of the Referrers are bankers, he said "Well, that's a highly selected refined group" and suggested that it is of importance that, as he asserted, Sony wanted another party to meet the costs of its distribution expenditure:

> "you have to go back to the reason why Sony entered into this transaction in the first place. You have tried to suggest to me that the reason why it did so is for the studio benefit of $15 million. I have explained that that is what in America is called chump change for them. It's not a justification for them to go into the transaction. Why it does make commercial sense for the studio to get involved with us is because of the collateral benefit that it got from somebody else, in this case Gala, agreeing to spend distribution expenditure not on Sony's behalf but on its own behalf. The reason why the studio agreed to this structure is because it came to understand that's the only basis it could get somebody to spend this money…"

420. We note again that (1) we do not accept that Gala has established that Sony had any interest in anything other than the fee of £15 million it received for its participation in these transactions, and (2) the contractual rights in the DA speak for themselves; Gala simply did not have any meaningful rights.

421. Mr Yusef continued that he/Invicta/Gala were not saying that "Gala controlled these rights", rather that it "participated in the distribution of the pictures". He repeated that the way in which the transaction was structured with Sony was unique, Sony had never done it before and "no studio had done what we were asking them to do." Whether Sony had entered into such arrangements before or not does not inform our

understanding of what Mr Ackerman/LBPC/Gala did as regards the distribution of the films.

422. He repeated that Sony dealt with the distribution of films by committee, there was not one person who has the right within Sony to green light anything of any consequence and Mr Ackerman was part of that consensual process and there was a joint exercise in relation to the pictures within the slate. Again this does not inform us if or how Mr Ackerman inputted into the consensual process referred to.

423. He concluded that it was not commercial suicide, rather:

> "It was inherently commercially very logical, commercially logical for the studio to agree to the terms and conditions that we insisted on, and there wasn't really a major leap for them to do that once they got used to the idea that *we were not there to put their programme at risk, but to ensure that there were checks and balances to ensure that we weren't going to be paying for things that didn't belong to us. That was the biggest danger that we were looking to do.* So we were not saying "We control these rights". We were saying we participated in a meaningful way to protect our trading position."

424. Mr Yusef here appeared to accept that Mr Ackerman/LBPC's role was confined to checking that Gala paid for the correct agreed Gala Expenses, as accords with his evidence regarding the importance of Mr Ackerman's role in relation to the invoices.

425. In re-examination, he said the following as regards the termination of the LBPC agreement:

> "even though the formal contract was terminated, at that stage we were still hopeful that we would be able to continue in the format or a variation of that format. It was still necessary for us to have…Mr Ackerman on board, but not in a formal way, but my recollection is that the degree of contact that I personally had with him in relation to Gala, it wasn't as intense as a daily conversation, because, of course, we weren't in the distribution programme for any of the films. *But it was certainly regular and wouldn't be less than once a week. The conversations were detailed, to do with variations on the way in which this business was done.* He and I had hoped that we would continue much in the same way, that the period leading up to the December 2nd contract -- he did an enormous amount of work for Invicta, and therefore [Gala]….it wouldn't have been possible to enter into those agreements with the knowledge that we had without the work that was done, and that is the way the business works. It's highly speculative. So people don't normally commit until the piece of paper is there that funds the project. Films are made that way. Distribution deals are made that way, and ours was no different. The period after the end of the contract is really another phase that was very similar to the way in which we hoped it would work. *So the dates are less significant than what was actually done, and this is what that points to*." (Emphasis added.)

Whilst Mr Yusef here emphasised the importance of what was actually done, he again did not provide any meaningful description of what it was that Mr Ackerman actually did following the termination of the LBPC agreement. We have commented further on this evidence in our conclusions below.

Evidence of Mr Ackerman

426. In his witness statement Mr Ackerman gave a similar description of his activities and interaction with Invicta and Sony to that which Mr Yusef gave in his statement:

(1) The "vast majority" of his day-to-day work occurred in the months following the first and second closings and the "vast majority" of this work consisted of (a) agreeing revisions to the Plans with Sony, and (b) reviewing the expenditure incurred (to include receipt and review of invoices relating to the distribution expenditure) to ensure it was consistent with the Plans. On average

he would spend around 60 hours per film in considering and discussing all revisions to get to the final Plan. He probably spoke to Mr Yusef around 3 times a week as regards proposed amendments up to them being agreed by Invicta.

(2) He gave an overview of when revisions are required. The process would involve him being notified of Sony's proposed amendments to the Plans:

> "we had already seen and approved, me discussing those with Sony to ascertain what these looked like and why they were considered necessary, me proposing further revisions if I thought they appeared sensible and, once Sony and I had settled on what the amendments would look like, me providing written advice and recommendations when a decision as to how to proceed was required to be made by Gala."

(3) Latterly he was involved in reviewing and amending the home entertainment marketing plans but it is fair to say that his primary involvement related to amending the Plans.

(4) Sony had very sophisticated methods for reviewing the impact of their advertising campaigns and quickly reacting to ensure they were adapted to achieve maximum potential. Sony's marketing team carried out a significant amount of research prior to release and then constantly tracked the film's performance against expectation at a granular level and that data was used to suggest amendments to the Plans on the basis of how the film or marketing materials were actually performing. There has to be a continuous process as the information needed to refine the Plans would not be known when the Initial Plans were produced and Sony's sophisticated methods of constantly reviewing performance were part of the reason why "we" chose to agree a deal with them. Initial Plans generally need to be updated to take into account the success of films that are released at the same time in competition and of what is happening in real time with such films. The results of Sony's market research and success of competitor films were discussed at many meetings he had with Sony where he was provided with amended versions of the Plans to review and discuss with Sony.

(5) Meetings took place 2 or 3 time a week - they could go on for a number of hours. He sought clarification and used his knowledge to test assumptions that had been made, where relevant challenging proposed amendments. One of his primary roles was to monitor the expenditure Sony was planning to ensure that they did not spend more of Gala's money than was necessary and to challenge where any proposed spend did not maximise the commercial potential of a film. He also recommended his own changes to the Plans either based on the market knowledge that Sony had presented at the meetings or from his own experience. His intention was always to seek to incur the spend in a way so as to maximise the profitability of the film in light of the real time information available. He usually phoned Mr Yusef after the meetings. A single film can often go through up to 8 to 10 versions of amended plans – one of the reasons Gala chose to work with Sony was their agreement for him to be provided with full details of the Plans as they developed to comment on and to attend meetings.

(6) The final Plan that optimised the films potential was essentially a collaborative effort between him, the teams at Sony and McCann Erickson. It was standard practice at the time for the studios to engage such media agencies to oversee their bulk purchasing of media advertising capacity. Allocation of the available advertising space was something considered in great detail by Sony, McCann and him in preparing, adjusting and finalising Plans. He attended regular calls with McCann to discuss and agree the allocation of the media space between

the transaction films. McCann were very experienced and their feedback on the Plans was also very valuable in reaching final plans. His attendance on these calls ensured he was always involved, had visibility of the changes proposed and could provide his input. The revised media plans taking account of McCann's suggestions would then be circulated at the next meeting with Sony and he would (a) review these to ensure they accurately reflected the agreed approach on the calls and the advice of McCann, (b) if there was something incorrect or inconsistent, raise this with Sony and (c) also make any further comments where he felt that further amendments or refinements were required from his previous experience.

427. He also said there were more than 60 reports to Invicta and described the process with them as Mr Yusef did. He exhibited the following documents:

(1) Summaries which were used to track the information received in respect of each transaction film. He said these showed the significant amount of documentation passing between him and Sony and that Gala was keen to ensure that it had a full suite of information on which to evaluate and comment on the Plans and determine the appropriate level of investment for Gala. He thought he would have shared this with Invicta but could not be sure.

(2) A document relating to Something's Gotta Give which shows television expenditure broken down by various markets and a comparison with expenditure on other films. He said that (a) this shows the level of detail the Plans were broken down into and the data that needed to be obtained to monitor and adjust this, (b) due to the quantity of documents "we needed to establish a legal style filing system of our own" so that "we could locate and access all of various versions of the documentation provided by Sony at any given time", and (c) this was akin to the studio's own system. There was also a lot of work going on which is not reflected in the documents as the film industry is one where not everything is captured in writing. In re-examination, he said "this would reflect notes taken and made during meetings with the Sony team and that adjustments that are being discussed in connection with the marketing issues for" this film

(3) Preliminary media plans for Big Fish comprising 3 pages which had some annotations which he thought might be his notes from the meetings. He said he made recommendations on other documents relating to Big Fish which provide a detailed breakdown of the Plans for the film as well as home entertainment budgets, visuals and release plan breakdowns of the film production expenses and contractual information regarding the film's cast. He did not say what those recommendations were or whether or how Sony took his recommendations into account.

428. In re-examination, he was taken to a Plan for "You Got Served". He said that in the course of preparing for and during the release of any of the films there would be multiple variations and versions of this type of marketing plan. The differences between those iterations would be documenting and recording the type of expenditures in relation to the issues of tracking and performance he had mentioned.

429. At the hearing he was questioned about his/LBPC's capabilities compared with those of Sony and the media agencies:

(1) He agreed that (a) as one of the 5 major US films studios Sony is well equipped to monitor the impact of its marketing plans as he had set out in his statement, and (b) it was fair to say that the agents that Sony engaged added value to Sony, by giving Sony something that it did not have or could not do as effectively in-house. He added that this type of relationship came about as a result

of "Sarbanes Oxley" legislation in the US in the mid to late 1990s, which obligated the studios to change their accounting practices substantially. A solution that the studios came up with was to create an arm's length relationship with an agency. He considered that something unique about what he did which he is quite proud of is that, based on the strength of his relationships and having been vetted by Sony leadership, Sony were prepared to give him access, one on one, with McCann Erickson for him to ensure that there was accounting transparency in the spending that was being reported; this was unique and "quite important to the performance of my duties in endeavouring to maximise the...potential profitability of these films as it was being planned and adjusted and decided upon by the parties". Otherwise, he would only have had the figures that Sony gave him.

(2) He said that McCann Erickson was performing a function for Sony in light of Sarbanes Oxley legislation but Sony would have been quite capable of purchasing its own media spend had it wanted to. He agreed that Sony engaged McCann Erickson because that put them in a better position to distribute the films.

(3) He believed that he processed information on as efficient and timely a basis as he could as it was being shared with him by the Sony team and as it was being discussed in meetings with the Sony team.

(4) He agreed that his involvement in plans relating to DVDs was a slightly lesser element of his role. He explained that adjustments in home entertainment marketing decisions would be made in consequence of the theatrical performance results. Usually the more successful a film, the less marketing is needed in home entertainment.

(5) He agreed that Sony had a very substantial in-house expertise, know-how and resource in relation to marketing and distributing their films, they are well renowned and there is no point in being one of the biggest film studios in the world if you cannot distribute and market films effectively. He thought it was fair to say that a constant refrain in his statement is Sony's level of professionalism and detailed precision. It was put to him that his evidence is that Sony and the agencies were big, serious, multi-million or even billion dollar players at the top of their game in this area. He said that McCann Erickson is a media agency whose function in the context of this business was to pre-buy media on a bulk basis and understand where the availability is on a dynamic basis throughout the entire year, and thereafter advise its client and it is the "job of Sony studio's marketing team to decide how to allocate the media, the pricing of the media available to them at the time, and those were decisions that I subsequently participated in". He was introduced to McCann Erickson by the Sony marketing team and was given permission to have a direct relationship and direct communications with them on an independent basis without going through Mr Smith or Mr Litt.

(6) He agreed that Sony and McCann Erickson are serious players at the top of their game and LBPC was a very different animal and his engagement with Invicta was 2 or 3 days a week. He said that his comment in his witness statement that he estimated that at its busiest period around 75% of his working week was spent on Gala business and at other times approximately 50% is approximately correct. However, it varied week to week and he did not necessarily limit his work for Invicta to such percentages. Some weeks he would find himself working more. It was a decision that was again dynamic in discussions with Invicta. He agreed that, for at least some of the time, he operated entirely or predominantly from home using the mailbox drop but said that he was anxious to get into offices as

soon as he could and to establish correspondence for the company at the business address.

(7) It was put to him that in contrast to Sony and firms like McCann Erickson, LBPC was not able to bring something to the table that was in the same league. He did not challenge this and said that it was discussed at the time with Invicta and Mr Litt that it would not be either an efficient exercise or a wise financial decision for:

> "us to build up a marketing team that would be the size of Sony's own marketing team and duplicate those talents...That would have been very, very costly. It was understood that we would work with Sony's team, their expertise, their ability to collect and manage and display the amount of dynamic data in realtime of a theatrical release and leading up to such a release, and it was my job to analyse that data and to advise Invicta, Mr Yusef and Niall Bamford, on the contents of the various different plans. The adjustments were being made, and to seek their approval and transmit that approval in turn back to Sony, at which point Sony would then proceed with its specific plan or with adjustments in a given plan."

(8) He was asked if he was suggesting that it was even within the universe of real possibilities that LBPC and Invicta would build up marketing teams on a par with one of the biggest media organisations in the world. He said that one can certainly hire former studio marketing executives but that would not have been a sound decision for their purposes. When it was put again that this was not a real possibility, he agreed. When it was put to him that Sony would not come looking for a company like LBPC to help with distribution and marketing but would go to a major player such as McCann Erickson, he said that they would actually hire additional expertise on to their team.

(9) He agreed that (a) if Mr Ackerman and LBPC were removed from the equation, nothing would change in that the transaction films would still get made, marketed and distributed by Sony in accordance with Sony's marketing plans and with assistance from big media buyers in just the same way, and (b) regardless of the involvement of LBPC or Invicta or anyone with Gala, Sony would use its vast resources and expertise to market and distribute its films to the very best of its very considerable ability. He appeared to agree, therefore, that his involvement did not make any difference to the distribution process.

430. Mr Ackerman was questioned about the detail of what he actually did on an on-going basis once the transactions were completed. He did not provide any specific example of his input and the overall tenor of his evidence on this is that he monitored and transmitted information on the discussions at Sony as regards changes in the Plans, sought and transmitted Invicta's approval of such changes to Sony and kept a filing system of all the information he received from Sony:

(1) He agreed that there are no examples of him making recommendations or comments or providing input as necessary in the bundles. He added that there was (a) actually an enormous amount of documentation and flow of information between Sony and the office of LBPC which had, as was built on week to week, essentially a duplicate filing system, in a very similar way to that in which the studio had for tracking and decision-making, pricing and so forth, and (b) certainly a significant flow of information, phone calls and so forth between him and Mr Yusef and Mr Bamford regarding that information and:

> "the process involved in obtaining their decisions on one variation of a plan over another, and again these were sometimes small changes, sometimes larger changes in a marketing plan based on a film's pre-release tracking and also

current release tracking in the marketplace...I believe Mr Davey and his team had actually had access to the considerable volume of files relating to that data and that exchange of data and those files have been here in London since I believe 2018 in total…"

(2) When pressed he said those documents (meaning those illustrating his input) may not be here, but there are certainly documents in which:

"I transmit to Invicta changes that are being discussed at Sony between myself and the marketing team and which I seek approval from London for Gala's agreement to proceed with those changes. Once I obtained that approval from London, I then communicate the same back to the studio."

(3) He said that when he said he would have done something he meant to the best of my recollection he did these things.

(4) He agreed that in the documents he exhibited there is not a single recommendation by him and it is a fair comment that there is nothing in his witness statement which says what his recommendations were, only a vague assertion without particularisation and without a document to back it up. When it was put to him again that his witness statement does not actually say what the recommendation, comment or the input actually was, he said:

"You may see it as such. I know that the amount of work was done. I know the amount of meetings that were held. I know the amount of phone calls that were made and the amount of information that was exchanged in arriving at multiple different plans, upon which one was eventually decided by both Gala and by Sony together. The documentation regarding that flow was bidirectional and I was a key player in making sure that that information flowed both ways."

(5) He agreed that there is nothing before the tribunal showing him/LBPC putting something to Sony and Sony reacting to or agreeing to whatever was put.

(6) He did not accept that there is no reliable evidence that anything LBPC did in relation to the marketing and distribution of films had any consequence or any material effect on anything of substance. It was put to him that insofar as the statement purports to give a different picture in slightly vague generalised language backed up by exhibits which do support it, it is not reliable. He disagreed.

431. Mr Ackerman's other role appears to relate to a filing system employed by Mr Ackerman whereby he received, checked and coordinated payment of invoices and then filed them. Mr Ackerman was taken to the following correspondence:

(1) An email dated 30 June 2004 from him to Ms Taylor at Sony in which he asked her to inform Ms Nielsen at Sony that "Gala is not paying for DVD and video manufacturing invoices. Gala funds are applied to P&A costs only…"

(2) An email from Ms Taylor to others at Sony, including Ms Neilson, in which she said: "I can't believe they waited this long to let us know that they would not be paying these invoices. Can I please proceed and pay these invoices? DADC [Sony Digital Audio Disc Corporation] has been waiting for months for payment."

(3) An email of 1 July 2004 in which Miss Nielson replied: "What the heck is going on?....I want an accounting asap on what to date has been paid by Gala…"

(4) An email from Mr Litt to Ms Nielson of 1 January 2004 in which he said that: "The DVD costs are to be paid for. I had [Mr Goffman] look into this and they are supposed to be paying for DVD costs. If you like [Mr Goffman] can send a note to Justin..."

(5) An email from Mr Goffman of 2 January 2004 to Ms Nielson and Mr Litt in which he said that he had "just got Justin's voicemail and explained it all to

him. Let's see what happens" and further email from him on the same day in which he said: "Justin called back. He agrees that Gala is supposed to pay for the DVDs…He says the directive not to pay came from one of Invicta's UK accountants. He's going to check on it over the weekend."

432. It was put to him that this does not demonstrate a smooth-running operation which was adding substantive value. He seemed to agree but said that before he sent his email in June 2004, he would probably have sought advice from either Mr Bamford or Mr Bold in London, and he would have only written this on instructions. He said that (1) it is not unusual in an operation of this size and with international communications sometimes for there to be miscommunications and misunderstandings which are then corrected, and (2) it is very common in the film industry, which is remarkably complex (in terms of dealings between people/executives, agendas and schedules), involving many different layers of activity, that there are often misunderstandings that are corrected sometimes within hours or days or weeks. Whilst he agreed that the correspondence shows there was an error, he noted that it also shows him correcting the error as soon as he could.

433. He was taken to an email of 26 November 2003 in which SPE advised McCann Erickson that all invoices related to media airing for the first transaction films on or after 2 December 2003 should be addressed to Gala and that "Gala will pay you, McCann, under the exact terms as SPE currently does". It was put to him that this shows that the only difference in the position after 2 December 2003 compared with that before is the name on the invoice and the account from which the payments were to be made. He said that in terms of this document that would appear correct. Mr Vallat said that this shows that Mr Ackerman and Mr Yusef were not the only ones who took action in anticipation and on trust that events would happen and that HMRC's criticism of their evidence in this regard is not justified. We cannot see that this has any bearing on or relevance to our comments and conclusions on the evidence of Mr Ackerman and Mr Yusef.

434. Finally, he was taken to (1) an email of 24 March 2004 to him from Sony where he was asked to review and process for payment invoices relating to some of the transactions films, and (2) an email from him to Mr Litt in response, in which he asked Mr Litt who approved certain invoices and when and said "assuming there's no problem, we just need confirmation ASAP". He said that this is an example of him coordinating payment of invoices. He agreed that in substance the name on the invoice changed and he assisted with the making of the payment and that this was an administrative e-mail exchange.

435. When it was put to him that it is fair to say that the early termination of his services sheds considerable light on the true nature and value of the services he/LBPC provided he said: "One could infer that, yes". It was put to him that initially he worked for free, then LBPC worked under a contract which he described as drafted in a light touch way for a fee which he said was on the low side, he then sent out short letters from the wrong address, the services were administrative, and the contract was brought to an end prematurely while Gala's activities were still on foot. He said counsel can certainly paraphrase it in that way but:

> "many of the documents that I wrote followed an extensive amount of work, extensive amount of communication and involvement with Sony, and in terms of the work I did, as Mr Davey says, for free, I did on reliance of entering a contract on the strength of a relationship, professional relationship with Mr Yusef, whom I had known for some years, and on the basis of honour and trust, which is again often based on the relationships in the motion picture industry not uncommon. *Following the termination of my contract in December of 2005, I continued to*

provide Invicta with a service insofar as storing all of the files until 2018. That is an example again of a relationship of trust. Nobody was compensating me to do that and that was quite a period of time from 2005 to 2018 before those files were shipped to London." (Emphasis added.)

Conclusions

436. Having regard to all the evidence, we accept that during the period from the closing of the transactions until the LBPC agreement was terminated:

(1) Mr Ackerman (a) regularly and frequently attended meetings with Sony at which discussions took place in relation to (i) possible changes to the Initial Plans and later Plans, and (ii) the activities of Sony's agents such as McCann Erickson, such as in relation to the allocation of media slots that that firm bought for Sony, and (b) these discussions took place with a view to Sony maximising the Gross Receipts from the transaction films, and (c) Mr Ackerman considered that his job, as regards his engagement with Invicta, was to analyse the relevant data and to seek to advise Invicta on the contents of the various Plans and to seek Invicta's "approval" of the Plans for transmission to Sony, and (d) accordingly, Mr Ackerman reported to Mr Yusef/Invicta in the way he and Mr Yusef described and Mr Yusef/Invicta provided him with "approvals" for transmission to Sony.

(2) Mr Ackerman was allowed direct access to McCann Erickson which ensured that there was accounting transparency in the spending reported; otherwise, he would only have had the figures provided by Sony. We take Mr Ackerman to mean that his "unique" direct access enabled him to check that the sums set out in the Plans regarding McCann Erickson's activities were in fact correct. He viewed this function of checking the figures as "quite important" to the performance of his duties "in endeavouring to maximise the...potential profitability of these films as it was being planned and adjusted and decided upon by the parties".

(3) Mr Ackerman reviewed a significant volume of invoices to ensure that they were in accordance with the Plans and budgets and that the correct distribution expenses were allocated to the transaction films and was involved in arranging for payments to be made from the expenditure account.

437. We do not consider, however, that Gala has established that (1) Sony regarded it as Mr Ackerman's role (or the role of Invicta or Gala) to make comments, proposals, recommendations or provide input as regards the formulation of or changes to the Plans, (2) Mr Ackerman made any such comments, proposals, recommendations or provided input which Sony considered, made any response to, took on board or took any other action in respect of, (3) Invicta/Gala gave consideration to, or had any discussion internally, or with Mr Ackerman or Sony on, any information which Mr Ackerman provided to them in relation to the Plans or any aspect of Sony's marketing and distribution of the transaction films. It seems that Invicta simply "approved" changes to the Plans they were informed of by Mr Ackerman as a matter of course, and (4) Invicta/Gala/Mr Ackerman made any substantive contribution to the formulation of and changes to the Plans and/or to the distribution process.

438. Both Mr Ackerman and Mr Yusef suggested that the Secret Window letter illustrates that Gala rejected a revision to a previously agreed Plan. However, that is plainly not the case (see section 13). Otherwise, neither of them provided any examples of any recommendations, comments, proposals or input Mr Ackerman provided to SPR or of any discussions or consideration of the Plans between Mr Ackerman and Invicta/Gala and the very limited documentary evidence also does not provide such examples and is uninformative for the reasons set out above. When pressed to explain

why Mr Ackerman's activities matter and what evidence there is that it matters, Mr Yusef did not provide any specific illustration of Mr Ackerman's asserted input into SPR's Plans or proposed changes to them. His comments were largely framed as a mixture of generalities, assertion as to SPR's thoughts and actions, including as regards discussions with SPR at which he was not present, and legal argument, which does not provide the tribunal with any insight into the nature of, and consequence of, Mr Ackerman's role or that of Invicta/Gala.

439. Moreover, that LBPC/Mr Ackerman played a substantive role in relation to the marketing and distribution of the transaction films is inherently implausible:

(1) As set out in section 9, under the DA, Gala did not have a contractual right to play a part in the distribution process in the way Mr Yusef suggested it did. There was no contractual obligation on SPR to take account of any comments Mr Ackerman may have made on the Plans at any discussions at which he was present.

(2) On Mr Ackerman's own evidence, there was a huge disparity in the scale and expertise of the resources already present at Sony and available to Sony compared with those of a one-person entity, LBPC. Mr Ackerman worked 2 or 3 days per week, operated entirely or predominantly from Mr Ackerman's home and using a mailbox drop and initially worked without remuneration and without a contract, and was subsequently engaged to provide "limited administrative, oversight and quality monitoring services" in return for compensation Mr Ackerman regarded as low. Mr Ackerman agreed, in effect, that, in comparison with Sony and McCann Erickson, he and LBPC were simply not able to bring to the table anything in the same league and that Sony would not look to a company such as LBPC for assistance. Moreover, he agreed that (a) if Mr Ackerman and LBPC were removed from the equation, nothing would change in that the transaction films would still get made, marketed and distributed by Sony in accordance with Sony's Plans and with assistance from big media buyers in just the same way, and (b) regardless of the involvement of LBPC or Invicta or anyone with Gala, Sony would use its vast resources and expertise to market and distribute its films to the very best of its very considerable ability.

440. In the period following the termination of the LBPC agreement, Mr Ackerman's only role in relation to the Gala arrangements was to store files for Invicta. Mr Ackerman gave clear evidence on this. In light of Mr Ackerman's evidence, we do not accept Mr Yusef's repeated comments that (1) Mr Ackerman carried out work for Gala after the termination of the LBPC agreement of a substantive ("significant" and "not trivial" but unspecified) nature, and (2) he had regular conversations with Mr Ackerman, once a week "to do with variations on the way in which this business was done". Moreover, these comments conflict with Mr Yusef's earlier comment that in fact the asserted substantive work was over by the time the LBPC agreement was terminated, and he did not explain what "variations" there could be or precisely what Mr Ackerman did in this period.

441. We note that Mr Vallat relied on the totality of Mr Ackerman's and Mr Yusef's evidence as demonstrating that Gala carried out activities of substance and meaning as regards a trade of film distribution. As regards the evidence set out in this section:

(1) He referred in particular to the evidence (a) as regards the importance of the collegiate meeting and that cancelling meetings would not have appealed to Sony as it would have damaged the relationship with Gala, and (b) on Mr Ackerman's "unique" position as part of which he had a direct relationship with McCann Erikson and so Gala had proper transparent oversight of the

expenditure. As noted, we accept that Mr Ackerman attended meetings with Sony and that Mr Ackerman had access to McCann Erickson as he described. However, the issue remains the lack of evidence of what input Mr Ackerman had at those meetings and/or of evidence that Mr Ackerman had a role beyond monitoring expenses and transmitting information from Sony to Gala/Invicta.

(2) He said also that it is not right that there is no or only very limited evidence of the Plans; there is illustrative evidence which the tribunal has no reason to doubt is properly illustrative of a far wider body of information. We do not dispute that Sony produced detailed budgets and Plans for the transaction films. However, the existence of some such documentary evidence and the fact that Mr Ackerman and Mr Yusef may have seen many such budgets and Plans tells us nothing about what they and/or Invicta/Gala did in relation to the Plans and does not, of itself, provide a basis to infer that they took any particular action.

(3) He added that (1) the emails put to Mr Ackerman demonstrate that Sony relied on Gala to pay invoices; Sony got upset when Gala did not pay them when expected, and (2) invoicing and ensuring payment of invoices against the right film is in itself a highly useful function, as Mr Yusef said. We have commented on this function at [459(2)] and in our conclusions on the trade issue.

Section 15 - Termination of the arrangements

442. On 10 February 2004 HMRC issued a press release which, under the heading "Tackling Avoidance: Income Tax – Manipulation of Partnership Losses", announced the Government's intention to bring forward legislation "to address tax avoidance schemes which exploit relief for trading losses through partnerships". The announced changes were made by the Finance Act 2004 in July 2004 and limited relief to partnership losses incurred by active partners, defined as those carrying out more than 10 hours per week of partners' activity. In a letter dated 18 October 2005 Mr Bold said that Gala's arrangements were rendered "obsolete" after 10 February 2004 "by an announcement that changed the treatment of any transaction involving any loss relating to rights or licences".

443. Mr Yusef said in his witness statement that there were 3 primary reasons why there were no further transactions:

(1) First, "we did not do the volume of transactions that we were hoping to before the law changed in such a way such that the tax mitigation element became unavailable for investors". Invicta was aiming for participants to become so comfortable with what Gala was doing with Sony that they did not need the tax mitigation element to be willing to invest. However, by the time of the change in the law, the whole Gala project was "not at a sufficiently mature stage for us to offer the opportunity without the tax mitigation element and we had not reached the necessary scale to convert the Gala opportunity into a pure equity play".

(2) Sony "made it clear to us that they were not interested in transacting with us again unless the volume of money available was at similar levels to the transactions".

(3) By 2004, the whole film sector was becoming overheated. He spoke to a number of people in the film industry at the time, and the overwhelming sentiment was that it would be best to put the project on hold. Accordingly:

> "we decided that Gala should cease trading and not attempt to complete any more transactions until the opportunity was right to do so (to this day, I have ambitions to execute fully an opportunity similar to Gala, but a combination of factors have to be present for it to be a success, and I am waiting for the right opportunity to do it again)."

444. It was put to him that when it was announced that the law was to be changed the arrangements were instantly dead and buried. He said that was not the case; they ended up being difficult as what "we had hoped would happen did not happen" and "we spent some time and a great deal of effort to try and structure the business in a way where we could continue to enjoy the benefit of some, if not all, of the downside protections that we initially had". He noted that if, as they had hoped, over time the tax element would get smaller and smaller, "the element of risk would also increase, thereby exposing us to the possibility of greater shares in the profits of the business" as has happened in similar situations across the world in many sectors, including film and: "We hoped there would be successive deals and each time the element of protection would get less and less and our share of profits would get more and more".

445. It was put to him that obtaining the loss and tax relief was the main purpose of the arrangements and they would have continued but for, as Mr Bold said, the announcement rendering them "obsolete". He agreed that the arrangements as they stood then were no longer viable, but said Invicta thought they would be able to structure deals so that clients would still invest. In effect, the point that they hoped would only arise after 2 or 3 seasons, so that people could see how the film industry actually operates, was accelerated to February 2004, and they found that people were not willing or comfortable, particularly because of the publicity at the time, to entertain any form of film schemes, whatever they may be. It took time to get to that point; they did not immediately fold up:

> "That form of downside protection was no longer available…we needed the downside protection that the tax element produced…Tax was an important element of the transaction...in order to attract people and give them the confidence of entering into the transaction until such time as they could see how this would operate without the tax but…I accept that we needed the tax in order to give people the comfort, but that wasn't the sole driver…"

446. We have already set out why we do not accept that Mr Yusef had the long term aim he referred to and that this structure offered only "a form of downside protection" or that he and/or the Referrers viewed it in that way.

447. As regards the Call Option, Mr Yusef said the following in his witness statement:

(1) Such an agreement was neither uncommon in the industry, nor was it uncommercial. As new entrants in the market who wanted to be involved in distribution on a joint basis with Sony, Invicta had to prove to Sony that:

> "we could build and develop a lasting relationship that could work between the parties - in short, we had to gain their trust. No Major Studio (Sony or anyone else) would be willing to give away such extensive rights relating to the distribution of their key assets for 21 years without a break clause that they could exercise if the relationship did not run as smoothly as had been anticipated...We concluded that Sony would be not willing to give us a meaningful involvement over such a long period if they did not have a way out (effectively a "divorce mechanism") if things were to not work out (for example, if there was a change of personnel at Gala) and the Option seemed like a sensible way in which we could provide the comfort that Sony required."

We have already set out why we consider that Gala did not have a meaningful involvement in the marketing and distribution of the transaction films, whether as a matter of contractual entitlement or in practice.

(2) In any event, "we were very comfortable that we would harness a relationship with Sony such that the Option would not be exercised" and "were willing to allow a number of points" at which Sony could exercise, on the basis that once such a divorce mechanism is included, "there is really no reason to

object to a number being included as to do so would create distrust between the parties".

(3) The dates on which the option could be exercised were agreed at 2, 5, 7 and 15 years on the basis that:

(a) the "guiding motive behind the timing of the first 2 trigger dates was preserving the relationship with Sony. I certainly felt it unlikely that Sony would exercise the option after year 2 – the way I had envisaged things, by year 2, they would be so enamoured with the relationship and Gala's involvement for the mutual benefit of the parties that the likelihood of them exercising the Option would be low";

(b) the trigger point at year 5 was to give Sony an opportunity to get out of the relationship at that stage if required although this was the approximate date by which Invicta anticipated that the members would see a return on their capital so considered it unlikely that Sony would want to exercise then.

(c) the last 2 dates were structured around the 7-year cycles of exploitation.

(4) During early February 2006, Mr Yusef was contacted by Sony who said that they were uncertain whether to exercise the option on 28 February 2006 and would like further time to consider this. He did not recall being told what they were considering. Sony agreed that they would provide some financial reports in relation to the films and as "we were trying to harness a good working relationship," he considered it was pointless simply to refuse. He had wanted to keep the US side of the Gala operation going for longer in the hope that Gala might trade with Sony again in a variation to the transaction at some point in the future and he thought that it was "in our interest to maintain a good working relationship with them" and keeping Sony onside, would facilitate future negotiations with further transactions. He arrived at a figure of £75,000 which he considered a fair payment to cover legal fees were Gala to agree to extend the date by which the option could be exercised.

(5) On 7 February 2006, Invicta notified the members of the position and on 10 February 2006 gave a notice of a meeting of members of Gala to take place on 21 February 2006 to discuss Sony's request to extend. The members approved the extension.

(6) In his view, Sony's uncertainty as to whether to exercise the option proves that it was by no means a "racing certainty" that it was always going to do so. He believes that the main reason Sony did so in April 2006 is that:

> "we perhaps oversold our capacity for future funding to them during the negotiations with them. We did not convey the fact that the process of raising a billion dollars for them...would be a more gradual process than they were anticipating at the outset of the relationship, such that Sony started to lose interest. Once they realised the billion dollars was not coming in the near future, especially with the adverse legislative changes discussed which made it harder for us to secure sufficient interest, they were willing to sever their ties with us."

448. At the hearing it was put to Mr Yusef in a number of ways that the Call Option was part of the design or architecture of the scheme from the outset and it was not designed specifically under negotiation with Sony to meet Sony's requirements:

(1) He said that Invicta introduced it once they became aware of a concern that every studio they spoke to had, namely, that "we wanted it [the licence of the relevant films] long-term" but the studios did not "want to be in a loveless marriage". So, from the outset, "once we got down to term sheets and deal

memorandums", he knew the only way he could get a 21-year term for the licences was to introduce that mechanism.

(2) He first of all discussed this informally with one of the senior executives at Paramount and "by the time we got to Sony I had inserted it, because I knew that that was going to be a central point which was common to all of the studios. It was a concern that they had, and the solution was a universal solution for all of them. All of the deal memos have that same term, which I initiated, being aware of the concern". He added that from the outset it was a concern of Sony as he had known it would be and that is why he introduced it as an element of the deal from the outset.

(3) It was put to him that, given it was stated in the IM that the studio (as then unidentified) would have a Call Option exercisable at year 2, it is not correct that the guiding motive behind the timing of the first 2 exercise dates was preserving the relationship with Sony. He seemed to agree and noted that when the IM was created, he was already in discussions informally with most, if not all, of the studios, so he knew that "all of them would want to have a period quite soon after the beginning of the term, say halfway into the distribution 7 year term" when they had the ability to look at the situation, to see how it was working, and to buy the business back.

(4) He was shown an email which refers to a call option and instructions to counsel (Mr Andrew Thornhill QC), both from March 2003, in which counsel was asked to consider: "Whether the option price would constitute a capital receipt". He said that he did not deny that the option was a constituent element of the structure from the very beginning but that was for the reasons he had given. He did not agree that the way matters were put in his witness statement is seriously misleading for the reasons he had already given. He added that 4 of the studios had the same concern in the informal discussions when he first put it to them, so by the time he put it to them formally or in more detailed discussions, it was already clear in his mind that for any deal to succeed it would either have to be for a short period or it would have to be a period that was capable of terminating at the call of the studio. It was there from the outset, because he knew that this was a hurdle that Invicta had to overcome and find a solution for. That became more formal as the discussions went through. When he spoke to the very first person at the Cannes Film Festival was not the first time that he had encountered that obstacle. He knew "from the very beginning that that was a feature of the deal that would have to be there. Either that or short-term. That was the give-away."

449. It was put to him that for a number of reasons the exercise of the Call Option was inevitable from the outset:

(1) It was put to him that, in March 2003, counsel had identified that the Minimum Amount may be taxable as an income receipt, which would be problematic, but for the studio to exercise the Call Option would obviate any need to call upon that sum. He agreed that is what the counsel's note says but he did not recall this.

(2) He said that he had his good guesses as to why Sony wanted an extension to the option exercise dates but he did not think that he knew for certain what the reasons were.

(3) It was put to him that (a) in March 2003 counsel advised that if it was "a racing certainty" that the Call Option would be exercised at the end of year 2, there would be no reasonable expectation of global revenue profit from the trade,

and (b) this advice was why he said that the exercise of the option was not "a racing certainty". He said:

(a) That term was in his mind, because if he had thought that it was "a racing certainty", they would not have done the transaction not only because the tax element would be in jeopardy, but also as the transaction altogether would have been pointless. So he went to some lengths at the beginning to try to ascertain what Sony's view was, and the discussions led him to believe that they were looking for a long-term relationship, which is why initially they said they needed a billion dollars but they settled on an initial figure of 250 million with a view to that being the first tranche.

(b) When the extension was discussed Sony "were pretty disappointed that we had only managed to raise two-thirds or less than that," and he thought that was at the forefront of the reason as the conversations were all about what monies he thought could be raised and that there had been a change of law and "...certainly at the beginning they were looking for a lot more than 250 million" and that is why, at the time, he was "quite comfortable that it wasn't a racing certainty that they would exercise, as long as I was able to deliver what was expected".

(4) When it was put to him that there is no witness statement from Sony, he said he would not have expected them to be involved. As a matter of policy, US studios are very shy of getting involved in litigation and he thought it is a bit farfetched to assume that they could be called with no means to force them to attend this hearing, and he thought that it is the policy of all of the studios not to get involved in litigation in any jurisdiction unless they are subpoenaed to do so.

(5) He said, "their intentions at the point at which we entered into this transaction is a matter for them" and he could not say what their intentions were. He could only refer to the conversations that he had with 2 executives at Sony at the time, and their focus was "how much have we got. How much are we going to get…There was no other motive or anything like that that they were explaining to me. I wasn't privy to their conversations about whether or not they should exercise the option, nor could I force them to exercise the option". He agreed that on any view this enterprise was barely off the starting blocks when Sony exercised the Call Option.

450. It was put to Mr Yusef that Sony were simply focused on getting out of the deal as quickly as they could and that this is demonstrated by the following correspondence all of which took place by email:

(1) On 1 December 2005, Mr Goffman, the legal affairs person at SPE, wrote to Mr Winston Fan of the accounts department at SPE (and copied in his boss, Ms Lynn Fulman and Mr Litt) and, under a heading "Gala termination", said:

> "The deadline for the Gala option exercise is March 3 2006 (25 months after the last partner joined, which was February 3, 2004). We can give notice no sooner than 28 days before that. The closing of the option will be 5 business days after we give the notice. Keep it on your calendar and let's deal with this in February".

(2) On 5 January 2006 (a) Mr Fan informed Ms Nielsen at SPE that he had been informed that MPG was thinking about delaying the repayment of the Gala P&A Fund to April and said: "Would you please confirm? If it is true, we do not have sufficient defeasance deposit in the account to cover the added interest. We will need to purchase additional Sterling to put on deposit", (b) Ms Nielson replied that "We won't know until early next week whether or not this can get

delayed to sometime mid-April" but assuming it was, she asked how much more sterling would be needed to deposit.

(3) On 1 February 2006 Mr Fan informed Mr Litt that he had spoken to SG regarding rolling over the loan for 2 months and that, as regards incremental interest expense, Sony only needed to pay the margin on the loans of around £70,000, there would be a loan re-structuring fee of £110,000 and they would need to pick up SG's and the defeasance bank's fees so that the bank cost may run slightly above £200,000 or $355,000. He said "These are a real cost to the company because we do not have offsetting inter- company interest with SGTS since the money to pay off the loans is already on deposit". Mr Yusef agreed that this shows Mr Fan was concerned that Sony's deposit with Barclays was only sufficient to cover the interest on the SG loans up to March 2006 and that delaying the exercise of the Call Option would require additional sterling to be placed on deposit by Sony.

(4) On 8 February 2006 (a) Mr Litt informed Mr Charlie Falcetti of SPE that the maximum cost of extending the exercise date would be $500-600k, around $350k to SG and $150k to Gala, and said that whilst he was trying to get the overall incremental costs down, he wanted to know if he was authorised to proceed with the extension and: "If not, we will finalise the calculation of the option, and exercise before the end of the month", and (b) Mr Falcetti said in his response that this "is still a big help for cash this year and we should try to get this done even with" the costs Mr Litt referred to.

(5) On 10 February 2006 (a) Mr Fan queried with Ms Kelly of SG whether "the original due date of the [SG] loan was Feb 28" or whether there was an amendment which changed the date to 3 March, (b) Ms Kelly replied stating that it appears the 3 March date was a mistake:

> "as any Call Option should be designed to occur on the same day as the loan cashflow interest rollover periods in order to eliminate mid-period interest rate breakage costs. As you are aware, all cashflows are based on annual payments being due on 28th January each year…Given this, please can we ensure that any amendment to the Call Option agreement, includes the facility for any Call Option to occur on the 28th of a month to coincide with the loan."

(6) On 21 February 2006 (a) Mr Litt informed Mr Falcetti and others that Gala had voted to approve the extension and: "We will be able to move the payment into the next fiscal year. Subject to final documents, I will let you know the incremental costs of the extension of the payment in the next day or so.", (b) Ms Nielson said in her reply "very cool. We've put the payments (approx. £173 m) in late April 06."

(7) On 3 March 2006 (a) Ms Mary Jo Green of SPE asked Mr Goffman for an update on the exercise of the Call Option: "On the "Schedule of Important Dates" you had for March 3, 2006 – deadline for SPE to notify [Gala] of SPE's exercise of option to acquire back distribution rights to [the transaction films]. Please update me if this option has been exercised. Thanks.", and (b) Mr Goffman responded: "We have negotiated an extension of the deadline until February 28, 2007."

451. Mr Yusef said:

(1) (a) If Sony had said they wanted an extension and, on that extension, they were going to exercise the Call Option, "we would have said, "I am sorry. We are not going to do the deal", (b) the first e-mail from Mr Goffman simply reflects what all business affairs people do in the studios. They ensure that their counterparties within the organisation are aware of all relevant dates such as an

option exercise date, and (c) the email from Mr Litt does not prove "that the state of mind from day one is that they will [exercise]. It is our state of mind that is important in this regard". He did not recall any suggestion from the other side, "Oh, this is just a façade", and (d) as regards the email of 3 March 2006, he suspected from what he knew of how the studio system works that Mr Goffman would have given not just the second-year date for exercise but also the subsequent dates in the schedule of important dates, which Sony would then diarise centrally so that the date could not be missed.

(2) The correspondence shows merely that when the exercise date came up Sony were thinking about exercising the option but not that exercise was a foregone conclusion. The e-mails talk about the mechanism for extending the option period for doing so and the cost and not about what the non-accounting people were thinking in terms of this particular business. He could say with certainty that at the time, the conversation he was having was "whether or not there was any prospect of this relationship continuing", and it was put to him on a couple of occasions that a consideration was whether Sony was going to get any more money out of Gala, and it looked to Sony that that would not be the case and:

> "...at the outset, when we set this transaction into motion, we did not know with a racing certainty that Sony would exercise the option. We did not believe they would. They had no reason to. If we had delivered as we had anticipated, that would have been a reason for them not to mess with the option."

452. He was taken to a letter of 2003 in which Invicta agreed to provide SG with a non-refundable fee of over £16,000 for breakage costs if the Call Option was exercised. It was put to him Invicta had to pay SG this fee because it was known that the Call Option would be exercised. He said that was not true and that banks want to be covered for all eventualities, whether actual or theoretical. Here, SG identified a risk, that the early termination would happen, and said that they needed to be covered for that and Invicta paid it because it was an essential way of getting the loan in place. He noted that the letter says: "We acknowledge that should the studio exercise its option" and not that the studio will do so. It was put to him that the fact that Sony were willing to incur costs to revise slightly the first exercise date rather than to wait for the next exercise date clearly indicates they wanted to get out at the first opportunity. He disagreed and said that is just an assumption. It was put to him that all of the evidence referred to above supports that the exercise of the Call Option was inevitable as an integral part of the scheme. He said that he did not believe it was inevitable at the time and he does not believe that now and there is nothing, so far as he can see, that indicates otherwise:

> "What you have pointed me to is documents which talk about what they were looking to do in 2006, but I was concerned at the time with whether or not they would exercise the option from the outset, and it was my belief that they would not."

453. It was put to Mr Yusef that (a) it is not feasible that Sony could have been required to pay a higher price on the exercise of the Call Option than a sum equal to the Minimum Amount (of around £102 million) on the basis that the market value of the Rights could, in 2006, have exceeded that price, and (b) that is a further reason why it was inevitable that Sony would exercise the Call Option at the first opportunity; Sony did not stand to gain anything by staying in the arrangements for longer. He said that the HL letters provide evidence that there could be an increase in market value from £15.1 million in 2003/04 to in excess of £102 million in 2006. It was put to him that if Sony had to pay a price greater than £102 million, Sony would not receive the full amount of its benefit

of £15 million. He initially said that £15 million was not refundable but then agreed that, in that case, necessarily Sony would no longer have the full amount. He did not agree that it is not plausible that Sony would have agreed to there being a real possibility that would arise or would have participated in the structure on that basis and that there is no rational reason for Sony to do so. He said that:

(1) The price is a function of the value of the assets at the relevant time and that could not have been known when the Call Option mechanism price was created; Sony would not have known for certain that would be the case.

(2) It is plausible they would have agreed to that because they derived a benefit in addition to the £15 million, namely, of somebody else paying a portion of their distribution expenditure: "that was a significant driver" for the transaction from Sony's perspective in addition to this benefit. As he understood it there had been changes in the way in which they accounted for their distribution costs, which had a detrimental effect of changing the accounting processes for expenditure in an adverse way and that is why they were looking for partners to be involved in that process. He agreed that there is no evidence from Sony of this alleged additional benefit but said that the evidence is the incurring of the relevant expenditure by Gala and not by Sony. He added "he did not think that the situation was as clear cut as you say". We have already set out why we do not accept that Gala has established this was Sony's motivation in section 2.

(3) He added that the understanding was that there was a possibility that, if these films had been "successful in the way that we contemplated", the price would have exceeded the amount of the deposit and that was "the central question" that "we were asking when we commissioned [HL] to investigate the transaction and specifically in relation to the waterfall and the distribution of revenues" and:

> "..at the beginning when we were in negotiations with Sony, it was quite clear that they were looking to enter into a long-term series of contracts or agreements. They were not interested in a one-off deal, which is why they were putting tremendous pressure on me to commit to a certain number, not just the one-off picture. So they had an incentive...that if this first phase of the transaction was successful, then that would make it easier for us to raise more funds and to continue the business. So…[when] we were drafting these contracts - everybody was looking towards a long-term relationship. So, it is certainly not inevitable that the call option would be less, because the state of mind of everybody - the principals involved in the transaction was to build for the benefit of the studio and for the benefit of Gala a successive arrangement and not one that was just for the benefit of securing the £15 million…advantage. They saw the business as being far greater than that, as did we."

454. Counsel put to Mr Yusef that it was inevitable that the Call Option would be exercised for a number of other reasons:

(1) It was put to him that (a) the Sony benefit of £15.1 million was received by Sony straightaway, so there was no commercial reason for Sony to prolong the arrangements, and (b) their role was to allow the film rights to be passed from one Sony entity to another in return for that sum. He said that the arrangements have to be viewed within the context of what both sides were seeking to achieve at the time and, as he had already explained, his understanding was that Sony and, in fact, all of the other studios were keen to get involved in a transaction where a third party paid for a portion of expenditure because of a change in accounting treatment:

> "So the studio at the time wasn't solely focused on receiving an additional 15 million, which for them is not a huge amount of money in the context of their overall turnover. They were looking to build a system with us where a trusted third party, which hopefully we would become, would provide additional prints and advertising to alleviate the cashflow position of the company. That's the background against which all of this has to be seen, not in isolation. The studio would not have gone to all of this bother, as they used to call it, just for 15 million. It is not in their interests. Their overheads are huge, and they don't frankly get excited at the prospect of earning just 15 million. They were excited at the thought that we would partner with them in a slate of films that extended far beyond and for a longer period than that, and that's what would have coloured their entire decision-making process and why they wouldn't have at the outset decided that they were inevitably going to call the option at the end of two years. I don't believe that. I didn't believe it then and I don't even believe it now with the benefit of hindsight."

(2) It was put to him that it was obvious that all this bother for Sony, as he put it, was always going to be ended straightaway as within 1 year Sony and all parties received what they expect to get; Gala incurred the losses to generate the tax relief, Sony had its benefit and Invicta and SG had their fees. Hence, within the first year, for Gala, the matter had run its course and his own evidence is that without the loss relief available in year 1 the structure was not viable (hence there were no further transactions once the law changed). Mr Yusef insisted again that the object of the exercise for Sony was considerably more than obtaining £15 million and made the following main points:

(a) If he had gone to Sony on the basis that was what they were going to get he would not "have got past the first junior set of lawyers". He said the transaction was considered at the highest levels not just in Los Angeles but also in London, Japan and New York, because the studio was looking for:

> "something far, far greater from me than 15 million....to do with the partnership in terms of prints and advertising. On the day that this agreement or set of agreements was signed it was not a foregone conclusion that the option would be exercised, because SPR and SPE were looking for far more than what they actually got in the end."

(b) Had circumstances developed differently Gala could have introduced more capital, that was always envisaged by him and Sony, that is why Sony got involved and why at the end of the initial 2-year period they were concerned to see whether or not Gala had the ability to raise more money. Had he been able to say at the end of the second year that he had another 100 or 200 million of investment, the result would have been far different. There was no indication to him either in the negotiations or in the first couple of months of the transaction that the studio was minded to terminate the arrangement at the end of year 2.

(c) It is true that "the loss relief was an influential factor in the raising of the money", but:

> "for the 65 members ...it wasn't the only reason to do this deal. They could have achieved the loss relief in a different way. They were interested to try to achieve the trade and the loss received in the way that we actually transacted. It was hinted at the time that perhaps we could try to raise money -it wasn't hinted. We worked to see whether or not we could put - you know, continue the structure, but it proved not to be the case, I think largely because the sentiment had gone from the marketplace."

(d) Whilst it is true that the scenarios demonstrate that it is positively preferable to Gala for the Call Option to be exercised, the members/Gala could not be certain that that would be the case and they anticipated at the time that situation would arise "if the results of the performances were poor such that...there would be downside protection for the partners. What they were focused on was the possibility" that they could make more money this way with the downside protection that existed. That was the attraction for them.

(e) It was envisaged from day 1 that there would be a series of Gala transactions so that "we could build a distribution company or entity over a period of years". He said this to Sony and that is why they got involved in the transaction and they made it clear they were not interested in a one picture deal under a short-term arrangement for an upfront licence fee of £15 million. If he had tried to pitch that as a deal to Sony, he would have been shown the door. It was put to him that (a) his counsel said that exercising the option was expensive: "Funds had to be paid even if they were covered by a guarantee at a time when cashflow was not necessarily easy for Sony", and (b) the internal Sony communications show that any cashflow issues did not stop Sony from exercising the Call Option in 2006. He said that there were cashflow considerations at Sony and they would have preferred not to exercise the option if Gala were continuing to provide funding under the Gala structure but that did not happen and may have led to the decision to exercise their option: "If the transaction had gone the way it was contemplated from day one, I believe that option would not have been exercised, because there were funds and deals flowing through".

(3) It was put to him that (as his Counsel also said) Sony's intentions were irrelevant and that for the reasons given he knew and intended Gala arrangements would come to an end with Sony's exercise of the Call Option in 2006. He said he "strongly" said "no" to that. It was not discussed in those terms. The opposite was discussed in that the desire on both parts was to have a long-term relationship. It was never put to him at any time during the negotiations that Sony were going to exercise in 2006. That would have been the end of it. It was never directly said or hinted at, and the option programme was to deal with a different point, which all the studios raised in discussions with him and that is why it became a feature of the transaction. Everybody said: "You are asking us to enter into...a 21-year arrangement with an entity we don't know and there has to be a mechanism whereby if it doesn't work for us any longer, we can terminate the situation….". If somebody had said at that time, "by the way, we are getting out at the beginning 2 years", he would have said "that doesn't work". When it was put to him again that there was no evidence from Sony, he noted that Sony is not a party to this issue and it is not surprising and he did not even think to ask them, because he would guess they would respond that it was none of their business what happened almost 20 years ago.

455. In re-examination Mr Yusef made the following main points:

(1) The point about the option dates and making sure that Gala preserved the relationship with Sony was that (a) "we wanted to be in business with Sony for a lengthy period of time", as there are 3 commercial exploitation cycles and every decade or so a new platform comes along, (b) but the studio had justifiable and understandable concerns about that, particularly in dealing with HNWIs who they were not used to dealing with, and (c) the idea of the 2 year and then subsequent exercise dates was designed to deal with that situation.

(2) Around about the time when the studio's request for an extension to the first exercise date became a live issue, he was being pressured enormously to determine whether or not there was any prospect of Invicta or Gala "putting more money into the distribution apparatus that we had set up" given Sony had started with the aspiration of receiving certainly in excess of 250 million from Gala, and "the hope of both sides is that we would contribute significantly more". He noticed at the time that there was not irritation but disappointment that the prospects were not looking good, as far as that was concerned, and as far as he could work out at the time there was a danger that "we would disappoint them. But I am firmly of the view...that had we delivered successive bundles of money into the distribution apparatus, I believe sincerely that that option would not have been exercised at that time. That is what I believe."

(3) He said that the internal note from Mr Goffman, who was head of Business Affairs at the time and the point of contact as regards the transaction, is a record of what, as a standard operating procedure, takes place in a studio. It is a huge organisation, and many departments have an interest in certain aspects of the contracts. It is standard procedure for the business affairs person to notify accounts and others within the organisation of key dates which everybody must be aware of and this is a record of the notification to all of the departments "to diarise a date and that is all it is". He noted he was not involved in this communication because he was never approached about any of these issues. There was no issue at the time that Gala entered into the transactions given that the motivation of this studio to enter into this deal was not to get £15 million or even for £100 million but:

> "they managed to get themselves convinced that this was a structure that would churn out a very long-term relationship between Gala and the studio. So, I don't think they had a settled, formal situation at all. I think the main motivation - they could have easily let this go into the next session and the session thereafter, and I think would have been happy to do so if we were still providing them with the kind of money that they had hoped for."

Conclusions

456. HMRC submitted that Mr Yusef/Invicta expected the Call Option to be exercised at the first available opportunity and that its exercise was inevitable essentially for the reasons they put to Mr Yusef. Mr Vallat said that, on the contrary, there is no evidence that, when the transactions were entered into, the view was that the Call Option would be exercised in 2006, and (1) from the documents in the bundles it is clear that Sony prepared illustrative figures for a number of exercise dates, (2) Sony's internal correspondence just shows that Sony diarised the exercise dates and, in 2006, was thinking about exercise and not that there was any settled intention to exercise in 2004, (3) Mr Yusef's evidence should be accepted that he did not expect the Call Option to be exercised from the outset and there was genuine uncertainty about that in 2004, (4) the option price was variable given the market value formula is pinned to box office performance of the transaction films, which is innately variable, and there is no upside limit to what the formula could produce. Mr Yusef certainly thought that he had negotiated an option price at market value, albeit calculated according to a formula and with a minimum guarantee.

457. We accept that Mr Yusef considered that any studio willing to enter into the proposed Gala arrangements would want a mechanism to terminate those arrangements before the proposed end date. However, we do not accept that (1) Sony wanted the ability to exit the arrangement because Gala had access to substantive, meaningful rights as regards the distribution process; for all the reasons set out above Gala had no

such rights, (2) Mr Yusef's/Invicta's motivation and purpose for including in the structure a termination mechanism in this particular form, as a Call Option, with the ability for the studio to exercise it as early as just over 2 years after closing was to do with a desire to keep the studio on-side as regards an on-going relationship, (3) Mr Yusef/Invicta did not expect the Call Option to be exercised at the earliest opportunity, and/or (4) SPE would not have exercised it when it did, if Invicta could have demonstrated that Gala could raise further funds.

458. We consider that it is reasonable to infer from all the circumstances that, in fact, (a) Invicta/Gala incorporated into the structure the ability for the studio to exit the arrangements, at an early stage, specifically under the Call Option mechanism, because this would provide the members with the ability to make a positive cash return from their investment in Gala from tax relief alone without the need to rely on what, on any view, is an unreliable and speculative, and in our view, wholly unrealistic, prospect of Gala receiving sufficient Gross Receipts under the waterfall for them to do so, (b) Mr Yusef/Invicta designed the arrangements to have run their course by around the end of the 2003/04 tax year, and they/Gala intended and expected SPE to exercise the Call Option at the earliest opportunity, and (c) in light of the design of the arrangements, it was inevitable that SPE would do so. We note that:

(1) As set out in section 1, the Call Option was included in the proposals put to studios at the outset (see [85]) and was plainly not inserted in the structure by negotiation with Sony at Sony's insistence. Moreover, contrary to Mr Yusef's suggestion in his witness statement and, as he agreed, that the first exercise date would fall just over 2 years into the arrangements was also part of the initial proposal and was not inserted in the structure due to any particular requirement of Sony.

(2) The fact that Gala granted SPR the right under the Call Option, in effect, to bring the arrangements to an end after little more than 2 years is entirely inconsistent with Mr Yusef's insistence that the aim was for Gala to pursue a trade of film distribution in return for a share of Gross Receipts from the transaction films on an on-going basis over a number of years (as part of a plan involving 3 phases with a view eventually to a listing on AIM). There is nothing to back up Mr Yusef's assertion that he thought that, by the first exercise date, Sony would be so enamoured with the relationship with Gala that it would not want to exercise the Call Option at that time. For all the reasons already set out and as summarised below, Gala did not have meaningful contractual rights and obligations to make any meaningful contribution to the distribution process and did not provide Sony with any economic or commercial benefit from the arrangements other than the licence fees of £15 million paid on closing. On Mr Yusef's own evidence, Sony viewed the arrangements as a "bother". That makes sense given that, whilst SPR essentially had the right to market and distribute the films as it chose, it had to go through a process in order to be able (as a contractual matter) to pay approved Gala Expenses.

(3) It is clear from the notes relating to the conference with tax counsel in March 2003 that (a) there was concern from the outset that, if termination of the transactions occurred on payment of the Minimum Amount, that sum would be subject to income tax which would, unless Gala were to receive a very substantial share of the Gross Receipts from the transaction films, remove the benefit of the tax relief the members claimed in respect of the loss, (b) that issue did not arise if instead termination triggered a CGT event, such as on the exercise of the Call Option, (c) it was important to the tax analysis, however, that the exercise of the option was not perceived to be a "racing certainty". The importance and

significance of the Call Option, as an essential element of the transaction due to that concern, is recognised in various ways:

(a) It is spelt out in the IM, in scenario 2 (see section 4), that the termination of the Gala arrangements in year 2 on SPE exercising the Call Option, would produce the tax benefit, as a substantial positive return for members due to tax relief alone, without the need for Gala to receive any Gross Receipts under the waterfall.

(b) As HMRC submitted, the importance and significance of the Call Option to obtaining such a return for members was recognised by various persons such as the solicitors involved, who wrote in instructions to counsel that: "It is essential to the success of the scheme that the payment of the Call Option Price be treated as a capital receipt and not a trading receipt", Smith & Williamson in their letter to Mr Mallett (see section 5), UBS in its marketing document (see [127]), Ms Challons in her letters to Mr Mallett and Mr Lewis (see [128]) and the Referrers in their evidence (see sections 5, 7 and 13 and our conclusions on their evidence in Part C). The importance of the loss and the members' ability to obtain tax relief in respect of it is also recognised in the evidence in various ways, as set out in our conclusions in Part C (see [520] onwards).

(4) The evidence shows that there was a distinct lack of interest on the part of all relevant persons involved in the arrangements, in Gala's prospects of making a profit, and/or in the members' prospects of making a return, through Gala's receipt of a share of Gross Receipts under the waterfall, and that there was no such realistic prospect (see sections 4, 5, 7, 11 and 13). In our view, in these circumstances, any reasonable business or investor, who had a serious interest in whether and what level of return it/he was likely to make from the receipt of Gross Receipts from the business' purported trade of film distribution, would want an assessment of the likely level of such receipts as at the first exercise date given that, on any view, it was entirely possible that SPE would exercise the Call Option at the first opportunity. However, for all the reasons set out in sections 11 and 13:

(a) Mr Yusef/Invicta/Gala did not make, or procure the making of, any such meaningful assessment whether by reference to the first exercise date or over the term of the DA or LA. In our view, the HL letters do not provide a meaningful assessment (see [388] to [397]).

(b) It is clear from HMRC's illustrative computations that, from the outset, due to the disadvantageous terms of the waterfall for Gala, there was no realistic possibility that, if the Call Option were exercised on the first exercise date (or shortly after), Gala would receive a share of Gross Receipts under the waterfall sufficient for Gala (and, so the members) to recoup the outlay of £25 million which was not virtually guaranteed to be returned under the loan repayment arrangements. That is the case even on Mr Yusef's own estimate of likely Gross Receipts (although we do not accept Mr Yusef's figures).

(c) Either Mr Yusef/Invicta/Gala knew that to be the case or were indifferent to and disinterested in whether Gala would receive sums under the waterfall. In light of the factors highlighted here and in [459], it is reasonable to suppose that this lack of concern with, or indifference to, the likely level of Gross Receipts emanates from the fact that Mr Yusef/Invicta/Gala were relying on the members' receiving a positive return from tax relief alone, under circumstances akin to those in scenario 2, as realistically the only reliable way

(on Gala's analysis of the tax position) for members to make a positive return from their investment in Gala.

(5) As explained in [459] below, (a) it is inherent in the way the arrangements are structured and designed that they would have run their course by around the end of the 2003/04 tax year such that (i) Sony would have no reason to want the arrangements to continue beyond the point at which all the funds had been released from the expenditure account, and (ii) rather, would want to terminate them as soon as possible after that so that it could pursue its distribution activities as it would usually do, without the complication or "bother" of Gala's involvement, and (b) therefore, Mr Yusef/Invicta/Gala had every reason to expect and anticipate that SPE would exercise the Call Option at the first opportunity, thereby giving rise to the tax benefit.

(6) HMRC thought that further evidence that Invicta/Gala fully expected SPE to exercise the Call Option when it did is provided by the fact that (a) Gala ended LBPC's formal appointment in 2005, and (b) LBPC's lease of office premises was extended by 1 year rather than 2, so that it ended on the first exercise date. Mr Vallat said that Mr Yusef's explanation of these events should be accepted (see section 14 for his evidence on this). In our view, for the reasons set out below, the fact that Mr Ackerman/LBPC had no on-going role (and so had no need for an office to carry out activities in relation to Gala) reinforces our conclusion that, as explained below, the transactions were designed to have run their course by, or shortly after, the end of the 2003/04 tax year.

(7) Overall, we consider that it is reasonable to conclude that, in light of all the factors set out here and in [459] below and that, on the Referrers' evidence, investors were relying upon Mr Yusef to protect their interests (see sections 5, 7 and 13 of Part B), Gala was operated on the basis that, as under scenario 2, (a) it would only receive the Minimum Sums due prior to the exercise of the Call Option plus the option price, and (b) Gala would make a largely "self-funded" loss, as described in section 10, which would enable members to make a positive return without the need for Gala to receive any share of Gross Receipts under the waterfall. It is unrealistic to suppose that Gala would be operated in such a way that members would make six-figure losses so that Gala could make a small profit as under scenario 1 and there is no reasonable basis for the view that Gala would realise a sufficient share of Gross Receipts under the waterfall for members to make a positive cash return (as under scenario 3) (see sections 4 and 11).

459. We note the following as demonstrating that Invicta/Gala designed the arrangements so that it was inevitable that Sony would exercise the Call Option:

(1) As set out in sections 2, 9 and 10, as was part of the design of the structure, Sony received no economic or financial benefit from the transactions other than the licence fees of £15 million which it received on closing of the transactions and received no other material commercial benefit from the transactions. As regards the financial and funding position:

(a) Whilst, under the terms of the DA, Gala was required to provide the Initial Expenditure into the expenditure account on the basis it could be withdrawn only to meet approved Gala Expenses, any economic benefit to Sony was negated by the need for SPR simultaneously to place an equal sum on deposit in an interest bearing account with Barclays for the funds to be used, in effect, to meet the Minimum Sums/option price (and so to repay the principal of, and pay interest on, the Gala loans).

(b) For the reasons set out in sections 2 and 10, we do not accept that Gala has established that (a) Sony had any financial motivation for entering into the transactions other than to receive the licence fees of £15 million, whether as a result of a change in US accounting treatment or otherwise, and/or (b) that obtaining further funds in respect of these transactions was an attraction for Sony for the reasons Mr Yusef gave.

(c) Moreover, it is implausible that, at the time when Sony was discussing internally the extension to the first exercise date, either Gala or Sony contemplated that Gala would seek to raise further funding in respect of the transaction films. As explained below, as viewed from the perspective of both parties, the transactions had, by design, run their course by that time.

(d) It makes sense that, at that time, Sony could have been interested in doing further deals with Gala for the same reason as it entered into these transactions, namely, in order to receive sums as licence fees. However, (i) that is speculation, and (ii) any such assumed desire on Sony's part does not support the assertion that Sony had any interest in the continuation of these particular transactions. The replication of this structure in relation to different films, whether by Invicta seeking to raise funds from the existing or new members or a mixture, would not be dependent on or require the continuation of these transactions; it would require the replication of the full set of arrangements whether within Gala or in a different or related vehicle.

(2) Plainly, Sony had an interest in ensuring that the Initial Expenditure was in fact used to meet approved Gala Expenses. Otherwise, it would not be in the financial position it must have expected to be in; namely, that overall, it would have and retain a cash benefit of £15 million on the basis that its outlay of £102 million under the Deposit would be matched by the receipt of Initial Expenditure of £102 million. Hence, under the DA it was a signatory to the expenditure account and could authorise release of funds from it as Gala's agent and had the benefit of a charge over it. In that context, Gala could be said to have provided a service to Sony through Mr Ackerman's action in dealing with invoices and facilitating the withdrawal of funds from the expenditure account to meet approved Gala Expenses. However, in light of the correspondence set out in section 14, (a) evidently Sony had the resources to deal with processing invoices itself such that Gala's involvement simply added a layer of administrative process which, absent these arrangements, would have been unnecessary, and (b) Sony's evident irritation with that process accords with Mr Yusef's statement that Sony viewed the arrangements as a bother.

(3) It is clear that, from Gala's perspective, from the outset, the process of the withdrawal of sums from the expenditure account was intended to be completed on or around 5 April 2004, as Gala wished to generate a loss equal to the Initial Expenditure (plus related fees and expenses) in the 2003/04 tax year for off-set against the income of the members in that year and prior years. Hence, as the letters from Ms Challons to Mr Lewis and Mr Mallett demonstrate (see [128]), the level of a member's investment in Gala was set by reference to the size of loss that he could utilise to off-set his otherwise taxable income in 2003/04 and prior years. In instructions to Mr Thornhill QC of March 2003 it was noted that it was "essential to the success of the scheme" that the Initial Expenditure "is allowed in full as a revenue expense of [Gala] in the year in which it is paid" (see [136]). The proposal documents and the draft term sheet with Paramount refer to the need for the relevant sums to be spent by 5 April 2004 (see [85]) and the terms of the LA and the DA were framed accordingly. We note, for example, that the DA (a)

refers to the deadline for incurring approved Gala Expenses as 5 April 2004 (see the definition of the term "incurred"), and (b) provides for the "Underspend", essentially any sums remaining in the expenditure account which were not withdrawn to meet approved Gala Expenses as at 15 May 2004, to be allocated between the parties on that date (see section 9). We note also that the MA provided that no new members were to be admitted to Gala after 5 April 2004 (see section 3 of Part A).

(4) Moreover, as set out in full in section 9, contrary to Mr Yusef's assertions, (a) under the contractual terms of the deal with Sony, Gala had very limited rights and obligations as regards the distribution process (to approve or object to proposed material increases, or any decrease, in approved Gala Expenses) and the performance of those rights/obligations had the limited consequences set out in that section, and (b) such rights and obligations as Gala had, in effect, were to come to an end once sums were withdrawn from the expenditure account and spent by SPR on approved Gala Expenses, which, as noted, was intended to happen by 5 April 2004 (and see our comments in (2) as regards Gala's role in relation to the release of funds from the expenditure account).

(5) In light of the above factors, (a) Sony's role was, in return for the "studio benefit" of £15 million, simply to allow its rights in respect of the distribution of the transaction films to pass from one Sony entity to another, via Gala, (with Gala's Rights at all relevant times tied up in security arrangements) for what it is reasonable to suppose was regarded as a sufficient period for Gala to make a successful claim that it had realised a loss in carrying on a trade, and (b) it is reasonable to suppose that it was readily apparent to both Gala and Sony from the outset that Sony would receive no discernible benefit from the continuation of the transactions once it had received the licence fees and the full Initial Expenditure was released from the expenditure account for it to spend on approved Gala Expenses. As Mr Yusef seemed to accept, by 5 April 2004, all parties had obtained what they expected to get from these transactions. Gala had realised the loss, Sony had obtained the licence fees and Invicta and SG had received their fees.

(6) The subsequent events are in line with and reinforce our conclusion that from the outset the transactions were intended to be and were effectively complete around 5 April 2004. In practice, Gala had no material input into the distribution process whether during the 2003/04 tax year or afterwards (see sections 3, 6, 12, 13 and 14). Moreover, Gala terminated the LBPC agreement before the first exercise date and Mr Ackerman/LBPC did nothing of substance following that in respect of the Gala arrangements. Whilst Mr Yusef asserted that Mr Ackerman's role continued after the role was formally terminated, he did not state what any such activities comprised and Mr Ackerman was clear that the only role was the storage of files. In seeking to refute the suggestion that the termination shows Gala did not seriously pursue a distribution activity and that Mr Ackerman's role was superfluous, Mr Yusef said that (a) "the height of the distribution activity in relation to the expenditure, the selection of the slate, the expenditure monitoring, the dialogue with the counterpart, *most of that, if not all of that, had occurred prior to that date*", and (b) his role was substantive particularly at the point at which the primary activity of the partnership took place. Mr Yusef accepted, therefore, that most if not all or the primary part of Gala's activities took place prior to the termination of the LBPC agreement (albeit he insisted Mr Ackerman did unspecified activity after that).

(7) It is plain from its internal communications that Sony intended to exercise the Call Option using the Deposit to meet an option price equal to the Minimum Amount of £102 million. We can see no realistic basis for Mr Yusef's suggestion that the market value of the Rights could have exceeded £102 million when the option was exercised given that Gala acquired the Rights, less than 2.5 years earlier, for only £15.1 million. We note, in particular, that (a) the transaction films were regarded as successful (as Mr Bold said (see section 11)), and (b) a price over £102 million would have eaten into Sony's benefit of £15 million. It is implausible that Sony would have agreed to any mechanism which it thought could have resulted in that eventuality, and (c) there is no valuation evidence or evidence from Sony to support the suggestion. We consider it reasonable to infer, therefore, that it was readily apparent to the parties at the outset that (i) SPE would be able to exercise the Call Option on paying only a sum equal to the Minimum Amount/the balance of the Deposit, and, (ii) on the basis that the Initial Expenditure would be released from the expenditure account for SPR to spend on approved Gala Expenses before the first exercise date, essentially Sony would be in a neutral financial position as regards the exercise of the option (in that, in effect, it would have received £102 million as Initial Expenditure and paid the same sum as the option price, as funded by the Deposit) and would retain its full benefit of £15 million.

460. We consider that Sony's email correspondence set out above in this section reinforces the basis for our conclusion that Sony intended to exercise the Call Option at the earliest opportunity. We appreciate that the correspondence dates from 2006 and not 2004 when the Gala arrangements were entered into. However, in our view, it is clear from the overall tenor of the correspondence that, in 2006, as the first scheduled exercise date approached, the relevant personnel at Sony were acting on the assumption that, as a matter of course, SPE would exercise the Call Option on that date if Gala did not agree to amending the documents to allow SPE to exercise it in the next financial year, as SPE wished to do for financial reasons.

461. HMRC also noted that the extension to the Call Option exercise dates was granted in exchange for an amount described as "arbitrary" and it is apparent from the relevant meeting minutes that no proper consideration was given to whether this was an appropriate amount. The relevant minutes stated that: "The Chairman also *suggested* that a sum of £75,000 *could* be a reasonable level of consideration". Mr Vallat said that the fact that £75,000 was paid for the extension was decided upon at a meeting and is unobjectionable. In our view, it appears from this that Invicta/Gala had little concern with the requested extension. From the conclusions set out above it is reasonable to infer that this was because Invicta/Gala expected SPE to exercise the Call Option on one of the revised dates.

462. In our view, it does not detract from our finding that it was inevitable that SPE would exercise the Call Option, and its significance to our conclusions on the issues in this case, that, as Mr Yusef and the Referrers all emphasised, they could not *know* that SPE would exercise the Call Option, as it was entirely within SPE's control and discretion whether to do so, and SPE would only do so if it was to its benefit. All the circumstances set out above show that, from the outset (1) those who designed the arrangements and operated Gala had every reason to believe that they had successfully set up the arrangements so that SPE would take advantage of its right to terminate the transactions as soon as it could, and (2) the possibility that SPE would not exercise the Call Option at an early stage was remote. It is very difficult to see what realistically could have happened after the structure was put in place to prevent Sony wanting to put an end to the "bother" of the arrangements as soon as practicable. We note, in

particular, that that there was no realistic prospect that the option price would exceed a sum equal to the Deposit of £102 million. In light of that, for the purpose of determining, on a purposive construction of the relevant legislation whether, viewing the facts realistically, Gala carried on a trade (and, if so, "with a view to profit"), it is reasonable to assume that the clearly intended and expected plan of those who designed these composite arrangements and, in practice, operated the purported trading entity, would operate as they intended and expected (as in fact it did). In that respect, we rely on the decision of the Supreme Court in *RFC 2012 Plc (in liquidation) v AG for Scotland* [2017] 1 WLR 2767 at [65] (where they cited *IRC v Scottish Provident Institution* [2004] 1 WLR 3172).

Part C – Was Gala trading "with a view to profit"

Caselaw – general principles

463. The parties both referred to the summary of how the concept of trade is to be interpreted in *Eclipse CA* and *Ingenious CA*. In *Eclipse CA*, having made the general comments referred to in section 2 of Part A, Sir Terence Etherton MR remarked, at [111], that the concepts of an "unblinkered approach to the analysis of the facts" and a "realistic approach to the transaction" derive at least in part from the speeches in *Ransom v Higgs* and in that case:

(1) Lord Morris said (at 960c) that "[i]n considering whether a person 'carried on' a trade it seems to me to be essential to discover and examine what exactly it was that the person did".

(2) Lord Reid (at 955h) specifically examined what Mr Higgs had himself done and said: "It is necessary to stand back and look at the whole picture and, having particular regard to what the taxpayer actually did, ask whether it constituted a trade."

464. He set out, at [114], that in *Marson v Morton* 1986] 1 WLR 1343, which relates to the correct characterisation of "a one-off deal with a view to making a capital profit" Sir Nicholas Browne-Wilkinson V-C set out a list of matters which have been regarded as "badges of trading" (at pages 1348 to 1349). He noted that he "emphasised, however, that the list was not a comprehensive statement of all relevant matters nor was any one of them decisive in all cases" and that he said that:

> "the most they can do is to provide common sense guidance to the conclusion which is appropriate; and that in each case it is necessary to stand back and look at the whole picture and, having regard to the words of the statute, ask whether this was an adventure in the nature of trade."

He concluded that the cases by reference to which the list of the "badges of trading" was compiled are not sufficiently analogous to the facts of the *Eclipse* case to make the list of value in that case. We have set out this tribunal's summary of the "badges of trading" in *Ingenious FTT* below.

465. At [115] and [116], he set out that in *Ransom v Higgs*, Lord Reid and Lord Wilberforce said that "the word "trade" is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services", and "normally trade involves the exchange of goods or services for reward and pre-supposes a customer" (at 955 and 964). He said that the references to the normal feature of a "customer" in trading activity must be treated with care and the important point made by Lord Reid and Lord Wilberforce was that the taxpayer had no counterparty and as Lord Wilberforce explained (at 964f) "trade must be bilateral – you must trade with someone" and as Lord Cross said (at 974):

> "A man cannot be trading or engaged in an adventure in the nature of trade unless there is someone with whom he is trading – someone to whom he supplies

> something such as goods or services for some return. Here there was no one with whom Mr Higgs can fairly be said to have "traded" … Mr Higgs … simply told the parties concerned to carry out the transaction which the scheme which he had adopted required them to carry out."

He concluded that "undoubtedly trading activity involves a counter-party of some description" but said he did not find it helpful, however, "in a complex transaction" such as that under consideration "to seek to identify whether that counter-party is or is not properly characterised as a "customer", as that word is used in ordinary speech".

466. Finally, he noted, at [117], that, on legal principles, it is elementary that the mere fact that a taxpayer enters into a transaction or conducts some other activity with a view to obtaining a tax advantage is not of itself determinative of whether the taxpayer is carrying on a trade: *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655, 677 (Lord Templeman) ("*Ensign Tankers*").

467. In the later decision in *Ingenious CA,* at [50], the court cited the following comments from Lord Wilberforce in *Ransom v Higgs* (at 1610-1611) noting that he observed that the court was there "concerned with some sophisticated transactions, evidently the product of expert intellects in the tax avoidance business":

> "Trade is infinitely varied; so we often find applied to it the cliché that its categories are not closed. Of course they are not: but this does not mean that the concept of trade is without limits so that any activity which yields an advantage, however indirect, can be brought within the net of tax…
>
> "Trade" cannot be precisely defined, but certain characteristics can be identified which trade normally has. Equally some indicia can be found which prevent a profit from being regarded as the profit of a trade. Sometimes the question whether an activity is to be found to be a trade becomes a matter of degree, of frequency, of organisation, even of intention, and in such cases it is for the fact-finding body to decide on the evidence whether a line is passed. The present is not such a case: it involves the question as one of recognition whether the characteristics of trade are sufficiently present...
>
> [Lord Wilberforce made the comments set out in *Eclipse CA* as recorded above]…
>
> …Then there are elements or characteristics which prevent a trade being found, even though a profit has been made - the realisation of a capital asset, the isolated transaction (which may yet be a trade)…Although these are general characteristics which one cannot state in terms of essential prerequisites, they are useful benchmarks, so when one is faced with a novel set of facts, as we are here, the best one can do is to apply them as tests in order to see how near to, or far from, the norm these facts are. I attach no importance to the fact that, if there was trade, there is a difficulty in knowing what to call it. Christening normally follows some time after birth…"

468. At [51], they referred to the comments of Lord Morris of Borth-y-Gest in *Ransom v Higgs* regarding the importance of examining "what exactly it was that the person did", and noted that the tribunal in *Ingenious FTT* quoted that statement, before continuing in terms which they endorsed, (at [358] of the tribunal's decision) that that means:

> "what the LLPs did, not their members, and not what was done by Ingenious for itself or other persons. It will involve a weighing of a number of factors, the relevance and importance of which will depend on the circumstances. There is no complete list of those factors and no rule that any one or more of them are decisive…"

469. At [52], they referred to the "badges of trade" and the comments in *Marson v Morton* on their limitations and noted, however, that "these observations were made in the context of a "single transaction" case", where the question was whether it

constituted "an adventure in the nature of trade". At [53], they referred to Sir Terence Etherton MR's comments in *Eclipse CA* at [112] and, at [66], described that case as providing "a useful and influential summary of the relevant legal principles for determining whether a particular activity is a trade".

470. At [68], they set out that in *Samarkand Film Partnership No. 3 v HMRC* [2017] EWCA Civ 77, [2017] STC 926 ("*Samarkand CA*"), the Court of Appeal upheld the tribunal's decision that (a) Jersey partnerships which entered into sale and leaseback transactions for certain films in return for fixed, increasing, secured and guaranteed rental payments over a fifteen-year period were not carrying on a trade, and (b) therefore, the individual partners were not able to access substantial first-year trading losses to set against their taxable income. They noted that a similar result was also reached in another film scheme case, *Degorce v HMRC* [2017] EWCA Civ 1427, [2018] 4 WLR 79 ("*Degorce*") and in *Brain Disorders Research Ltd Partnership v HMRC* [2018] EWCA Civ 2348, [2018] STC 2382.

471. In *Degorce*, the purchase and immediate disposal by the taxpayer of film rights, in return for a speculative share of film receipts, were held not to be in the nature of a trade.

472. In *Ingenious CA*, the taxpayers placed considerable reliance on the decision of Millett J (as he then was) in *Ensign Tankers (Leasing) v Stokes* [1989] 1 WLR 1222 as well as the decision of the House of Lords in that case (*Ensign Tankers (Leasing) v Stokes* [1992] 1 AC 655) ("*Ensign*"). The Court of Appeal, therefore, considered that decision at some length. Gala also placed reliance on these decisions.

473. In summary, in *Ensign*, as set out in detail at pages 229 to 231 of the decision of the House of Lords:

> (1) Four UK companies entered into a limited partnership (VP), as limited partners, with the subsidiary of a US film production company, as general partner, to produce and exploit the film "Escape to Victory". Under the Limited Partnerships Act 1907 and by the express terms of the partnership agreement, the limited partners were not liable for the debts and obligation of the partnership beyond the capital they contributed.
>
> (2) Under the agreement with the production company, LPI, (a) VP contributed \$3.25 million towards the cost of the film, (b) VP was entitled to the master negative of the film and was granted the exclusive licence to make and exploit the film, (c) LPI agreed to complete the film and to lend VP the cost of making the film in excess of \$3.25 million.
>
> (3) LPI "loaned" VP \$10.75 million. Under the terms of the loan, (a) until VP had received \$3.25 million from 25% of the net receipts from the exploitation of the film, an amount equal to 75% of the net receipts was to be applied towards repayment of the loan (and thereafter all receipts were to be applied in discharge of the loan), and (b) however, under a provision headed "Non-recourse Loan", VP and the partners were freed and discharged from any liability to repay the loan and related costs or any other monies which became due to LPI under the terms of the agreement.
>
> (4) VP granted 2 of LPI's subsidiaries the exclusive right to distribute and exploit the film in perpetuity. The subsidiaries agreed (a) to pay 25% of the net proceeds from the film to VP and 75% to LPI until VP had received \$3.25 million, (b) thereafter, to pay 100% of such proceeds to LPI until it had received essentially all monies due under the loan agreement, and (c) thereafter, to pay 25% to VP on the basis the subsidiaries were to retain the remaining 75%.

(5) The limited partners claimed they were entitled to first year capital allowances pursuant to s 41 of the Finance Act 1971 in respect of the whole of the cost of the film of around $14 million on the basis that they had incurred that full sum on the provision of the master negative.

(6) The parties were agreed that the documents were interdependent and constituted one single composite agreement or transaction, which was a tax avoidance scheme and must be read as a whole. HMRC argued that the members of VP were not entitled to any first-year allowances on the basis that it did not carry on a trade but carried out a device to avoid tax.

(7) The Special Commissioners and the Court of Appeal held that no allowances were available on the basis that VP did not trade whereas the High Court formed the opposite conclusion. In outline, the House of Lords held that the Commissioners and the Court of Appeal had erred in disregarding the entire fiscal effect of the transaction and had asked themselves the wrong question:

(a) The legal effect of the transaction, whatever its design, was as a trading transaction. Given that the master negative belonged to VP and it expended $3.25 million towards the production of a film in which it had a 25% interest, the members were entitled to first-year allowances on that sum on the basis it was incurred for the purposes of its trade (see pages 231 and 243).

(b) The remaining amount of $10.75 million was not incurred by VP on the master negative. The effect of the loan arrangements was that that sum was incurred by LPI and not VP.

474. In *Ingenious CA*, the Court of Appeal focussed on the judgement of Millett J as regards the principles he set out for determining whether an entity is trading:

(1) The Court of Appeal said, at [58], that it is important to appreciate that the Commissioners decided VP did not trade on the basis that "transactions which are entered into with fiscal motives as their paramount object are not…trading transactions" (see the judgment of Millett J at 1234C-D) but (b) this conclusion was heavily criticised by Millett J, who said at 1234E:

"the commissioners' whole decision betrays a confusion between the motives of the taxpayer company and the purpose or object of the transaction which led them to concentrate on the motives of the taxpayer company and the Thomas Tilling group in investing in the partnerships instead of on the purpose or object of the transactions into which the partnerships entered" (see [59]).

(2) They set out, at [61], that Millett J described the Commissioners' reasoning as "an astonishing mixture of error and irrelevance" at 1237B, before concluding, at 1239C, that the only possible conclusion from the facts they had found was that the partnerships were trading and that this accorded with the justice of the case:

"The fiscal advantage which the commissioners found so unpalatable was obtained by the element of "gearing" which inflated the amount of the first-year allowances beyond the sums which the partnerships had to finance out of their own resources…But that was the result of the use by the partnerships of borrowed money to finance their activities, not of anything uncommercial in the nature of those activities."

(3) They continued, at [62], that Millett J then considered, and rejected, an argument that the limited partnerships were not trading at all, but merely investing in films to be made and distributed by others. He said, at 1239G, that the submission appeared "promising at first sight", but it had to be rejected because:

"the subject matter of the purchase was an uncompleted film, and the partnership arranged for it to be completed on its behalf with a view to its commercial exploitation. The returns were incapable of calculation. The film

might have yielded substantial profits or no net receipts at all. Once fully exploited, the film would have negligible residual value. The transaction has all the characteristics of a typical though speculative trading transaction and none of the characteristics of an investment."

(4) The Court of Appeal then set out extracts from Millett J's understanding of the relevant law as set out at 1232D to 1234B (and noted that the whole passage is set out in the UT's decision in *Ingenious* at [164]):

> "(1) In order to constitute a transaction in the nature of trade, the transaction in question must possess not only the outward badges of trade but also a genuine commercial purpose.
>
> (2) If the transaction is of a commercial nature and has a genuine commercial purpose, the presence of a collateral or ulterior purpose to obtain a tax advantage does not "denature" what is essentially a commercial transaction. If, however, the *sole* purpose of the transaction is to obtain a fiscal advantage, it is logically impossible to postulate the existence of any commercial purpose.
>
> (3) Where commercial and fiscal purposes are both present, questions of fact and degree may arise, and these are for the commissioners. Nevertheless, the question is not which purpose was predominant, but whether the transaction can fairly be described as being in the nature of trade.
>
> (4) The purpose or object of the transaction must not be confused with the motive of the taxpayer in entering into it…
>
> (5) The test is an objective one…
>
> (6) In considering the purpose of a transaction, its component parts must not be regarded separately but the transaction must be viewed as a whole…" (See [63].)

(5) The Court of Appeal commented, at [64], that Millett J's judgement illustrates the need to find "a genuine commercial purpose", and the general irrelevance of fiscal motive in answering the objective question whether the transaction viewed as a whole constitutes a trade. They noted that Millett J not merely disagreed with the reasoning of the Commissioners, but was satisfied that they had erred in law in finding that no trade was carried on by the partnership and that his conclusion on that critical issue was not overturned in the higher courts, although:

> "the House of Lords (in the leading speech of Lord Templeman) disagreed with his acceptance at face value of the non-recourse borrowing, and relied in part on the *Ramsay* principle (as it was then understood) to analyse the true legal effect of the transaction as a joint venture which contained no element of loan: see [1992] 1 AC 655 at 666 to 667. So viewed, the only real expenditure of [VP] was the $3.25 million contributed by the limited partners, and the partnership's claim for capital allowances had to be reduced accordingly. In very general terms, it may be said that the approach espoused by Millett J to the analysis of the facts had much in common with the Ingenious basis in the present case, whereas the approach of the House of Lords accorded much more closely with the 30:30 basis."

(6) At [65], they noted that in the House of Lords Lord Templeman said at 669A that "the contribution by [VP] to the cost of the film of the sum of $3¼ m. in consideration for 25 per cent of the net receipts from the exploitation of the film can only be described as trading". They thought that although this passage appears in what seems to be a summary of HMRC's submissions, it must reflect Lord Templeman's own analysis, because HMRC submitted that there was "no trading": see the report of the argument at 659E. In any event:

> "if there were any room for doubt about this point, it is laid to rest by the explicit statements of Lord Templeman at 677D-E and 680A-C that the

transaction was a trading transaction. As Lord Templeman said, in the second of those passages:

"In the present case a trading transaction can plainly be identified. [VP] expended capital in the making and exploitation of a film. That was a trading transaction which was not a sham and could have resulted in either a profit or a loss."" (Emphasis added.)

475. Gala referred to the full passages in Lord Templeman's judgement which the Court of Appeal made reference to:

(1) Lord Templeman thought that the Commissioners had taken the wrong approach by simply disregarding all the fiscal consequences of the transaction on the basis that it was a tax avoidance scheme with fiscal motives as the paramount object. In his view, at 676H to 677A, the *Ramsay* line of cases does not authorise that approach:

"The principles of *Ramsay* and subsequent cases do not authorise the court to disregard all the fiscal consequences of a single composite transaction read as a whole on the grounds that it appears that the transaction is a tax avoidance scheme…In the present case the commissioners felt bound to ignore all the fiscal consequences which are beneficial to the taxpayer because [VP] had entered into the scheme with 'fiscal motives as the paramount object'."

(2) He said, at 677A, that similarly Sir Nicolas Browne-Wilkinson V-C had applied the wrong approach in holding that "the taxpayer is deprived of all the beneficial effects of the scheme if the scheme was entered into essentially for the purpose of obtaining a fiscal advantage under the guise of a commercial transaction: [1991] 1 WLR 341, 357." He then quoted, at 677C, the following from the Vice-Chancellor's decision (taken from page 355 of that decision):

"if the commissioners find as a fact that the sole object of the transaction was fiscal advantage, that finding can in law only lead to one conclusion, viz. that it was not a trading transaction....if the commissioners find as a fact only that the paramount intention was fiscal advantage…the commissioners have to weigh the paramount fiscal intention against the non-fiscal elements and decide as a question of fact whether in essence the transaction constitutes trading for commercial purposes."

(3) He criticised that approach in the following well-known passage, at 677 D to F:

"My Lords, I do not consider that the commissioners or the courts are competent or obliged to decide whether there was a sole object or paramount intention nor to weigh fiscal intentions against non-fiscal elements. The task of the commissioners is to find the facts and to apply the law, subject to correction by the courts if they misapply the law. The facts are undisputed and the law is clear. [VP] expended capital of $[3.25m] for the purpose of producing and exploiting a commercial film. The production and exploitation of a film is a trading activity. The expenditure of capital for the purpose of producing and exploiting a commercial film is a trading purpose. By section 41 of the Act of 1971 capital expenditure for a trading purpose generates a first year allowance. The section is not concerned with the purpose of the transaction but with the purpose of the expenditure. It is true that [VP] only engaged in the film trade for the fiscal purpose of obtaining a first year allowance but that does not alter the purpose of the expenditure. The principles of *Ramsay* and subsequent authorities do not apply to the expenditure of $[3.25m] because that was real and not magical expenditure by [VP].

The Vice-Chancellor referred to authorities in which intentions sometimes illuminated and sometimes obscured the identification of a trading purpose.

But in every case actions speak louder than words and the law must be applied to the facts."

(4) Following his review of the cases, at 680A to C, he made the comment set out by the Court of Appeal in *Ingenious CA* above and added:

"…The expenditure of $[3.25m] was a real expenditure. The receipts of $3m were real receipts. The expenditure was for the purpose of making and exploiting a film and entitled [VP] to a first year allowance equal to the expenditure. The receipts imposed on [VP] a corporation tax liability."

476. The parties were agreed that the correct approach to determine whether Gala acted "with a view to profit" is that set out by the Court of Appeal in *Ingenious CA*. In summary:

(1) As set out at [119], this is a wholly subjective test:

"It must be the actual subjective intention or purpose of the putative partners to make profits from carrying on their trade, profession or business. It is not a question of motive. People may have many reasons why they aim to make profits, including, for example, to support themselves and their families, to make charitable gifts or to create tax losses. For these purposes, they are beside the point. It is the genuine subjective purpose of the partners to make profits from their trade, profession or business which is the defining feature of a partnership."

(2) At [121], the Court of Appeal endorsed the way the test was expressed by the UT at [333] of their decision in *Ingenious UT*:

"We consider the better view to be that the test is a purely subjective one. There is no need for profit to be the predominant aim. As is noted in Lindley & Banks, difficult questions can arise when any profit-making aim is subsidiary to other purposes. In those circumstances, it is necessary to consider at what point the line is crossed and there is in fact no view to profit. Some sort of "reality check" is needed. It is necessary to identify whether there is a "real" intention rather than something that was not, in fact or reality, aimed for. The question as to whether a trade was carried on "with a view to profit" also cannot be answered in isolation, divorced from the context of the business in question. The context of "carries on a trade…" directs attention at least to some extent to the way in which the trade is conducted. Furthermore, an indifference to whether a profit is realised is not sufficient to meet the test. In this case, therefore, the FTT would have had to have been satisfied that the LLPs had genuinely intended to seek a profit from their activities."

(3) The Court of Appeal continued, at [122], that, while there is no objective element to the requirement for a view to profit, the likelihood of profits and the timescale in which they might be achieved will often be relevant to testing whether there is a genuine subjective view to profit. They considered this was well expressed by the UT, at [345], as follows:

"Where the intention being tested is that of experienced businessmen, the lack of any realistic potential for or likelihood of profit on an objective basis may call into question whether there is a (subjective) view to profit. Experienced businessmen of course take risks, and different individuals will be willing to take differing levels of risk, but businessmen will generally seek to satisfy themselves that the risks are worth taking for the potential return on capital employed, at least if they are risking their own funds. The dynamics may differ where it is someone else's money that is at risk of being lost. HMRC repeatedly submitted that this was a case where the investment was being made with other people's money, namely that of the Exchequer in the form of the monies that the investors expected to receive from HMRC by way of tax repayments. And the extent of the risk taken may depend not only on the risk appetite of the

investors but on the degree to which the individuals making the decisions are answerable for any failure, or incentivised by success."

(4) They said, at [123], that other aspects of the test are uncontroversial.

"[a] First, "profit" has an objective meaning. If putative partners only have a view to making what they wrongly believe to be profits, for example gross revenue, they will not have a view to profit.

[b] Second, there is no maximum period during which the partners must intend to make a profit, although no doubt the longer the period the more searching the inquiry into the real subjective purpose of the partners.

[c] Third, in broad terms, "profit" has the basic meaning of an excess of income over costs over a possibly indefinite period. It follows that the complex mosaic of generally accepted accounting practice (GAAP), which enables accounts to be properly prepared for defined periods, most commonly for a year, will generally have little part to play.

[d] Fourth, as noted by the UT at UT/333, the view to profit need not be the predominant subjective purpose, but it must be part of the partners' subjective purpose." [Numbering added for ease of reference.]

(5) At [125] they set out that many of the propositions, which derive from a variety of authorities and writings over many years, were considered by the Supreme Court of Canada in *Backman v The Queen* 2001 SCC 10, [2001] 1 RCS 367. In its unanimous judgment, the Court said:

"22. A determination of whether there exists a "view to profit" requires an inquiry into the intentions of the parties entering into an alleged partnership. At the outset, it is important to distinguish between motivation and intention. Motivation is that which stimulates a person to act, while intention is a person's objective or purpose in acting. This Court has repeatedly held that a tax motivation does not derogate from the validity of transactions for tax purposes…similarly, a tax motivation will not derogate from the validity of a partnership where the essential ingredients of a partnership are present…The question at this stage is whether the taxpayer can establish an intention to make a profit, whether or not he was motivated by tax considerations…

23. Moreover, in [*Continental Bank Leasing Corp v The Queen* [1998] 2 SCR 298], this Court held that a taxpayer's overriding intention is not determinative of whether the essential ingredient of "view to profit" is present. It will be sufficient for a taxpayer to show that there was an ancillary profit-making purpose…

24. An ancillary purpose is by definition a lesser or subordinate purpose. In determining whether there is a view to profit courts should not adopt or employ a purely quantitative analysis. The amount of the expected profit is only one of several factors to consider. The law of partnership does not require a net gain over a determined period in order to establish that an activity is with a view to profit. For example, a partnership may incur initial losses during the start up phase of its enterprise. That does not mean that the relationship is not one of partnership, so long as the enterprise is carried on with a view to profit in the future."

(6) They also cited [25], where the Court said:

"…to ascertain the existence of a partnership the courts must inquire into the whether the objective, documentary evidence and the surrounding facts, including what the parties actually did, are consistent with a subjective intention to carry on business in common with a view to profit."

Parties' detailed submissions on trade issue

Eclipse CA

477. HMRC submitted that it is clear from the decision in *Eclipse FTT*, as endorsed in *Eclipse CA*, as well as from *Ingenious CA*, *Samarkand CA* and *Degorce,* that the acquisition of a right to receive income, whether fixed or variable or guaranteed or contingent, is not necessarily by itself trading activity or even necessarily indicative of trading activity. HMRC added that it is clear from the decision of the tribunal in the *Samarkand* case ([2012] SFTD 1 ("*Samarkand FTT*"), at [201] and [202], that the fact that the analysis is limited to the LLP's activities (and not that activity aggregated with the affairs of the members) does not mean that it is irrelevant to the analysis that those activities are designed to give rise to tax relief for the LLP's members.

478. In *Eclipse FTT*, the issue was whether the members of Eclipse were entitled to relief for pre-paid interest on a loan under s 262 ICTA as would be the case if it carried on a trade of acquiring and exploiting film rights and the borrowed money was used wholly for the purposes of that trade. The tribunal decided, as was upheld by the UT and Court of Appeal, that Eclipse did not carry on a trade, and that the transactions were of an investment character. The factual context was summarised by the tribunal as follows (as supplemented by additional explanation from the decision of the UT):

(1) On closing (a) Eclipse obtained a licence from Disney of rights to exploit and distribute 2 films produced by Disney for 20 years in return for (i) a licence fee, in aggregate of £503 million due in instalments but paid in advance, and (ii) variable royalties, and (b) Eclipse entered into a distribution agreement with a Disney entity ("**DE**") under which it sub-licensed the rights in the films to DE for 20 years and DE was required to exploit the films and ensure their distribution on paying Eclipse (i) "Annual Distributions" over 20 years, which matched the variable royalties, and (ii) "Contingent Receipts", payable under a complex formulation if gross receipts from the exploitation of the films exceeded a certain threshold after payment of prior charges.

(2) As security for its obligations to pay the Annual Distributions, DE provided Eclipse with a letter of credit issued by Barclays: (a) payments under it directly corresponded to the Annual Distributions, (b) its issuance relieved DE from its payment obligations to Eclipse (so that, in effect, Eclipse substituted Barclays risk for DE risk), and DE deposited around £497 million with Barclays and charged that sum to Barclays to secure the issue of the letter and to fund Barclays' obligations under it.

(3) Eclipse was financed by its members, who contributed capital to the partnership of a total of £840 million, financed as regards £50 million from their own resources but, as to around 94%, by borrowings of £790 million under a 20-year facility from Eagle. The borrowing was secured by a charge given by Eclipse over the letter of credit.

(4) Under the Eagle facility the members were required to pre-pay on closing a total of £293 million in respect of interest accruing at a fixed rate over the first 10 years of the loan. The members financed this with a payment to them by Eclipse expressed to be by way of loan on account of anticipated profits. It was this sum that the members claimed relief for under s 262 ICTA.

(5) The payments made between the parties on closing and those due over the term of the transactions, were in accordance with cash flow statements produced from financial models devised by the promoter of the structure, Future, and used in the promotion of Eclipse to potential investors.

(6) Shortly before closing:

(a) Eclipse entered into a marketing services agreement with WDMSP Ltd ("**W**") whereby, in return for a fee it agreed (i) to act as Eclipse's agent in

developing marketing and release plans for the films ("**the plans**") and (ii) to provide Eclipse with services relating to the supervision of DE in its implementation of such plans. Under the distribution agreement, DE agreed to implement the plans prepared by W.

(b) Eclipse appointed Future to provide it with services relating to the selection, acquisition and exploitation of films and film rights and the management of such matters in return for a fee based on a percentage of the capital raised and of the net proceeds from the exploitation of film rights licensed by Eclipse. Pursuant to this agreement, Eclipse paid Future a fee of approximately £44 million on the closing date.

479. HMRC emphasised that, as recognised by the Court of Appeal (see [61] of *Eclipse CA*), "critically" the tribunal rejected Eclipse's contention that "collaboratively with [DE], it was engaged in directing and supervising the marketing and release of the Films". HMRC submitted that the focus of the tribunal's findings in this respect was on the absence of consequence or meaning to the activities carried out and the crucial finding was that there was none.

480. The following facts, as summarised by the Court of Appeal, are relevant to this aspect of the decision:

(1) In order to assist it, W (a) agreed to procure the provision of services by specified employees of Disney distribution and marketing companies, the Buena Vista companies ("**the designees**") and to secure the services of "SFC", (b) engaged Mr Salter of SFC as a consultant, and (c) also engaged "SCI", a Los Angeles company, of which Mr Molner was the managing director ([31] to [33]).

(2) In return for a fee of £3,000 SCI agreed to assist the designees by (a) acting as a liaison between them and Mr Salter, and (b) assisting them in preparing and providing to Eclipse the reports which W was to provide ([34]).

(3) SFC agreed to provide W with services for a fee of £700 per hour per 8 hour day, including (a) liaising with the designees and SCI as regards the preparation of the plans and W's other services, (b) assembling the work product of the designees and SCI as regards preparation of the plans and ensuring that they were in a form to be presented to W, (c) if W approved the plans, presenting them to Eclipse, Disney and DE, (d) from the information supplied by W, the designees and SCI, tracking DE's performance in following the plans, including identifying whether it deviated materially from the plans, (e) reporting to W on the performance of the films (as informed by DE), and (f) generally providing written reports to W on matters relevant to W's services ([36]).

(4) The agreements contained a number of provisions intended to ensure that, in the event of any conflict between the interests of the Disney group and those of Eclipse, priority was to be given to the interests of the Disney group ([37] to [45]). For example, (a) the licence of the rights to Eclipse was subject to certain prior licence agreements, including those between Disney and the Buena Vista companies dating from 1990 ([38] to [40]), and (b) in the marketing services agreement it was acknowledged that W, as a member of the Disney group, may have obligations and duties to the Disney group in relation to the films which may compete or conflict with its obligations to Eclipse, in which case W was entitled to act in the best interests of the Disney group even if that was not in the best interests of Eclipse ([44] and [45]).

481. The Court of Appeal set out the following as regards the tribunal's findings on Eclipse's marketing activities:

(1) (a) W prepared, on Eclipse's behalf, an initial plan for each film, and (b) once those plans had been agreed its role was:

> "to monitor [DE's] exploitation of the Films in order to check whether [DE] was proceeding in line with the plans, to question any variations proposed by [DE] to the strategy laid out in them and to suggest any variations which [W] thought appropriate as matters unfolded following the release of the Films". ([61])

(2) In view of the expertise within the Disney group as to the marketing and distribution of film rights, there was little by way of intervention by W in DE's activities following the release of the films ([61]).

(3) W could not be regarded as an agent of Eclipse despite W's apparent appointment as such as it "is of the essence of a relationship of agency that the agent, when engaged on its principal's business, should act exclusively and in a fiduciary manner in the interests of the principal" but that was not the case as is evident from the provisions referred to above ([62]).

(4) Neither Eclipse, W nor SCI (a) "had any capability whatsoever to be a part of any strategic or day-to-day planning for the marketing or release of the Films, or to monitor or supervise [DE's] performance relative to any agreed plan", and (b) that capability resided within the Disney group, and in particular in the Buena Vista companies ([63]).

(5) It was noted that "whatever the contractual documents provided, there was not convincing evidence that what the documents provided for matched what happened in fact" ([63]).

(6) Mr Salter, with his long experience, may have had such capability but his role was limited to liaising between the designees and W ([64]).

(7) The tribunal said (at [349]) that the Buena Vista companies would:

> "regardless of the involvement of [Eclipse], have used their vast resources and expertise to market and distribute the Films to the best of their considerable ability; and the Disney group had a direct interest in their so doing in order to maximise the variable distributions which flowed back to Disney as variable royalties, and to maximise also the likelihood of generating Contingent Receipts (60 per cent of which went to the Disney group)."

The tribunal said that, in those circumstances, clear and convincing evidence was required that the designees stepped out of their position as employees doing for their Buena Vista employer what they did on a daily basis and performed their duties instead for W but such evidence was not made available to the tribunal ([65]). In this case, HMRC noted that the tribunal plainly was not satisfied that no-one from the studio gave evidence and that had a bearing on the decision and, as set out below, the Court of Appeal were satisfied that the tribunal's approach on this is reasonable.

(8) The tribunal concluded on this, at [356] to [358], as follows ([66]):

> "356.…we do not consider that Mr Salter's activities establish that [Eclipse] was, even on a collaborative basis, engaged in directing and supervising the marketing and release of the Films. [Eclipse] cannot be said to be directing and supervising matters in circumstances where [DE] had already come to a conclusion as to what it should do.
>
> 357. Finally, although there was undoubtedly a well-planned and well-executed regular flow of high quality and relevant information gathered by SCI and Mr Salter from the relevant Disney companies to [W] and [Eclipse], with pertinent comment by Mr Salter, and although that information was considered at board meetings of [W] and by the Designated Members (that is, in effect, the

executive Members) of [Eclipse], that does not in itself establish the case which [Eclipse] is asking us to accept.

358. Whilst we can conclude that, through [W], [Eclipse] monitored the activities of [DE] with regard to the marketing and release of the Films, and was kept fully aware of the activities in that regard which [DE] undertook and of the financial performance of the Films, we are unable to conclude that [Eclipse] had a part, or at least a meaningful part, in directing and supervising the marketing and release of the Films by [DE]."

482. The Court of Appeal also noted that the tribunal held that:

(1) Although a reasonable opinion was given at the outset that Contingent Receipts were possible, "the prospect of earning them was too remote to qualify as a basis or justification for entering upon a trading venture on any commercial level" ([67] and [74]).

(2) At [405] to [409], "..although the acquisition of the Rights by licence and sub-licence were not sham transactions, it was impossible to conclude that on any realistic or commercially meaningful basis [Eclipse] has a customer or has offered to provide any goods or services by way of business...". The tribunal referred to the fact that (a) Eclipse never received physical delivery of the physical manifestation or representation of the films, (b) the relevant agreements were co-terminous and were intended to be (and were) entered into concurrently and were interdependent, (c) Eclipse accepted that DE may act in the best interests of the Disney group even if that may not be in the best interests of Eclipse, and (d) the capacity of strategic and day-to-day planning for the marketing and release of the films was within the Disney group ([68] and [75]).

(3) As HMRC argued, the fact that Eclipse was prepared to take a licence of the rights subject to the prior agreements without obtaining some formal reassurance from Disney as to their purpose, effect and possible significance for the rights granted indicated "a degree of indifference about the value of what was being acquired", which "[went] to the significance which [Eclipse] attributed to this aspect of the transaction" ([69]).

(4) In light of the authorities and statutory provisions, at [398]:

"an element of speculation is a characteristic of the concept of trade – if a taxpayer is trading, what he does must, normally at any rate, be speculative in the sense that he takes a risk that the transaction(s) may not be as profitable as expected (or may indeed give rise to a loss)." ([71]).

The element of risk was absent because (a) leaving aside the Contingent Receipts, the profit from the sub-licence of the rights over 20 years, year by year, was determined at the outset and without any reference to the success or otherwise of the exploitation of the rights, (b) Eclipse took the commercial risk that Barclays may not meet its liabilities under the letter of credit, but the tribunal considered that (i) such a risk was too remote to cause the pre-determined profit to be speculative in any relevant sense, and (ii) such risk is not associated with the acquisition and exploitation of the rights but rather with the solvency of Barclays "which is a factor as far removed from what [Eclipse] actually did as the Members' financing arrangements" (see [401] to [403]) (and see the comment at (1) as regards the Contingent Receipts) ([73] and [74]).

(5) Their conclusion was further supported by the fact that the amount of the putative trading receipts of Eclipse was affected by the extraneous factor of the financing arrangements of the members, reflected in the special feature of the pre-payment of interest (see [410]). The Court of Appeal thought that the tribunal

meant that the profile of the Annual Distributions was influenced by the interest (including the pre-payment) payable by the members ([76]).

(6) The tribunal rejected Eclipse's argument that there was a trade by analogy with a sale and leaseback transaction was relevant. The purchase of an asset by a lessor on terms that it is leased back by a finance lease is properly to be regarded as a trading transaction, the essence of which is the provision of finance by the lessor. By contrast, Eclipse did not claim to be carrying on a financial trade and in any case did not provide finance ([77]).

(7) What Eclipse actually did was not a trading transaction but nor was it a mere device to secure a fiscal advantage; the activities of Eclipse "viewed realistically amounted to a business involving the exploitation of films not amounting to a trade, that is to say a non-trade business within ITTOIA s. 609" ([78]).

483. The Court of Appeal rejected Eclipse's arguments that the tribunal erred including on the ground that the acquisition of film rights and the sub-licensing of those rights for profit are inherently and as a matter of law carrying on a trade. They summarised the position at [123] and [124] as follows:

> "…..The proper characterisation of the business of [Eclipse] depends upon the totality of its activity and enterprise. Stripping the business down to its essential elements, the transactions on which [Eclipse] was engaged had two aspects. One aspect was that a payment by [Eclipse] of £503 million would be repaid with interest over a 20-year term and would produce a profit unrelated to the success or otherwise of the exploitation of the Rights sub-licensed. That aspect had the character of an investment...
>
> The second aspect was the possibility of [Eclipse] obtaining a share of Contingent Receipts and the activity on the part of [Eclipse] to secure such a share. The FTT considered that this second aspect was in real and practical terms insufficiently significant in the context of [Eclipse's] business as a whole to lead to a proper characterisation of [Eclipse's] business as one of trade within the meaning of the tax legislation. In our judgment, that was a conclusion which the FTT were entitled to reach and, indeed, with which we agree."

484. At [128] to [134], they referred to the following factors as providing a sound basis for the tribunal's conclusion that the possibility of obtaining a share of Contingent Receipts was not such as to lead to the proper characterisation of the business of Eclipse as a trade:

(1) The tribunal (a) referred to the evidence given by Mr Molner that no-one would be advised to invest in film rights by reference to the prospect of obtaining a share of Contingent Receipts, and (b) said that was borne out by the financial illustrations given to potential investors, which disregarded the prospect of such receipts in presenting an internal rate of return which was considered by Future to render the investment attractive even if an investor did not wish to borrow part of the capital intended to be contributed.

(2) The contractual documents themselves:

> "contained important provisions which so radically preferred the interests of Disney over [Eclipse] and so severely curtailed the legal obligations of [DE] and [W] to [Eclipse] as to add acute legal conditions to the prospect of [Eclipse] receiving a share of Contingent Receipts."

(3) The tribunal were entitled to conclude that the fact that Eclipse took a licence of the rights, subject to the prior agreements, without obtaining some level of satisfaction from Disney beyond, at best, an un-minuted oral remark as to their

purpose and effect and possible significance "speaks of a degree of indifference about the value of what was acquired".

485. At [135] to [138], the Court of Appeal commented as follows on the tribunal's findings in relation to Eclipse's marketing activities:

(1) At [135], they noted (a) that W carried out its functions for Eclipse using the designees, (b) the tribunal's findings at [349], and at [351] that, even before the involvement of Eclipse, it was probable that Disney would have engaged in a sophisticated preparatory process, and (c) those findings are not undermined by the tribunal's acknowledgment that Disney had never before prepared a comprehensive plan or that the marketing services arrangements were the subject of detailed negotiation or that the plans had some input from Mr Salter.

(2) At [136] they noted that (a) Eclipse relied on 2 occasions when Mr Salter made suggestions about the marketing of the films, but (b) as noted by the tribunal at [338], his consultancy agreement did not require him "to take an executive part in the marketing and distribution of the Films". Rather:

> "His role was to receive information from, or the work product of, others (such as the [designees] seconded to [W]) and to pass that on to [W] and generally to act as a liaison between [W], [Eclipse] and the Buena Vista companies".

(3) They concluded:

(a) At [137], that in the circumstances the tribunal's statement that witness evidence from one of the Buena Vista staff would have shed light on the commercial reality of the arrangements provided for in the network of contractual documents is understandable and was justified.

(b) At [138], the tribunal was perfectly justified in concluding that:

> "reducing the transactions to their core and notwithstanding some contribution by SCI and Mr Salter, the substantial reality was that Disney produced the Films; let the rights in them to [Eclipse], and immediately took them back again; Disney personnel created marketing plans and implemented them; and they reported back to [Eclipse] what Disney was doing."

(c) At [139], against that background, the tribunal's conclusion that Eclipse "was not in reality carrying on a trade was justified and indeed correct" and:

> "[Eclipse] did not discharge the evidential burden of showing that it was engaged in trade in any realistic or meaningful way. The possibility of obtaining a share of Contingent Receipts did not give the business of [Eclipse], looking at it as a whole, a trading character: having regard to the business as a whole, the right to Contingent Receipts was no more than a potential additional return on a fixed term investment."

486. HMRC submitted that (1) it is notable that the Court of Appeal specifically said that the tribunal's findings were correct. In doing so, they did not feel it necessary to consider the "badges of trade" and it is plain that no real significance was attached to Eclipse's right to Contingent Receipts, and (2) whilst the facts of Gala are not the same as those in *Eclipse*, if one strips down Gala's transactions to its essentials, one finds very much the same thing as was found in *Eclipse* at [123] and [124].

487. In HMRC's view, similarly to the situation in *Eclipse*, in substance and reality, Gala's activities constitute fundamentally, entirely uncommercial arrangements for the reasons set out in section 2 of Part A. They emphasised the following points, some of which we have already accepted in our findings in Part B:

(1) Gala had no contractual rights of substance or reality to contribute to the distribution of the transaction films or to share in the Gross Receipts from them and, in practice, Gala made no meaningful contribution, did not provide any

service to Sony and did not receive anything under the waterfall. There was no real prospect of Gala making money under the waterfall and an apparent lack of negotiation and/or indifference in relation to its terms, as evidenced by the absence of any meaningful appraisal of Gala's prospects of making a profit.

(2) In reality, the films were marketed and distributed by Sony in accordance with Sony's decisions and Plans using its own expertise and resources. Gala had no control over or material input into that process and was "bound by iron fetters" to follow Sony's wishes. Gala's only activity was in arranging for a large sum of money to go round in a circle and to pay fees to the third parties involved in the scheme:

(a) The activities in relation to selecting films were (i) devoid of substance, (ii) pointless given that Gala had no realistic prospect of receiving sums under the waterfall, and (iii) in any event, related to the selection of investments.

(b) As regards his attendance at meetings with Sony, at the most Mr Ackerman acted as a messenger between Sony and Invicta but there was no meaning or consequence to that. The transaction films would have been distributed and exploited in the same way regardless of the arrangements with Gala, which Sony viewed as a bother. Moreover, attendance at meetings to receive an update on another's activities is not itself indicative of trading.

(c) Mr Ackerman accepted that his other monitoring activities were administrative, and, in any event, such activity is analogous to monitoring the performance of an investment.

(3) Although Gala claims the arrangements were in some way "innovative", aspects of its arrangements bear a striking similarity to other (failed) tax avoidance schemes such as, in particular, that in *Eclipse*.

(4) There was no speculative aspect to Gala's arrangements. Gala was entitled to guaranteed Minimum Sums which had nothing to do with the exploitation of film distribution rights and everything to do with inflating the loss and hence the tax relief. The possibility of Gala receiving income from the waterfall was so remote that it is to be disregarded.

(5) The purpose and object of the transactions was to obtain the tax benefit; there was no other genuine commercial purpose. The arrangements are replete with entirely uncommercial features, namely, those put to Mr Yusef in cross-examination.

488. Mr Vallat disputed that the evidence supports any of HMRC's factual conclusions. His and Mr Yusef's detailed points on the evidence have been dealt with largely in Part B and/or are otherwise set out and considered in further detail below. We note here, in summary, that he placed particular emphasis on Mr Yusef's evidence that he had a long-term vision to grow Gala over 3 phases and said that Mr Yusef's and Mr Ackerman's evidence demonstrates that (a) Gala undertook a number of activities with a commercial purpose under meaningful rights in the DA and Mr Ackerman carried out a useful and meaningful function for Gala, (b) the waterfall was commercial for the reasons Mr Yusef gave (see section 11 of Part B), (c) tax relief was merely a mitigant and a form of "downside" protection and not the driver for the transactions, (d) the arrangements were entirely commercial for the reasons Mr Yusef gave in cross-examination, (e) the HL letters served a useful purpose (see section 13 of Part B), and (f) it was not inevitable that the Call Option would be exercised (see section 15 of Part B). Mr Vallatt also submitted that there are important factual differences in this case from those in *Eclipse*:

(1) In *Eclipse* the tribunal found that, under the specific contractual arrangements (a) W was not an agent for Eclipse, in particular, as there was a conflict of interest and responsibilities. W owed duties to Disney and Eclipse did not establish that W would act in its interest in light of that, (b) Eclipse did not show that the designees acted for W and so for Eclipse, rather than for Disney, and (c) Mr Salter, had a tightly defined role, merely as a liaison. That is far from the situation here where Invicta, LBPC and Mr Ackerman were plainly acting for Gala.

(2) Eclipse paid for the studio's distribution of the films, whereas Gala paid for *its own* distribution of Sony's films and it was found that Eclipse did not do anything of substance whereas things of substance were done by Gala. Whilst Eclipse maybe indicates a line, once those factual differences are understood, Gala is plainly on the other side of the line from Eclipse.

(3) HMRC are wrong to suggest that in *Eclipse* the tribunal wanted evidence from Disney in a general sense. The tribunal wanted evidence because of the position of conflict W was in and due to the relationship between the Buena Vista companies and Disney. There is no such difficulty here; the people whose activities Gala primarily rely on were not in such a position of conflict. There is not the same high hurdle and, in those circumstances, no particular adverse inference should be drawn from a failure to call Sony as a witness. Gala is not saying that the picture painted by the arrangements is not the one that arises in the contract and is not trying to set-aside or surmount a hurdle of the sort mentioned in *Eclipse*.

489. Mr Vallat also said that *Samarkand* is not relevant. The evidence is that the Gala arrangement was much more active than the sale and leaseback transaction that Mr Yusef had done previously. Hence, a conclusion that a sale and leaseback transaction did not constitute trading is not informative. HMRC responded that the points that Mr Vallat sought to highlight as regards *Eclipse* are certainly part of the picture but are not the entirety of the picture. The purported agency that Eclipse sought to set up with a studio agent did not work, but the key point is that Eclipse made no meaningful contribution to the marketing of the films.

490. As both parties seemed to acknowledge, (1) the tribunal's task is to determine whether Gala carried on a trade during the 2003/04 tax year by applying the principles and guidance set out in the case law having regard to all the facts and circumstances of this case, and (2) as has been emphasised repeatedly in the authorities, it is not a useful exercise for a tribunal to make such a multi-factorial assessment simply by comparing the facts of this case with those in other cases such as *Eclipse*. Therefore, we take *Eclipse* to be a highly influential and useful authority in demonstrating how the tribunal should approach the task in hand and, given the similar context of the two cases, what factors may be of particular relevance.

491. With that in mind, we note that (1) in *Eclipse*, evidently, the fact that some of the parties who were engaged to assist Eclipse in its activities owed a duty to Disney and that W was not its agent, was a factor taken into account in the tribunal's findings that Eclipse did not carry out activities amounting to a trade, (2) we accept that plainly there was no such conflict of interest as regards Mr Yusef/Invicta or Mr Ackerman/LBPC. However, equally plainly that, of itself, does not demonstrate that their activities had substance and meaning to them, and (3) for all the reasons already set out, we do not accept that the evidence establishes that Gala paid for *its own* distribution of Sony's films and that things of substance were done by Gala in relation to Sony's distribution of the transaction films, whether as a result of the activities of those parties or otherwise.

492. Similarly, we do not accept that the fact that there was no such conflict of interest means that the tribunal should attach no relevance to the fact that Gala did not call Sony as a witness. As already explained, in our view, (1) Mr Yusef is seeking to paint a picture contrary to that apparent from the design and operation of the arrangements, in his assertion that Sony had an interest in obtaining finance from Gala for its distribution expenses and not just in receiving the licence fees, as its fee for participating in the arrangements, and (2) if Gala wishes the tribunal to make a factual finding to that effect, it is incumbent on Gala to call Sony as a witness.

Ingenious FTT and CA

493. Gala said that the tribunal should consider the same factors and follow the same approach as the tribunal did in *Ingenious FTT*. In summary, in that case, the tribunal considered (amongst other issues) whether transactions made between (a) LLPs and film studios, and (b) an LLP and video and computer games developers, which in each case were designed to generate losses for the individual investors to utilise against their other income, were in the nature of a trade. The material facts of that case and the essential findings by the tribunal, as set out by the Court of Appeal in *Ingenious CA*, at [11] to [20], are as follows:

(1) Typically (in nominal terms) for every 30 contributed by the individual members to the LLP as capital, 70 was contributed by a corporate member ("**C**") controlled by Ingenious, the architect of the scheme ([11]).

(2) C borrowed 70 from a Hollywood studio or vehicle formed by independent producers and other financiers ("**D**") which entered into contractual arrangements with the LLP in relation to the production and distribution of a film ([11]). The loan (a) was made on limited recourse terms and was repayable only from C's drawings from the LLP, and (b) its stated purpose was to enable C to make a capital contribution to the LLP.

(3) The amounts advanced under the loan were paid direct by D to a production services company ("**PSC"**), which was set up to make the film. D and PSC were not Ingenious entities ([12]).

(4) An "executive producer fee", of 5% of the total film budget of 100, was deducted from the 30 contributed by the individual members and paid to Ingenious. The result was that only 95 reached the PSC, paid as to 70 by D, and as to 25 by the LLP out of the capital contributions of the individual members ([12]).

(5) The taxpayers claimed losses arose because each film had to be valued for accounting purposes, at the end of each accounting period at its net realisable value, "NRV". The NRV was individually calculated for each film but was typically 20% of the cost upon completion of the film, thus generating a loss of 80% of the cost. The idea was that the whole of this loss could be allocated to the individual members, even though 70% of the cost had been contributed by C using funds borrowed from D on limited recourse terms. ([13]).

(6) In broadest outline, the purported effect of the contractual arrangements was that:

(a) the film would be made by PSC in accordance with the agreed specification, cashflow and budget and, once made, would be distributed by D and the proceeds of distribution would be divided between D and the LLP in accordance with the terms of a waterfall; but

(b) the LLP was interposed into this structure in such a way that it ostensibly undertook the primary obligation to make the film in accordance with the same

specification, cashflow and budget, and sub-contracted the performance of this work to PSC; and

(c) upon completion of the film, the LLP would assign to D all its rights to the film, and until such assignment the LLP granted D a sole and exclusive licence of its rights to the film ([14]).

(7) As set out at [15]:

(a) At "a high level of generality....the business model which the LLPs sought to create was one where they engaged in the business of film production, through the services of the PSC as their sub-contractor, contributing 100% of the budgeted cost (although 70% of it originated with [D], and was paid direct to the PSC...), in return for a share of revenues from the completed film in the amounts specified in the waterfall as due to the LLP, amounting to up to 54.45% of the gross distributable income derived from the film".

(b) This was the model which Ingenious used to sell the schemes to potential investors, and the true legal effect of the composite transactions entered into by the parties had to correspond with the model if the individual members were to obtain the first-year loss relief which (for them) was the primary objective of the whole exercise.

(c) HMRC had consistently argued that the true effect in law of the arrangements was that the LLPs contributed 30% of the film's budget in return for 30% of the gross proceeds under the waterfall.

494. In a nutshell, "the tribunal upheld the 30:30 basis contended for by HMRC, as opposed to the *Ingenious* basis for which the LLPs contended" ([18]) and held that:

(1) The activities of the LLPs analysed on HMRC's 30:30 basis did amount to a trade, in relation to the LLPs which invested in films, but did not amount to a trade in relation to the LLP which invested in games.

(2) If the tribunal had found that the legal effect or commercial substance of the transactions was to be determined on the Ingenious basis, then it would have found that the deal was not commercial and therefore did not amount to a trade ([436]) (and the tribunal drew a similar distinction as regards the "view to profit" issue) ([20]).

495. Mr Vallat said that the positive thing Gala takes from *Ingenious* is that, albeit only on the 30:30 basis, it was found, as the Court of Appeal confirmed, that the film LLPs were trading with a view to profit, notwithstanding the knowledge or intention that certain tax reliefs would be available to the members. We accept the uncontroversial general proposition Mr Vallat then made, that the decision, therefore, confirms the principle that the fact there is tax in the background does not stop one trading (or having a view to profit). However, we do not accept, if Mr Vallat meant to suggest this, that the facts and circumstances of this case justify a conclusion that Gala carried on a trade or did so with a view to profit by analogy with those in *Ingenious* (as assessed on the 30/30 basis). As HMRC noted, the Court of Appeal said at [104] of *Eclipse CA*: "It is seldom, if ever, useful to look to early authorities for supposed analogies on the facts" and, in any event, as set out below, there are material differences in the facts and circumstances of the 2 cases.

496. HMRC submitted that the circumstances of this case are not analogous to those in *Ingenious FTT*. They noted, in particular, that:

(1) Gala does not argue that it carried on a financial trade of any kind.

(2) It was highly material in *Ingenious FTT* that the relevant LLPs had significant investment in independent films which required more work than in relation to the studio films; such films required "putting together" whereas studio

films came packaged by the studio, contracting with a studio took away the need to consider the creative aspects of a film package and left only finance, and the work involved in putting together a deal for a studio film and finalising its documents was less ([301] to [303]):

> "For a Studio film Ingenious had a lesser role in the film: the Studios were huge, diversified multinationals with all the requisite resources to produce films without reference to anyone else; they wanted the involvement of the LLPs for their money and to lay off risk; the LLPs and Ingenious had no role in putting the film together, what they did was by comparison closer to buying an income stream in a complex way."

(3) The tribunal considered the role of the LLP which invested in games was more akin to that the other LLPs had in relation to studio films at [124] and [133]:

> "…In the case of IG there was no evidence of creative input, evaluation of the merits of potential games..,no pulling together a financial package, but instead the insertion of IG into an existing project. Further, whereas in the film LLPs, the LLPs stepped in generally before filming began, IG could step in after development had started and a publisher had already committed funds to the development of the game. There was none of the more complex involvement which ITP and IFP2 had with Independent films....
>
> 133. The activity of IG involved some organisation, some modest repetition and was speculative in nature, but overall and on balance it seems to us to have been more the acquisition of a few financial assets dressed in a complex contractual."

(4) If one were to draw an analogy (albeit that is not the proper use of authority) it would be with the LLP which invested in games and the studio part of the business of the other LLPs.

497. We accept that there are material differences between the circumstances of this case and those in *Ingenious.* As noted, our task is, however, to carry out a multi-factorial assessment to determine whether Gala carried on a trade in the tax year 2003/04 and not to proceed simply by comparing the facts of these 2 sets of cases.

498. HMRC also noted that (1) in *Ingenious FTT* it was held (as HMRC did not dispute) that the relevant LLPs incurred 30 of real expenditure in return for a 30% share of receipts which they were not guaranteed to receive, but (2) here HMRC dispute that any of the Initial Expenditure was incurred by Gala. We comment on this aspect of the case in our conclusions.

499. On that point, Mr Vallat submitted that there are material factual differences between *Ingenious FTT* and this case:

(1) In *Ingenious FTT* the tribunal considered it highly relevant that (a) the LLPs were funded indirectly by loans from D, which, in the case, of the studio films, was a studio entity, and (b) the funds advanced were provided direct to, SPC, which in studio cases, was a studio entity. In that case, in a sense, money came from the studio and went back to the studio.

(2) Here, by contrast (a) Gala and the members obtained funding from a bank, (b) Gala used the funds provided to it to fund the Initial Expenditure in the expenditure account which was used to meet Gala Expenses due to third parties, and (c) Sony did not pay money to Gala straight away; rather it placed funds on Deposit with Barclays as security for the LC issued by Barclays and the funds were to be used to meet the Minimum Sums due only over the term of the DA.

We accept that to some extent these are points of factual difference between the 2 cases. We have commented on the significance of these factual matters in our conclusions.

500. Mr Vallat submitted that the tribunal should adopt a similar approach to deciding whether Gala carried on a trade to that taken by the tribunal in *Ingenious FTT* in considering a number of factors, including the badges of trade, which are set out at [402] to [438] of their decision, as summarised by the Court of Appeal at [85] of *Ingenious CA*. In his view, applying those 13 factors, Gala was trading.

501. In HMRC's view, however, as in *Eclipse*, the badges of trade are of no assistance in this case because the facts are too far removed from those of the cases cited as the basis of the badges. They said that it is clear from the case law that, whilst in some cases the badges of trade can serve to assist with identifying whether a particular activity has the typical characteristics of a trade, they are not to be elevated to the status of a test which, if passed or failed, means that the activity is, or is not, a trade: (1) in *Ransom*, Lord Wilberforce seemed to suggest that the test is not always relevant, and (2) the Court of Appeal has repeatedly made it clear that "the badges of trade are no more than a guide" (see *Samarkand CA* at [80]) and *Eclipse CA)*. HMRC submitted that, in any event, if the badges of trade are considered relevant, they point firmly to a conclusion that Gala was not trading: Gala did not supply goods or services to a counterparty for reward. It simply put sums of money in a circle and paid fees to the various parties involved for their participation.

502. We have set out below (a) details of the factors the tribunal considered in *Ingenious FTT* and how it approached them, and (b) Gala's comments on how the factors apply in this case and HMRC's responses. We note that it is readily apparent from our comments in Part B that we do not accept many of Mr Vallat's submissions on the evidence and the inferences to be drawn from it.

Ransom v Higgs factors

503. In *Ingenious FTT* the tribunal considered 2 factors derived from the comments of Lord Wilberforce in *Ransom v Higgs*. The first is that trade pre-supposes a customer (and the tribunal referred to the comments on that point in *Eclipse CA*). The tribunal decided, at [404] to [406], that:

> (1) Although the relevant agreements were drawn to give the impression of the acquisition by the LLP of rights in a film and their later sale to D, "such was not their substantial legal, or commercial effect. Not only were the agreements part of a single deal but the LLP never acquired any substantial interest in a film". At most the LLP contracted for a film to be delivered to D for a share in the income arising. It did not sell the film to D but it provided finance to D.
>
> (2) But "there is not such an absence of a counterparty as to deprive its activities of a trading nature". D was a counterparty with which each LLP had "commercial relations under which it agreed to do things and obtained substantial rights to receive money". The PSC was also a party to which the LLPs paid money in return for its agreement to make the film. The LLP's financial activity was the exchange of a sum of money paid to one party for a potential future financial reward from another.
>
> (3) The counterparties may have regarded the LLPs as sources of finance rather than as film producers but those counterparties did deals with the LLPs.

504. The second factor is organisation which the tribunal noted:

> "may be in the way in which things are done or in the resources used to do them. A well-run ordered activity with well-defined strategies, and a business which employs serious resource and effort exhibit characteristics of traders".

505. The tribunal decided, at [407] to [409], that this was present:

> "The work undertaken putting together Independent film projects may have been greater than that in negotiating with Studios, but in each case "there was an

organisation geared towards promoting the business of contracting for films and receiving the income from them".

506. Gala submitted that, in this case, both of these factors point towards trade: (1) Gala did a deal with Sony and Gala discharged its obligations to pay for services provided by the third parties, such as McCann Erickson, named on the invoices, and (2) it is clear that Gala had a sufficient organisation to indicate it was trading. It contracted with Invicta, as its media services adviser, to carry out functions for it, including negotiating and setting up the deal with Sony and, through its contract with LBPC, had an operation under its control in Hollywood that had meetings with Sony, checked the Plans, kept track of the films and paid the invoices.

507. HMRC said (1) for the reasons already set out above, Gala did not provide goods or services to a counterparty for reward, (2) activities which are organised are consistent with investment or (simply) operating a tax avoidance structure, as well as trade, and (3) the fact that there was some organisation to Gala's activities is not indicative of trading.

"*Badges of trade*"

508. *Repetition:* In *Ingenious FTT*, the tribunal decided, at [411], that: "There was repetition, with a number of distinct transactions in the case of each LLP". They thought repetition may form part of the character of an activity, or at least illuminate that character. Gala said that in this case there was repetition in that there were 2 closings covering a total of 6 films and there were numerous instances of the payment of the invoices and the checking of the Plans after the deals had been signed. HMRC said that repeating an activity which by its nature is incapable of constituting a trade cannot result in a trade arising and, in any event, 2 materially similar composite transactions entered into a couple of months apart is not indicative of a trade.

509. *Is the transaction related to an existing trade*? In *Ingenious FTT* the tribunal decided, at [413], that this was not the case. Gala said that one cannot say that Gala's lack of an existing trade, points towards trade whereas HMRC said this points away from trade.

510. *The nature of the subject matter: was the subject matter the kind of thing which is normally the subject matter of trade or can only be turned to advantage by realisation?*

(1) In *Ingenious FTT* the tribunal noted, at [415], that HMRC argued that, viewing the facts realistically, the composite transactions consisted merely in the acquisition of rights to possible future revenue. Essentially, they agreed with this, at [416], and said:

> "There was, realistically (and we would say legally) speaking, no acquisition of any beneficial right in a film or game of any value and no disposal of it. But a bank trades in making loans. A bookmaker trades in money and risk. Each of them tends to do it over a long period and with a degree of organisation."

(2) At [417] they concluded, in effect, that this factor did not point away from trade. They noted that in *Ensign* Lord Jauncey said that, as Lord Templeman had pointed out, expenditure "of [25%] on the making of the film in return for 25% of the net receipts carried all the characteristics of trade". Yet VP's transaction "was not substantially different from many of the film transactions carried out by the LLPs, and the LLPs had, through the Operator, more going on than ever [VP] did" and VP's "meaningless" right to the copyright in the film made no commercial difference.

(3) Gala said that this factor points towards trade or at least does not point away from it on the basis that:

(a) It is important that (a) Gala acquired 21 year licences with rights to "Sequels" and Gala entered into a DA limited to only 8 years without such rights (b) under the DA, Gala had meaningful rights and obligations, including the right to receive sums under the waterfall, and (c) as confirmed by HL, Gala had a reasonable possibility of profit both under the DA and from the residual rights.

(b) The facts of this case are significantly different to those in *Ingenious*. It cannot be said that there was no acquisition of any beneficial rights in the films and no subsequent disposal. Whereas in *Ingenious* the commercial effect of the contractual provisions was that the LLPs could do nothing with any part of the rights associated with the film at any time during its production and was thus "bound by iron fetters" this was not the case with Gala who at the very least had a right of approval with respect to the Plans and was actively involved with their development.

(4) HMRC said this factor points away from trade on the basis that Gala acquired and held no rights of any substance or reality in the films.

511. *The way in which the transactions were carried through: was it done in a way typical of a trading in that subject matter*?

(1) In *Ingenious FTT* tribunal decided, at [418] and [419], that:

> "The way in which the transactions were carried through was not "a structure for dealing in a film but one for the acquisition of an interest in the proceeds of exploitation of a film...On the other hand, what was typical of the transactions was the effort involved in their arrangement and negotiation, so overall this heading pointed towards trading, or at least not away from it..."

(2) Gala relies upon the fact that effort was involved in the arrangement of the transactions and negotiation. HMRC said this is not indicative of trading.

512. *The source of finance. Borrowing to buy may point to resale in the short term*.

(1) In *Ingenious FTT*, the tribunal decided, at [420], that this factor did not point towards trade. The LLPs did not borrow, because they were financed by the capital subscriptions of their members.

(2) Gala said that the fact that the members and Gala took out the SG loans is entirely consistent with a trading activity. HMRC said the fact that Gala borrowed for the uncommercial and fiscally motivated purpose of, in substance, placing that money on Deposit and repaying it, is a factor which points strongly away from trade.

513. *Was work done on the object? Work done may point to a trade.*

(1) In *Ingenious FTT*, the tribunal held, at [424], that there was some work done by the LLPs which was akin to work done on an object which was to be sold. They noted (a) at [421], that the form of the contracts was that the LLP took on a liability to produce a film. The legal effect of the contracts was that once the LLPs had paid they had no obligation to do anything further in relation to the making of the film: they were liable only if they interfered with what the PSC was doing. The LLPs did not add anything substantial to the making of the film once the contracts were signed, (b) at [422], that the LLPs' creative input took place before the contracts were signed; there may have been some such activity in relation to Independent films but not in relation to Studio films where the film was developed by the Studio and was ready to go when Ingenious stepped in, and (c) at [423], for Independent films, Ingenious played a greater role in putting together the finance for the film and to an extent the Ingenious personnel undertaking that

activity may have done it in part for the LLP (although in part it was also done for other Ingenious vehicles).

(2) Gala said this case is different to *Ingenious* in that Gala had ongoing meaningful rights and obligations under the DA. Work was clearly done by Gala over an extended period of time, which is a factor pointing towards trade. HMRC said that this factor points away from trade: Gala did not do any work on an object; it acquired and held no rights of any substance or reality in the films.

514. *Breaking down into lots may suggest trade.* In *Ingenious FTT*, the tribunal held, at [425], that this factor did not point to trade. Gala said that targeting of different markets and demographics etc in the marketing of the various films is analogous to breaking down a physical asset into lots and is indicative of trade. HMRC said this points away from trade as Gala acquired no rights of any substance or reality in the films and it had nothing which by analogy it could break down into lots.

515. *Whether the purchaser intended to sell at the time of purchase "if before the contract of purchase is in place a contract for sale is already in place that is a very strong indicator of a trading deal rather than an investment" (see the judgement of Browne-Wilkinson V-C at 471 in Ensign).*

(1) In *Ingenious FTT*, the tribunal said this factor also did not point to trade and commented, at [428], as follows:

> "… the commercial (and legal) reality was that the right acquired was the right to income and the LLP did not intend to dispose of it although the right was realised (so in effect consumed) as monies flowed into the LLP."

(2) Gala said this points towards trade. The intention at the outset was for Gala to do an initial deal with a view to deriving income from it and doing further deals in later years. There was no intention simply to buy the Rights and sell them back to Sony pursuant to the Call Option. That was envisaged as a possibility for reasons that Mr Yusef has explained, but it was clearly not a certainty or even an odds-on probability. HMRC said this points away from trade as Gala acquired no rights of any substance or reality in the films and it had nothing which it could "sell".

516. *Did the asset provide enjoyment or an income pending resale? If so it would be more likely to be an investment.*

(1) In *Ingenious FTT*, the tribunal held this factor did not point to investment, "but on balance did not point towards trade" and said, at [430]:

> "We do not regard any satisfaction the members of the LLPs had in knowing that they were indirectly associated with well-known films as relevant. We do not think it realistic to regard the LLPs as acquiring a film or game which they held pending resale. Viewed as a right to income the asset *was* income pending exhaustion, but it was not the type of income one expects from an investment, which would normally have some residual value."

(2) Gala said the business involved turning the Rights to account by virtue of further activity and expenditure which points to trade. HMRC said on the contrary Gala acquired no rights of any substance or reality in the films and so had nothing to exploit or turn to account.

Factors based on the decision in Ensign

517. In *Ingenious FTT*, the tribunal took account of two further matters taken from the guidance set out by Millett J in *Ensign*:

(1) *Speculation: the possibility of profit; the undertaking of risk.* The tribunal noted that (a) in *Ensign*, Millett J regarded the speculative hope of profit as indicative of trade, (b) in *Harrison* 40 TC 281 at 293 Lord Reid said that absence

of profit motive may not be fatal to a conclusion that a person is trading, and (c) in *Eclipse FTT* (at [398]) the tribunal regarded the speculative hope of profit as an important factor.

(2) *A genuinely commercial purpose: a transaction must possess not only the outward badges of trade but also such a purpose.* The tribunal commented that (a) this may be regarded as a requirement rather than a factor to be accorded appropriate weight, and (b) this was the first of Millett J's list in his judgement in *Ensign* and he clearly regarded this condition as satisfied in that case. VP acquired, as a result of the composite transaction, an interest in 25% of the film revenues. The LLPs in *Ingenious* acquired, as a result of the composite transaction, a specified interest in the film revenues. In each case there is a possibility of profit. Whilst in Ensign, VP acquired the film negative beneficially whereas the LLPs had no beneficial interest in the negative, Lord Goff regarded that interest as "irrelevant"; it is thus difficult to see that as a distinguishing feature.

518. The tribunal held, at [432], that speculation was present, "as there was a possibility of profit and a risk of loss" and, at [435] and [436], that there was also a genuinely commercial purpose, at least on the 30:30 basis:

> "We find this requirement is satisfied. In commercial substance the LLPs paid and were obliged to pay 30% (35%) of the budgeted cost and received and were entitled to receive 30% (35%) of GDI. That was a genuine commercial deal.
>
> If we were wrong and the legal effect or commercial substance of the transactions was that the LLPs bought the film or game for 100% of budget and became entitled to at best 54.45% of GDI we would find that the deal was not commercial, and that this test was not satisfied."

519. The tribunal commented, at [437], that they must then stand back and look at the whole picture having particular regard to what an LLP actually did. They concluded as follows, at [438]:

> "In relation to Independent films there was more substance to the LLPs' activities; for Studio films the activities had more of the characteristics of arranging and monitoring investments in an income stream (that was particularly the case where an LLP came into the picture at a very late stage when almost all the elements of the film had been pulled together and principal photography was about to start). But the two activities were part of the one business.
>
> Taking all this together we conclude, on balance, that the LLPs were trading: the Operator did more than act as an investment manager of a portfolio of investments: through its actions and those of its agents the LLPs engaged in speculative, organised, repeated transactions in a way which involved work beyond that which would have been involved in the mere making of an investment."

520. In this case:

(1) *Speculation*: Gala said this points towards trade as (a) there was clearly the possibility of profit because the waterfall was not capped. Mr Yusef, as Gala's controlling mind, understood at the outset that Gross Receipts of between $1 and $1.5 billion would generate a profit for Gala as is supported by the HL letters and is consistent with Mr Ackerman's understanding, (b) risk of loss was minimised by the various guarantees, which are commercially sensible but there is speculation in the wider sense, because Gala or Invicta acting on its behalf, spent money on things such as engaging Mr Ackerman. HMRC said an element of speculation which is typical in trading transactions is entirely absent. This factor points away from trade

(2) *Commerciality*: Gala said that Mr Yusef has explained repeatedly why the various things that happened were undertaken commercially, why it was reasonable to rely on the HL letters and why the timing of the provision of information by Sony was adequate to allow proper decision-making by the members. In fact, it is obvious that Gala was trying to do a commercial deal, that it organised itself commercially and took time to negotiate the best deal it could with Sony in the hope of a long-lasting relationship that would lead to far bigger and better deals. All the time, effort and complexity that went into this is explicable by Gala's intention to put in place a commercially viable arrangement and a commercially viable deal with Sony. HMRC said that it is clear that the purpose of Gala's transactions was to obtain the tax relief and the tax benefit. There was no genuine commercial purpose.

Conclusions on trade issue

521. Our view is that this is a situation like that in *Eclipse* where the cases by reference to which the list of the "badges of trading" was compiled are not sufficiently analogous to the facts of this to make the list of value in these proceedings. However, on the basis of our findings in Part B as summarised below, we consider that Gala did not carry on a trade during the tax year 2003/04, whether matters are viewed on the approach in *Eclipse FTT*, or according to the badges of trade, on the approach taken in *Ingenious FTT*.

522. As the Court of Appeal said in *Eclipse CA*, the proper characterisation of the activities of an entity such as Gala depends upon the totality of its activity and enterprise. Stripping those activities down to their essential elements, overall we consider that it is apparent from the design and operation of the transactions, and the facts and circumstances summarised below, that:

(1) Gala's purpose and object in setting up and entering into the transactions was not to exploit the Rights it acquired in respect of the transaction films, and/or to participate in the distribution process, with a view to receiving a share of Gross Receipts generated by the exploitation of those films. On a realistic view of the facts, Gala did not at any point carry out any activity which had any material meaning or consequence as regards the distribution process.

(2) Rather Gala's purpose and object was to provide members with the tax benefit through (a) the generation of a substantially "self-funded" loss for Gala in the 2003/04 tax year of over £102 million (as described in section 10 of Part B) for which, on its analysis, members could claim tax relief, and (b) structuring and operating the arrangements embodied in the transaction documents so that it was inevitable that they would be terminated on or around the first exercise date by SPE exercising the Call Option on payment of £102 million. As explained below, the idea was that this would enable the members to retain the benefit of a sufficient portion of the claimed tax relief to make a positive cash return from their involvement in Gala through tax relief alone (see section 15 of Part B).

(3) As accords with the lack of any commercial objective underpinning the arrangements of the type which may be expected in a "real" trade of film distribution, none of the activities which Gala undertook under the transactions had the characteristics of a trade. In light of all the facts and circumstances set out below and focusing on what Gala actually did, (a) Gala did not provide goods or services to Sony or anyone else, or make any material contribution, in respect of the distribution process, and (b) there was no speculative aspect to Gala's involvement with Sony of the kind involved in a trade of film distribution. Gala had no meaningful right to profit, and was not at risk of suffering a loss, from its

purported activities relating to the distribution of the transaction films and did not carry out any such activities with a view to it profiting from Gross Receipts. Gala's operations were focused on (i) the creation of a loss, which was "self-funded" in the sum of £102 million, and (ii) the carrying out of activities which, at first sight, are of the kind which may be expected in a "real" trade relating to the distribution of films (so that Gala could claim that the loss was generated in the course of such a trade), but which, on closer scrutiny, were devoid of meaning and commercial consequence.

Overview

523. Using rounded simplified figures for illustration, under the Gala arrangements, Gala received total funds of around £127 million, of which (a) £102 million was funded by its SG loans and the members' contributions, as funded by their SG loans, and (b) the remaining £25 million was funded by the members' cash contributions. It used these funds:

(1) Under the terms of the LAs, to pay the Sony licensors £15 million, as licence fees for the grant of the Rights to it under the LAs.

These were paid, in effect, as Sony's reward for participating in the arrangements. As explained below, Sony did not receive any other financial or commercial benefit from its involvement in the transactions.

(2) Under the terms of the DA, to deposit £102 million of Initial Expenditure into the expenditure account on the basis those funds could only be used to meet approved Gala Expenses.

Under the DA, Gala agreed to provide the Initial Expenditure and to sub-licence the Rights to SPR, in effect, in return for the right (a) to receive the Minimum Sums as supported by the LC, and a share of Gross Receipts under the waterfall, and (b) to approve or object to any material increase or, any decrease, in approved Gala Expenses. As set out in sections 9, 10 and 11 of Part B, Gala had no other material substantive rights or obligations under the LAs or DA which had meaning or consequence.

(3) To pay the costs relating to setting up and operating the arrangements of around £10 million, being primarily the Invicta Fees and the SG Fees.

524. As HMRC submitted, the transactions are replete with uncommercial and odd features. It is notable that the amount of the licence fees and the Initial Expenditure was not set by a valuation of the Rights and/or an appraisal of how much Gala ought to contribute to the Gala Expenses in respect of each transaction film nor by commercial negotiation. It was stated in the proposal documents sent to the studios in March 2003 that the aggregate figures for the licence fees and Initial Expenditure would be computed as 13.5% and 91.5% of the total contributions respectively and that the sum payable as licences fees, as computed in this way, was the maximum "studio benefit". Informing the studios in advance of what the maximum "studio benefit" could be would plainly not result in a better outcome for Gala and, unsurprisingly, Sony did not agree to take a lesser sum. Whilst in each LA, separate amounts were allocated as the licence fee and the portion of Initial Expenditure attributable to each transaction film, it is unclear on what basis this allocation was made and, in any event, given the way the arrangements operated, the allocation was pointless. Gala's prospect of receiving Gross Receipts under the waterfall and the amount of any such receipts could not be impacted by precisely how much of the total Initial Expenditure was allocated to each transaction film (see [373] to [380]).

525. As set out in full in section 10 of Part B (see, in particular, [300] to [307]), the overall economic, practical and commercial effect (and the purpose and object) of the

loan repayment arrangements for Gala and its members was to create a "self-funded" loss in the sum of £102 million. Gala argued that this aspect of the transactions was a normal and usual commercial arrangement of a type which may be expected in a film distribution trade of the kind Gala asserts it carried on for the reasons Mr Yusef gave. However, in our view, it is plain that this aspect of the arrangements had nothing to do with any such purported trade:

(1) In economic and commercial terms, SPR gained nothing from Gala fulfilling its obligation under the DA to provide the Initial Expenditure of £102 million into the expenditure account, except the ability to fund the Deposit without an actual cost to it. SPR's entitlement under the DA to use the Initial Expenditure to meet approved Gala Expenses relieved SPR of the need it would otherwise have had to fund those expenses from other resources. As set out in section 9, we consider that, in meeting such expenses, SPR acted on its own account in the course of its own business, and not as agent for, or otherwise on behalf of, Gala. However, SPR did not thereby receive any funding benefit given that it simultaneously had to provide Barclays with the Deposit of £102 million in order to induce Barclays to issue the LC. As noted, it was a condition to Gala's obligations under the DA taking effect, that SPR had procured the issue of the LC to Gala.

(2) From Gala's and the members' perspective, the provision of the Initial Expenditure under the terms of the DA enabled Gala to claim, on Gala's analysis, that it had incurred a loss of £102 million but without it/the members having a substantial risk of suffering an economic loss of £102 million:

(a) Subject to the relatively remote risk set out below, Gala was guaranteed to receive back (i) £102 million, a sum equal to the Initial Expenditure/principal of the SG loans, by no later than the end of the term of the DA, as the Minimum Amount due under the DA, or option price due under the Call Option, if it was exercised, plus, (ii) in the interim, annual fixed sums calculated to cover interest due on the SG loans and, over the term of the DA to generate a small profit, as the other Minimum Sums due under the DA.

(b) In practice these sums were to be met by Barclays paying equal amounts under the LC using the Deposit and interest accruing on it. Under the LC and related security arrangements, the Deposit was held in a blocked interest bearing account and the funds in that account could only be used, in effect, to meet the Minimum Sums/option price/corresponding sums due under the SG loans.

(c) Therefore, Gala's entitlement to receive the Minimum Sums, and its prospects of receiving amounts equal to them under the security arrangements, was not dependent in any way on the success of Gala's purported or Sony's actual exploitation of rights in relation to the distribution of the transaction films, any purported contribution which Gala made to Sony's distribution process and/or the commercial success of the transaction films. The payment, and amount of, the Minimum Amount, as a guaranteed *minimum* sum, did not depend on Gala continuing to sub-licence the Rights (it was payable on an early termination) or being required to provide, or having a right, or any obligation, to do, anything after closing, and/or on the fulfilment of any future criteria or condition, in respect of the distribution of the transaction films, whether under the terms of the DA or of any other transaction document. Similarly, the payment and amount of the Minimum Sums did not depend on such factors; they were simply fixed amounts, calculated as set out above, due

on annual specified dates (corresponding to the dates on which interest was due under the SG loans) as long as the DA remained in place.

(d) As Gala emphasised, Gala (and ultimately the members) did, of course, have a risk inherent in any such security arrangements, that the issuer of the LC may not be able to meet its payment obligations. We consider that (i) for the reasons set out in [303] in section 10 of Part B, this was a residual, relatively remote risk, (ii) this risk was too remote to render the receipt of the relevant sums to be speculative in any relevant sense, and (iii) in any event, this risk had nothing to do with any purported trade relating to film distribution. In short, as is evident from the points made above, in providing the Initial Expenditure, Gala did not put £102 million at risk in funding or carrying on any activity related to the distribution of the transaction films; Gala simply, in effect, thereby put SPR in funds to make the Deposit and thereby ensured that, subject to a remote risk, it was guaranteed to receive sums sufficient to meet the payment of principal of, and interest on, the Gala loans when due.

526. In our view, Gala and the members also did not put their remaining outlay under the transactions of around £25 million (the sum in excess of £102 million which was subject to the loan repayment arrangements) at risk in any activities related to film distribution. For the reasons set out below, we do not accept Gala's stance that it had meaningful and substantial rights and obligations under the LAs and DA which it exploited in the course of a trade of film distribution from which it had a realistic prospect of realising a sufficient share of Gross Receipts under the waterfall for it to recoup the outlay of £25 million (corresponding to the licence and other fees) and generate a profit for Gala and a positive return for the members. In our view, from the outset, the aim of those who devised and operated Gala, and the purpose and object of the arrangements, which on Gala's analysis was achieved, was (1) as described above, for Gala to realise the loss (as substantially generated as a "self-funded" loss of £102 million) and (2) as described below, for the members to recoup the outlay of £25 million and to make a positive return through the tax relief they claimed in respect of the loss.

527. As set out in full in section 9 of Part B, and as accords with the lack of any commercial purpose to the transactions other than that set out above, for the term of the DA, Gala had no material contractual rights or obligations of substance or reality in respect of the distribution process, and SPR was free to market and distribute the transaction films as it wished, acting in its sole and unlimited discretion. Such limited rights and obligations as Gala had under the DA were without meaning and consequence and, in practice, Gala made no meaningful contribution (whether financial or otherwise) to the distribution process (see [537] to [542]). As regards the effect of the contractual position:

(1) In effect, as a single composite transaction, under the LAs, Sony entities licensed distribution rights in respect of the transaction films to Gala on the basis that, under the DA, Gala would licence them back immediately for an 8 year term, in all material respects in their entirety, to another Sony entity, SPR.

(2) On the correct construction of the DA, for the 8-year term, SPR had the right to market and distribute the films as it chose, acting on its own account and for its own gain, including to incur such distribution expenses as it chose to incur, subject only to certain administrative and practical constraints. Under the DA, SPR had to go through a process to withdraw sums of Initial Expenditure from the expenditure account to meet approved Gala Expenses (although it had some control over that process and a charge over the funds in the account); SPR had to give Gala the opportunity to approve or disapprove any material increase or, any

decrease, in approved Gala Expenses proposed by SPR. This limited right of approval did not give Gala the ability to control, limit or have any effective input into SPR's decision making in respect of spending on Gala Expenses (or on any other distribution expenses) or to input into any other aspect of the Plans or SPR's distribution process. We refer to our comments in section 9 of Part B (at [272] onwards) and note, in particular, that:

(a) If SPR proposed a material increase in approved Gala Expenses in relation to a transaction film, Gala's right of approval gave it the ability to choose whether to provide further funds into the expenditure account to be used to meet the increased expense. However, if Gala chose not to provide further funds, SPR could simply fund the additional Gala Expenses from other resources and, if it did so, was entitled to recover the relevant sum from Gross Receipts under the fifth provision in the waterfall, in priority to Gala's entitlement to receive any share of Gross Receipts. Moreover, for the reasons set out in section 9 of Part B, we can see no commercial reason for Gala/the members to want to provide any such additional funds. In fact, Gala did not do so and there is no evidence that it considered doing so.

(b) If Gala did not approve a proposed decrease in Gala Expenses in relation to a transaction film, SPR could simply terminate the DA as regards the relevant film (and the relevant licensor could terminate the relevant LA).

(3) During the term of the LAs (and of the DA and SG loans), (a) all of Gala's supposed Rights were assigned absolutely to SG and Sony pursuant to the debentures, and (b) Gala covenanted not to carry on any business, which did not involve contracting with Sony or its approved sub-licensees and vendors, unless Sony gave its prior written consent.

(4) As set out in section 11 of Part B and summarised below, Gala's rights under the waterfall did not give it a realistic prospect of receiving Gross Receipts of a sufficient amount for Gala/the members to recoup the outlay of £25 million which they were not virtually guaranteed to receive under the loan repayment arrangements described above. Gala did not in fact receive any such sums.

528. Although under the LAs Gala acquired the Rights for 21 years and had an option in relation to "Sequels", these "additional rights" were devoid of consequence given that, from the outset, it was expected and inevitable that SPE would exercise the Call Option at an early opportunity (see section 15 of Part B and our conclusions below).

529. For its participation in the transactions, the only benefit that Sony received was £15 million, structured as licence fees paid to the licensors. Looking at the overall picture, in economic and commercial terms, Sony otherwise ended up in broadly the same position immediately after the closing of the transactions, as it had started out immediately before the transactions took place, in that:

(1) As noted, SPR did not in real terms, obtain any "funding" from Gala for its distribution expenses on the transaction films. Gala has not established that Sony entered into these transactions due to concerns over a change in US accounting or to obtain any other benefit (see sections 2 and 10 of Part B).

(2) As noted, (a) SPR had the right to market and distribute the films as it chose, subject only to the limited administrative and practical constraints set out above, and (b) SPR did not grant Gala rights under the waterfall which gave it a realistic entitlement to receive sums under it. Moreover, Sony could simply cut off Gala's ability to receive sums under the waterfall, as early as just over 2 years into the arrangements, by SPE exercising the Call Option. Overall, in light of these points and for the reasons set out below, realistically Sony was the only party who stood

to benefit (or was at risk of loss) from the exploitation of rights to distribute the transaction films.

530. As we consider was expected and inevitable from the outset, SPE exercised the Call Option less than 2.5 years into the arrangements and thereby acquired Gala's Rights and ended the transactions:

(1) It appears that, at that point, (a) all of the transaction films had been released, and (b) all of the Initial Expenditure had been withdrawn from the expenditure account, so Gala says, to meet Gala Expenses on the transaction films under the terms of the DA. (HMRC dispute that Gala has demonstrated what the Initial Expenditure was spent on and whether it was all spent within the 2003/04 tax year.) The actual Gross Receipts from the transaction films were in the region of $741 million from box office receipts and an additional $300 million for DVDs and other exploitation.

(2) Gala received the Minimum Sums due prior to the exercise date and, on the exercise of the Call Option, a sum equal to the Minimum Amount of £102 million, as the option price for the sale of its "business" to SPE. Accordingly, the principal of, and interest due on, the SG loans were repaid in full.

(3) Gala did not receive any sums under the waterfall. Moreover, as HMRC's computations illustrate, the Gross Receipts actually received by Sony were very far short of what was needed for Gala to receive anything under the waterfall (see section 11 of Part B).

531. In effect, therefore, the cost of the arrangements for Gala's members was a sum corresponding to the cash contributions of around £25 million, and CGT due on the option price. However, on Gala's case, the members are nevertheless in a cash positive position because (1) the members are entitled to tax relief for the loss of around £112 million which Gala says arose in the 2003/04 tax year as a result of it spending £102 million on approved Gala Expenses and £10 million on fees and expenses, and (2) as explained below, the members retained a sufficient portion of the benefit of the tax relief to realise a positive cash return. Gala's stance is, in effect, that the members are in the position illustrated by scenario 2 in the IM, whereby the members, in effect, make a positive cash return solely due to the tax relief claimed in respect of the loss (as set out in section 4 of Part B):

(1) The scenarios in the IM plainly illustrate that, unless Gala received a very substantial share of Gross Receipts, the members would be in a positive position only if the Call Option was exercised (with the precise position depending on when that occurred) (see section 4 of Part B). The importance of the Call Option in this respect is recognised in some of the instructions to counsel and notes of conference with counsel and other documents (see section 15 of Part B).

(2) As illustrated by scenario 1 in the IM (see section 4 of Part B), if the arrangements had remained in place for the full 8 year term of the DA and Gala had received only the Minimum Sums, Gala would have made a small profit but the members would have made a substantial loss in cash terms. In that case, the benefit of tax relief generated by the loss, in effect, would be clawed back in its entirety through income tax due at the higher rate on the Minimum Sums, in particular, that due on the Minimum Amount. Overall, therefore, the members would receive only a form of tax deferral benefit.

(3) However, in the actual circumstances and as illustrated by scenario 2, on Gala's analysis, the receipt, at an early stage, of the sum required to repay the Initial Expenditure/principal of the SG loans, in a form which would attract a much lower CGT tax charge for the members, enabled the members (a) to retain

sufficient benefit from the tax relief claimed to cover their outlay under the transactions of £25 million, which was not covered by the loan repayment arrangements described in [524], and (b) make a substantial return in excess of that. On Gala's analysis, the members achieve an absolute tax benefit, as the option price was taxed in the members' hands at the lower CGT rate with the benefit of taper relief.

532. For all the reasons set out in section 15 of Part B, we consider that it is reasonable to infer from all the circumstances that:

(1) Invicta/Gala designed the structure so that the studio would have the ability to exit the arrangements, at a relatively early stage, specifically under the Call Option mechanism, because the termination of the arrangements in that way would, on Gala's analysis, provide the members with a reliable means of obtaining a positive cash return from their investment in Gala, from tax relief alone, without the need to rely on what was, on any view, the speculative prospect of Gala receiving Gross Receipts under the waterfall and, in our view, a wholly unrealistic prospect (see [533]).

(2) Invicta/Gala expected SPE to exercise the Call Option at the earliest opportunity, and it was inevitable that SPE would do so, given, in particular, that Invicta designed the arrangements so that, from the perspective of both Sony and Gala, they would have run their course by around the end of 2003/04 and Sony would have every reason to wish to terminate them as soon as possible after that. For the reasons set out at [462], we consider that there was only a remote possibility that SPE would not exercise the Call Option, and that, for the purposes of this analysis, we may disregard that remote possibility and assume that matters would proceed according to the clear intent and plan of those who devised and operated these arrangements (as they did).

533. As set out in section 15, it is highly material to this conclusion that:

(1) As set out in section 11 of Part B, from the outset, given the disadvantageous contractual terms of the waterfall, as HMRC's computations illustrate, (a) assessing the position on the assumption that the Call Option would be exercised in early 2006, there was no realistic prospect that Gala would receive a share of Gross Receipts under the waterfall in a sum sufficient for Gala and the members to recoup the outlay of £25 million which was not subject to the loan repayment arrangements. That is the case whether or not the Minimum Sums are taken into account in HMRC's illustrative computations, and, (b) there was no realistic prospect of Gala making a profit, assessing the position over the term of the DA and beyond, if the Minimum Sums are left out of account.

(2) As set out in section 11 of Part B, in our view, Mr Yusef/Invicta/Gala knew that was the position or were indifferent to and disinterested in the level of Gross Receipts the transactions films were likely to generate and the prospects of Gala receiving a share of them under the waterfall. In all the circumstances, it is reasonable to infer that their lack of interest emanates from the fact that their intention and expectation and the purpose of the arrangements was that SPE's exercise of the Call Option at an early stage, on payment of an option price of a sum equal to the Initial Expenditure/Minimum Amount/principal of the SG loans, would enable the members to make a positive return from tax relief alone.

534. In our view, Gala's lack of meaningful contractual right to a share of Gross Receipts is not surprising, given the lack of Gala's rights or obligations under the contractual arrangements to make any meaningful contribution to the distribution process or to provide anything else of value or consequence to SPR or to any other Sony

entity, other than the licence fees of £15 million. Moreover, Invicta's and Gala's lack of interest in Gala's prospects of receiving Gross Receipts is also evidenced by:

(1) The lack of evidence of any negotiations in relation to the waterfall. There is no documentary evidence in support of the extensive negotiations in relation to the waterfall which Mr Yusef asserts took place with Sony and, as set out in sections 2 and 3 of Part B, we do not accept much of his evidence on that topic. Moreover, it is reasonable to infer an absence of effort and serious interest in any such negotiations from the disadvantageous terms achieved, which are very far from what Mr Yusef said he was seeking to achieve, and the absence of any meaningful appraisal of the prospects of Gala making a profit.

(2) The lack of any meaningful appraisal of Gala's prospects of making a profit and/or of the members making a return otherwise than solely through the tax relief by anyone involved in these arrangements; Chiltern, Mr Yusef/Invicta, Gala or the Referrers. It is clear that Mr Ackerman's role did not extend to making any such assessment and, on his evidence, he did not make any such assessment. As set out in sections 6 and 13 of Part B, we do not accept that the HL letters provide such an appraisal (see, in particular, [388] to [396]). It is reasonable to suppose that an entity, with the scale of funds Gala had, with a serious intent to carry on a trade on a commercial basis with a view to profit, would carry out appraisals of the profitability of the business, stress test the business model, model the effect of the waterfall on Gala's share of film income on comparative films, and project the likely Gross Receipts of the films, and would have at least some documentary evidence of this (such as formal projections, informal calculations, emails and/or minutes of meetings). Given that Gala granted SPE a Call Option which could be exercised as soon as just over 2 years into the arrangements and, on any view, it was entirely possible that SPE would exercise it at the first opportunity, it is reasonable to suppose that any such serious business entity (or investor in it) would want to make the relevant assessment by reference to that date, as the likely date on which the arrangements would be brought to an end. There is no evidence of any such exercise.

535. Moreover, the fact that Gala granted SPR the right under the Call Option, in effect, to bring the arrangements to an end after little more than 2 years and that Sony exercised this option at the first available opportunity (subject to its requirement for an extension to the first exercise date) is entirely inconsistent with Mr Yusef's insistence that (1) the aim was for Gala to pursue a trade of film distribution with a view to receiving a share of Gross Receipts on an on-going basis over a number of years, as part of a plan over 3 phases, and (2) Sony regarded the Gala arrangements as having something more to offer than the £15 million it received in the form of licence fees.

536. As set out in section 11, HMRC submitted that the Minimum Sums should be disregarded in assessing whether, if Gala traded, Gala carried on the trade "with a view to profit". HMRC seemed to suggest that they should also be disregarded in assessing whether Gala carried on a trade in the first place. For clarity, in our view:

(1) As is evident from the case law set out above, the assessment of whether Gala carried out a trade requires close scrutiny of what Gala actually did and the effect of what it did. Carrying out this exercise, taking a realistic view of the facts, requires us to consider the overall effect of the contractual arrangements, pursuant to which Gala asserts it carried on a trade, from an economic and commercial perspective, and assess whether or how that affects the analysis of the nature of the activities carried out by Gala.

(2) That approach does not justify simply ignoring the Minimum Sums in assessing, as a material aspect of the overall factual matrix, what Gala was likely to receive and did receive under the arrangements albeit that analysis is required of the precise nature of the receipts. To ignore them entirely would involve viewing the arrangements relating to (1) Gala's provision of £102 million as Initial Expenditure, and (2) SPR's Deposit of £102 million with Barclays, as though they were immediately self-cancelling transactions with no on-going legal, commercial and economic consequences. As is apparent from the analysis set out above, that is not the effect of the relevant arrangements albeit that they do not have the purpose and effect Gala asserts, and the overall transactions of which they form part were only intended to remain, and in fact remained, in place for only around 2.5 years.

(3) As we see it, the point of relevance to this analysis is that, viewing the facts realistically, for the reasons already set out, the Minimum Sums were not due to Gala in respect of, or in return for, it carrying out any of the activities which Gala argues constitute a trade. They should not, therefore, be taken into account in assessing whether Gala had a realistic prospect of making a profit from those activities. We have commented further on this issue in the context of the "with a view to profit" analysis below.

Gala's activities - selection of the films

537. Mr Yusef and the Referrers emphasised repeatedly that it was important that Gala had the ability to choose which films it wished to invest in from Sony's full slate of films. This meant, so Mr Yusef said, that Gala could "cherry pick" such of Sony's available films as it considered stood the best chance of achieving commercial success. Mr Vallat put emphasis on this as evidencing that Gala carried out meaningful activities indicative of a trade.

538. As set out in full in sections 3 and 6 of Part B, we accept that Mr Ackerman was asked to review Sony's slate of films in June 2003 and to recommend which films to invest in in November 2003 and that he, accordingly, produced the June letter and the November letters, however:

(1) It is doubtful that Mr Ackerman carried out an extensive exercise in June 2003 given the limited time period in which he considered Sony's summer and winter slates of films.

(2) We consider that a reasonable business/investor who is seriously interested in carrying on a trade of film distribution or investing in it, with a view to receiving a return from Gross Receipts from the selected films, would not be satisfied with the cursory and limited November letters as the sole basis for a recommendation of which films to invest in.

(3) Mr Vallat emphasised that Mr Ackerman discussed the November letters with Invicta. However, on Mr Ackerman's own evidence, those discussions did not extend beyond his views on the screenplays and whether he thought the relevant film would be a success, in terms of its ability to generate box office and other receipts, in light of his experience in the industry. He did not mention discussions on the likely amount of Gross Receipts or on any other relevant elements or documents, such as the Initial Plans or any other financial information, which could shed light on the likely level of Gross Receipts and what share of them Gala was likely to receive under the terms of the waterfall. Moreover, there is no evidence that Gala, Chiltern and/or Invicta considered or had any internal deliberations about what Mr Ackerman said in any such discussions or about the November letters.

539. As HMRC submitted, even if it is accepted that Gala considered it important for Mr Ackerman to have access to Sony's data on the transaction films and to take reasonable steps to assess the likelihood of the transaction films achieving commercial success, that activity does not of itself suffice to indicate that Gala carried on a trade of film distribution and/or that Mr Yusef/Invicta/Gala were interested in whether Gala would make a profit. Any such assessment was something of a futile exercise in light of our other findings, in particular, that (1) from the outset, the intention and expectation was that Gala would carry out its limited activities essentially only for long enough for Gala to claim it had realised the loss in the course of a trade, and (2) Gala had no meaningful contractual rights and obligations in respect of the distribution process and had no realistic prospect of receiving material Gross Receipts under the waterfall. On that basis, it is reasonable to infer that the interest of Mr Yusef/Invicta/Gala in this assessment exercise and, in Mr Ackerman having access to data to enable him to carry it out, was confined to being able to point to what Mr Ackerman did as evidence of the sort of activity that would be undertaken in a trade of the distribution of films but without any real, substantive interest in Mr Ackerman's activities and advice in this respect.

Gala's activities – monitoring the Plans and invoices

540. As set out in sections 12, 13 and 14 of Part B, in practice, Gala did not make any meaningful contribution to the distribution process. Overall, as accords with the contractual position and as Mr Ackerman, in effect, recognised, the transaction films were marketed and distributed by Sony in accordance with Sony's decisions and Plans using its own considerable expertise and resources for its own benefit and gain. Gala did not did not carry out any meaningful activity in relation to the distribution process at any relevant time, which had any meaningful commercial consequence for it or for Sony. Gala had no meaningful entitlement to and did not, in practice, add anything to the distribution process carried out by Sony.

541. As set out in sections 12 and 14 of Part B, we accept that, from around November 2003 until LBPC's appointment was terminated, Mr Ackerman attended meetings with Sony, monitored their Plans, reported back to Invicta/Gala on them and transmitted Gala's approval of the Plans to Sony. However, Gala has not demonstrated that:

(1) (a) Mr Ackerman's activities in the run up to the production of the December letters had any impact on the formulation of the Initial Plans by Sony, and/or (b) Mr Yusef/Invicta/Gala gave any particular consideration to the information which Mr Ackerman provided them with on those Plans, or had any internal discussions on that information, or provided Mr Ackerman with feedback on it for discussion with Sony. It is notable that Mr Yusef/Invicta/Gala were prepared to enter into the first transaction without having received any written or oral confirmation from Mr Ackerman that Gala should approve the Initial Plans then in place, albeit that they were provided with information on the Plans as matters progressed (see [349] to [352]).

(2) In practice, after Gala approved the Initial Plans on entering into the transactions (a) Gala/Invicta/Mr Ackerman/LBPC made any substantive contribution to the distribution process, and/or (b) Invicta and/or Gala gave any consideration to or had any internal discussions in relation to such information as Mr Ackerman provided to them in respect of any Plan, provided Mr Ackerman with any input on any Plan for him to discuss with Sony, and/or raised any material query on the Plans with him. Whilst Gala had the contractual right to provide more funds into the expenditure account, in excess of the Initial Expenditure, to meet further approved Gala Expenses (in excess of those to which the Initial Expenditure notionally related), there is no evidence that Invicta/Gala

considered whether Gala should do so, we can see no commercial reason for Gala to want to do so and no such funds were in fact provided (see section 9 of Part B).

542. Otherwise, Mr Ackerman's/Gala's activities in this period consisted of (1) checking that the sums which SPR spent on distribution expenses related to the transaction films and corresponded with the expenses shown in the Plans and (2) facilitating the payment of sums from the expenditure account to meet approved Gala Expenses. From Gala's perspective, at the most this amounts to Gala (a) checking that the right amounts were taken from the expenditure account to meet only approved Gala Expenses, and (b) with the benefit of Mr Ackerman's filing system, amassing the information required to check that the right sums would be deducted from Gross Receipts as distribution expenses under the correct provision in the waterfall, apparently with a view to ensuring that the waterfall would be applied correctly, according to its terms. We consider that this was a futile exercise, essentially for the reasons set out in [539] above, and the interest of Mr Yusef/Invicta/Gala in these activities was again confined to being able to point to what Mr Ackerman did as evidence of the sort of activity that would be undertaken in a trade of the distribution of films but without any real, substantive interest in these activities. As regards the impact of these arrangements from Sony's perspective, we note our comments at [459(2)] above.

Members' involvement and the importance of the loss/tax relief

543. Gala's interaction with those who invested in it forms part of the relevant context in which Gala carried out its activities as described above and the evidence on this aspect of the arrangements reinforces our conclusions:

(1) The Gala proposal was essentially promoted to investors in the IM:

(a) as illustrated by scenario 2, as an opportunity to make a return from an investment in selected films due to tax relief alone (in the form of the tax benefit), subject to the risks associated with obtaining the loss and tax relief. Hence, it is plain from the IM that the business model did not depend on Gala necessarily making a profit; profit was unnecessary to the success of the arrangements, combined with

(b) as illustrated, in effect, by scenarios 2 and 3, the speculative possibility of making a larger return by the time the Call Option was exercised through Gala's receipt of a share of Gross Receipts, depending on the success of the selected films and the terms concluded with the studio as regards sharing the Gross Receipts.

In our view, that is how a reasonable prospective investor would interpret not only the IM but also the UBS document (see [127]) and the letters from Ms Challons to Mr Mallett and Mr Lewis (see [128]). As set out below, the evidence of the Referrers demonstrates that this is how they viewed the Gala proposal.

(2) We do not accept that, as Mr Vallat said, (a) the IM demonstrates that Gala was promoted as having a serious interest in profit with a properly thought out business plan on the basis that the emphasis in the IM is on an opportunity that seeks to harness the contacts and know-how of established individuals in the film industry for a profit in relation to which the potential tax benefits were a cushion rather than a driver, (b) that was backed up by the steps taken to assess the likelihood of profit, and (c) the fact that the tax treatment is set out in the IM and that this was attractive to investors is immaterial on the basis that Mr Yusef and the Referrers regarded tax relief as a form of "mitigation" and "downside protection" if Gala was not in fact a commercial success and not as the driver for

the transaction. Mr Yusef saw it as providing a safety net to attract investors and hoped that once they became more comfortable with their participation in the film industry through Gala, over time the need for tax relief to attract investors would diminish and eventually disappear.

In our view, such an interpretation of the IM relies on reading selected parts of the IM divorced from the overall context. We have set out already why we consider that (a) adequate steps were not taken to assess the likelihood of Gala making a profit or of the members making a return from Gross Receipts, (b) it is plain that obtaining the tax benefit was the primary objective of the transactions, (c) the description of the effect of the tax relief as providing "mitigation" and "downside protection" only is inaccurate, and we do not accept that, in fact, Mr Yusef and/or the Referrers did not regard it as the driver for the transaction (see, in particular, sections 4, 5, 7, 10, 13 and 15 of Part B and (3) below).

(3) We conclude from the evidence in sections 5, 7 and 13 of Part B that obtaining the tax benefit was the dominant factor underlying the Referrers' decisions to invest in Gala. The receipt of a share of Gross Receipts under the waterfall would no doubt have been welcome but, from their perspective, the prospects of that occurring were entirely speculative. We note, in particular, that:

(a) When deciding whether to invest in Gala, the Referrers were only interested in their own financial positions, as regards whether they made a return on their investment; they had no interest in whether Gala, as a distinct entity, made a profit. As set out above, it is plain from the IM that members could make a return through tax relief alone without the need for Gala to receive a share of Gross Receipts (other than those notionally comprising the Minimum Amount) and/or itself make a profit. The Referrers accepted that the Gala model did not simply provide risk mitigation but a guaranteed positive return through tax relief alone. Mr Vallat said that there is a limit to how much weight can be attached to this legal distinction, and although they were sophisticated investors, there is no real evidence that the Referrers made this distinction with the sophistication that HMRC does. However, the Referrers were entirely clear on this distinction when questioned at the hearing and that, at the time, they were interested in their own position.

(b) The Referrers proceeded to make their investment in Gala and become members of Gala (a) without, at that time, or at any prior time, seeking to obtain a proper understanding of how the waterfall would operate and, in the case of Mr Lewis and Mr Mallett without checking (whether themselves or through Ms Challons) that the waterfall contained a 30/70 split of Gross Receipts (as they were informed by Ms Challons in her letters would be the case), and (b) apparently unconcerned by the evident limitations and inadequacies of the HL letters. Their view that there was a prospect of Gala receiving Gross Receipts was apparently based on (i) their faith in Mr Yusef and/or, as regards Mr Lewis and Mr Mallett, in Ms Challons, (ii) the fact that the films were produced by Sony (a major studio) and some had some well-known names attached, (iii) that Sony, so they thought, had good commercial reasons for entering into the transaction (due to a change in the accounting position), and (iv) the fact that HL had produced the HL letters which referred to some of the films in question.

(c) Mr Vallat said that this approach is normal; investors do not second guess professional advice of the kind received here. However, our view is that a reasonable investor, with a serious interest in whether he is likely to make a return from a venture such as Gala realising Gross Receipts from its asserted

trade, would want his trusted advisers at least to provide (a) some form of realistic appraisal of profitability, which the HL letters do not amount to. Moreover, given the existence of the Call Option and that it could be exercised as early as just over 2 years into arrangements, such an investor would want an assessment of the position at the first exercise date (as well as possibly at other dates), and/or (b) if not full details of, at least an explanation or summary of the terms of, the waterfall and its effect, at an appropriate time for the investor/his other advisers to give due consideration to, and raise any queries in relation to, this critical aspect of the transactions in terms of Gala's prospects of receiving a share of Gross Receipts. Overall, the Referrers showed no concern as to the obvious short comings and limitations of the HL letters and no or little interest in the waterfall, although they evidently appreciated that its terms determined what Gala would receive from the Gross Receipts, and/or did not check that its terms reflected what they had been told.

544. It is reasonable to infer that Gala's and the investors' primary concern was not with the prospects of Gala's success as a film distribution venture but with obtaining a return from tax relief, in light of how the proposal was marketed to them (as set out above) and the evidence regarding their involvement which shows (a) a general lack of concern on the part of both Gala and the investors with the provision and receipt of information relevant to that issue, and (b) a lack of engagement in Gala's meetings both on closing and on an on-going basis. We note, in particular, that as set out in sections 4, 5, 7 and 13 of Part B:

(1) investors signed up to the Gala proposal and paid money to Gala without knowing what studio and films would be involved and what the terms of the deal with the studio would be, in particular, as regards the waterfall,

(2) in signing the acknowledgements, investors agreed they had received documents some of which they could not have received at the time,

(3) investors were not provided with the term sheet agreed with Sony in November 2003,

(4) investors were provided with extensive documentation, including the film files and transaction documents, only at the very last minute, at the most 2.5 to 2 days before the meetings at which they were admitted as members and the transaction documents were approved, and were not provided with any accompanying explanation or summary of the contents or effect of the deal terms such as, in particular, of the waterfall. It was only when they received these documents, at this late stage, that they had the means of knowing the films involved and what the precise terms of the deal with Sony were,

(5) relatively few investors attended those meetings and the minutes of the meetings indicate that the meetings were short,

(6) investors involved in the first closing were not invited to attend and were not sent material documents relating to the second closing and, on the evidence of the Referrers, may not even have been aware of the second closing, and

(7) on the evidence of the Referrers, investors showed no or little interest in the arrangements following closing.

545. Mr Vallat said that the 48 hours or so that the investors had to review the film files and transaction documents is not unreasonable for the reasons Mr Yusef set out. We do not accept, however, that an entity or investors in a venture such as Gala, who had a serious interest in whether the venture would be profitable would regard it as satisfactory to have such a short time to review the materials and consider what questions and issues to raise.

546. We note that, as HMRC submitted:

(1) It is apparent from a number of documents that the availability of the loss for the members of Gala was regarded as critical to the efficacy of the transactions, such as (1) the scheme summary (see [4]), the IM (see section 4 of Part B), (2) instructions to Mr Thornhill QC (see [136]) and the Counsel's Opinion of 10 July 2003, which was provided to prospective investors (see [87]), (3) the proposal documents sent to studios in which it was stated that "all distribution expenditure….to be incurred by Gala must be capable of being incurred prior to April 2004" and the draft Paramount term sheet which stated that all expenditure was required to be incurred by 5 April 2004 (see [85]), (d) the UBS presentation (see [127]), and (e) the letters from Ms Challons to Mr Mallett and Mr Lewis (see [128]). Mr Yusef accepted the suggestion that the tax relief was "an absolutely essential component" (see [138]) and, as noted, we consider that the tax benefit was the dominant factor underlying the Referrers decisions to invest in Gala.

(2) The importance of the tax relief is reinforced by the fact that (a) the structure was shut down once HMRC announced the introduction of rules to prevent persons such as the members obtaining the benefit of tax losses in these circumstances. Mr Yusef accepted that the arrangements became "no longer viable" and his evidence was that Invicta spent some time seeking to design a tax workaround in respect of the new restrictions so that the scheme could remain alive (see section 15 of Part B), and (b) various disclaimers were given by those involved with the arrangements, such as that by SG in the loan agreements to the effect that SG had given no recommendation or advice in relation to the likely tax benefits which may be derived from the arrangements (see section 3 of Part A). There are similar provisions in the Call Option, the LAs and the DA, which provide that the Sony owed no duty of care to Gala or its members in respect of the availability of any tax relief (see section 9 of Part B).

547. Mr Vallat said that there is nothing unusual or artificial in (1) a business generating first year losses, where its trade involves it incurring a lot of expenditure upfront with a view to earning income over several years, (2) the business obtaining tax relief for interest paid on borrowings taken out to fund that expenditure, and (3) the fact that, where the trade is carried on by an LLP, the losses flow through to the members; that is simply what the rules provided for at the time. Whilst we do not dispute these statements as general propositions, the factual assumptions on which they are based are not applicable in the particular circumstances of this case for all the reasons already set out.

548. We do not accept Mr Vallat's further submissions that the commerciality of the arrangements and Gala's intent to make a profit is demonstrated by the following factors:

(1) The Referrers were clear that a principal attraction was that Gala could select films from a studio's slate such that, as long as the right films were chosen, the probability of a return would be enhanced.

This is what some of the Referrers said but that does not affect our overall conclusions on their evidence as set out in sections 5, 7 and 13 of Part B and below and summarised above.

(2) An awareness of tax mitigation, as a form of downside protection, does not alter the underlying purpose behind the transactions which was trade in anticipation of a commercial return.

As noted, we do not accept that this structure provided only "tax mitigation" as a form of downside protection.

(3) Gala tried to do something different to the other film investments in existence at the time. It was a "bespoke arrangement": Mr Yusef personally interviewed around 75% of the potential members in order to ascertain their financial objectives and understanding of the proposed trade.

The assertion that this was different to other structures and bespoke does not add to our understanding or analysis of these arrangements. We have explained in section 4 of Part B that (a) we accept that, in his oral discussions with investors, Mr Yusef may have presented this structure as involving them possibly realising more of a return than that generated by the tax benefit but (b) we do not accept that that of itself suffices to demonstrate that he/Invicta/Gala intended or expected that the investors would in fact make a return from anything other than the tax benefit.

(4) The evidence shows that (a) it was not the case that from the outset the Call Option was going to be exercised, and (b) it was a fall-back and it was exercised once it was not possible to obtain further funding when UK legislation had changed. We have set out above and in section 15 of Part B why we do not accept this.

549. Approaching this by reference to the badges of trade and the other factors set out in *Ingenious*:

(1) *"Trade must be bilateral" and "organisation"*: For all the reasons set out above, Gala did not provide goods or services to Sony for reward and we do not accept Gala's stance that it had obligations to pay for services provided by third parties named on the invoices. There was some degree of organisation but in relation to activities, such as those of LBPC/Mr Ackerman, which were without consequence or meaning. Gala cannot be described, as the tribunal said of the LLPs in *Ingenious FTT*, as "an organisation geared towards promoting the business of contracting for films and receiving the income from them".

(2) *"Repetition"*: It is not indicative of trade that Gala entered into 2 materially similar, composite transactions and as regards each of them performed repeated activities (namely, monitoring the Plans and checking invoices) which, for all the reasons set out above, did not have material consequence or meaning.

(3) *"Relating to an existing trade"*: Gala had no existing trade so this factor is neutral.

(4) *"Nature of subject matter", "Way in which transactions carried through", "Work done on an object" and "breaking down into lots" "Whether purchaser intended to sell before purchase", "Enjoyment or income pending resale"*: For all the reasons set out in Part B and the summary of the relevant facts set out above, (a) Gala acquired and held no rights of any substance or reality in relation to the distribution of the transaction films, and (b) we do not accept Gala's submissions on these factors that it is significant that (i) Gala at the very least had a right of approval with respect to the Plans (see section 9 of Part B) and was actively involved in their development (see sections 6, 9 and 14 of Part B), (ii) Gala had ongoing meaningful rights and obligations under the DA over an extended period of time (see section 9 and 14 of Part B), (iii) the intention at the outset was for Gala to do an initial deal with a view to deriving income from it and doing further deals in later years and there was no intention simply to buy the Rights and sell them back to Sony pursuant to the Call Option (see sections 3 and 15 of Part B), and (iv) Gala's "business" involved turning the Rights to account

by virtue of further activity and expenditure (see the summary of our conclusions on the facts above).

Whilst we accept that, as Gala said, there was clearly effort involved in putting the structure together that of itself is not indicative of trading given the nature of the resulting structure. As set out in sections 2 and 9 of Part B we do not accept that there were negotiations as regards the terms of the transactions of the nature and extent Mr Yusef said there were.

Gala said that targeting of different markets and demographics in the marketing of the various films is analogous to breaking down a physical asset into lots and is indicative of trade. However, that is irrelevant given that Gala had no right to and did not provide any meaningful input into the distribution of the films.

(5) *"Source of finance"*: The fact that Gala obtained its SG loan and arranged for the members to obtain SG loans to finance their contributions to Gala, in order to create a largely "self-funded" loss so that the members could obtain the tax benefit is not indicative of a trade.

(6) "*Speculation" and "commerciality"*: For all the reasons set out in Part B and summarised above, (a) the element of speculation typical in trading transactions is absent, (b) the only purpose of the transactions was to enable members to obtain the tax benefit; otherwise there was no genuine commercial purpose, and (c) we do not accept Gala's submissions that (i) there was a clear possibility of profit and a risk of loss in respect of any activities relating to the distribution and marketing of the films or that that is, so Gala said, supported by the HL letters and is consistent with Mr Ackerman's understanding (we refer in particular to sections 6 and 13 of Part B), (ii) speculation is evidenced by the fact Mr Ackerman was engaged, (iii) Mr Yusef's explanations as to why the transactions were undertaken commercially are to be accepted and/or demonstrate that was the case, (iv) Gala had long term aims of the type Mr Yusef said (see sections 2 and 15 of Part B and our conclusions above)).

Other arguments on trade issue

550. Gala contended that, "in any event, Gala is trading by virtue of its relations with various (sub-) contractors/agents including not just Invicta, LBPC, [Chiltern] but also SPR pursuant to the [DA]". That is on the basis that:

(1) The case law establishes that (a) the well-established principle that the acts of an agent are attributed to the principal applies for tax purposes including as regards assessing whether a person is trading, and (b) that principle extends to the acts of an independent contractor and to any situation in which a person procures that another person acts on his behalf. This is apparent from the judgement of Millett J in *Ensign Tankers* [1989] 1 WLR 1222 at page 1236 and Eveleigh LJ in *Floor v Davis* [1978] Ch. 295 at pages 312 and 313.

(2) There are activities which are so clearly trading activities that one does not need to engage in a detailed consideration of the badges of trade or a detailed evaluation of the evidence, see the comments of Lord Wilberforce in *Ransom v Higgs* at 554D.

(3) Accordingly, there are cases where (a) the activities of a contractor or sub-contractor are clearly trading activities; (b) those activities must be attributed to the principal for tax purposes; and accordingly (c) the principal is clearly trading. This is such a case: there should be no doubt that "prints and advertising" activities carried out for profit amount to a trade and, on the basis that such activities are attributed to Gala, Gala was therefore trading at all material times.

551. In our view, as HMRC argued, it is not the case that, as Gala suggested, all acts of an agent or sub-contractor must be attributed to the principal/party in receipt of services for the purposes of assessing whether the principal is trading. Whether or not it is appropriate to have regard to the badges of trade, the tribunal must undertake a detailed evaluation of all of the evidence to determine whether the activity in question amounts to a trade. In the required multifactorial assessment, the tribunal has to stand back and look at what the taxpayer has done. The fact that a taxpayer engages a person to act as an agent or as a sub-contractor simply forms part of the overall picture. The focus must be on the taxpayer's activities and the relevance of an agent's or subcontractor's activities depends entirely on context. It is not the case that if a taxpayer engages an agent and the agent itself carries on a trade, then the taxpayer is trading. The substance and the reality of the whole picture must be evaluated.

552. Neither *Ensign* nor *Floor v Davis* provide authority for Gala's position and, in any event, the facts of those cases are not analogous to the present case.

(1) In *Ensign*, in assessing whether VP was trading, the court had regard to the acts of an agent engaged by VP to complete the production of the film, the master negative to which VP had acquired and which it agreed to distribute once completed. In the passage Gala cited, Millett J (as he then was), made the uncontroversial point that this forms part of the picture of what the taxpayer did but was not the beginning and end of the analysis. He said that:

> "The point is made, although in effect [VP] didn't have to do a lot, so those arrangements did not call for any significant degree of activity on the part of [VP], but it is not true that the partnership can act only through its partners. It is open to a partnership, like any other trader, to act through agents or independent contractors. Were it not for the availability of first year allowances and the effect of the gear introduced by the form which the arrangement took, no-one would think the absence of subsequent activity by [VP] deprived the arrangements made on 14th July 1980 of their commercial character."

Nor was Millett J saying that if a taxpayer enters into a contract for services (in that case for the distribution of the film) the activities of the service provider are in some way attributed to the recipient of the services. He was simply saying it is relevant to the analysis that the taxpayer has entered into a contract for the film to be distributed.

(2) *Floor v Davis* concerns whether a taxpayer had disposed of shares under a convoluted scheme put in place to try to avoid CGT. In the passage relied on by Gala, Everleigh LJ said that:

> "The question that the court has to determine is whether the transaction was in disposal of the KDI. If a man wished to sell his house to his mistress at an artificially low price and conceal it from his wife, he might need the cooperation of friends who have a controlling interest in the company to sell the house to the company at that low price, in the knowledge that his friend would ensure the house was sold to the mistress.
>
> No legal obligation on the company to do this. Nonetheless, in my opinion, the original owner were to dispose of his house to his mistress. Qui facit per alium facit per se is a maxim which does not depend on contractual relationship of principal and agent. A man may act through the hand of another whose conduct he manages to manipulate in some way, and whether or not he has so acted is often a question of fact to be considered by looking at all that is done."

He was saying that where A manipulates B into doing something, then what B has done might be regarded as having been controlled by A. The focus is on what A has done and the control that the A has over B. Mr Vallat emphasised that this case demonstrates that the circumstances in which the actions of one person can

be attributed to another is not limited to where one person acts as the agent for the other as principal. In his view, the scope of the decision is not limited to CGT cases. However, we cannot see that any of the relevant parties were subject to the sort of manipulation or control that existed in *Floor v Davies*.

553. As set out in Parts A and B, (1) Invicta was not appointed to act as Gala's agent but, in our view, Invicta did in practice operate the business of Gala and so, in effect, Invicta's actions are attributed to Gala, (2) however, Invicta had no formal authority to appoint LBPC as Gala's agent and the LBPC agreement makes it clear that LBPC and Mr Ackerman were not agents, and (3) for all the reasons set out in section 9 of Part B, SPR was not engaged to act as an agent for Gala in any material respect or to provide services to or for Gala. We can see no basis, therefore, for the actions of SPR to be attributed to Gala. Gala did not control or manipulate the actions of LBPC or Mr Ackerman, as regards the services which were provided to it or Invicta; those persons simply provided services in return for a fee. Moreover, in assessing whether a person carries on a trade, one does not simply attribute to that person the services which another party provides to it; the focus is on what, if anything, that person does once the services have been provided. In any event, even if all the actions of Invicta, LBPC and Mr Ackerman are attributed to Gala, the analysis remains as set out above as, for all the reasons already set out, those actions had no significant substance or consequence to them.

554. Given our conclusions above it is not necessary to consider HMRC's alternative argument that Gala's arrangements were "no more than a planned raid on the revenue" and are so affected by fiscal considerations that they cannot, on any view, answer the description of trading at all. We note only in brief that:

(1) HMRC relied on the "prominent landmark" decision of the House of Lords in *Lupton v F.A. & A.B. Ltd* [1972] AC 634 ("*Lupton*"), which refers to the earlier Privy Council decision of *Iswera v CIR* [1965] 1 WLR 663 ("*Iswera*") which has led to a number of expressions of principle, including that:

(a) A trading transaction might be "so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading transaction" (*Lupton* at 647G-H (Lord Morris)).

(b) The presence of a sole fiscal motive necessarily excludes the possibility that the transaction has any commercial purpose, and thus a key ingredient of a trading transaction is lacking (*Overseas Containers (Finance) Ltd v Stoker* [1989] 1 WLR 606 at 613F-G (Sir Nicolas Browne-Wilkinson V-C)).

(c) Motive, fiscal or otherwise, can be a material, perhaps even determining, factor in classifying a taxpayer's activity in circumstances where its nature is otherwise equivocal (*Iswera,* at 668A-C (Lord Reid)).

(2) Gala said that (a) fiscal motive is irrelevant to the question of whether a person is trading unless it becomes apparent that the arrangements are so affected or inspired by fiscal considerations that they are denatured. Gala relied on *Ensign Tankers* and *Ingenious*, (b) mere acknowledgment of the tax relief for the members is not enough to warp and denature the trade carried on by Gala in which they invested, (c) there is no indication, that Gala did things so differently because of a desire of the members to obtain tax relief, that Gala should be taken not to have been trading, if it would otherwise have been trading, and (d) if one concludes that Gala is prima facie trading, and the only question left is does the tax background affect the conclusion, the answer is clearly no, because tax did not cause Gala to reshape what it was doing. It was just part of the background, as far as Gala was concerned. We note that, as is apparent from our conclusions

in Part B and in this Part C, we do not accept the factual propositions underpinning Gala's stance.

Conclusion on "with a view to profit" test

555. As set out in section 3 of Part A, it was common ground that the "view to profit" test is to be applied by reference to the controlling mind of Gala but HMRC said that the controlling mind was those who operated Chiltern, whereas Gala said it was those who operated Invicta. In summary:

(1) HMRC submitted that, in any event, this test is not met whoever the controlling mind was. In their view, it is evident from the arrangements and the way in which they were promoted, that the purpose of Gala's activities was tax avoidance, not the operation of a profit-making business, and that the controlling minds were indifferent to profit. They emphasised that the objective evidence all points against there being a profit-making motive, such that Mr Yusef's assertions, as those of an experienced businessman, of an intention to make a profit, are not credible. As set out in section 11 of Part B, HMRC consider that this issue should be assessed without reference to the Minimum Sums but, in their view, the test is not met even if those sums are taken into account.

(2) Gala said that, on the contrary, the evidence, in particular, that of Mr Yusef and Mr Ackerman, which should be accepted in its entirety, demonstrates that the subjective intention of Mr Yusef was for Gala to make a profit. Mr Vallat essentially made the same points as he made in relation to the trade issue. He emphasised that it is the controlling mind's hope and expectation at the time the Gala arrangements were put in place that is important and, therefore, it is irrelevant that Gala did not make a profit and the envisaged further stages of the long-term plan did not occur due to unforeseen circumstances; as it turned out, an unexpected change in the law, which restricted the tax relief, made it harder to attract investors and to do further deals with Sony.

556. As set out in section 3 of Part A, we consider that Invicta was the controlling mind of Gala. However, our view is that, whether Invicta or Gala is taken to be the controlling mind of Gala, on the basis of the evidence and our findings in Part B as summarised in this Part C, Gala did not carry out its activities in the 2003/04 tax year "with a view to profit" as that test is to be applied as set out in *Eclipse CA:*

(1) As Gala has not adduced any evidence from Chiltern as to its state of mind, there is no positive evidence of Chiltern acting with a subjective "view to profit" in any actions it took on behalf of Gala. In light of that, and of the evidence which demonstrates the lack of any realistic prospect of Gala making a profit, we cannot find that Chiltern had any such subjective intention.

(2) Whilst if Mr Yusef/Invicta is taken as the controlling mind, as Mr Vallat said, it is his subjective view at the relevant time in 2003/04 that is relevant, we do not accept that Mr Yusef/Invicta had the hope and expectation which Mr Vallat attributes to them and/or that the evidence justifies the other conclusions Mr Vallat considers the tribunal should draw. On all the evidence, contrary to Mr Yusef's asserted views, we find that:

(a) Mr Yusef's intention and purpose from the outset was to ensure that the members would receive a substantial return from their involvement in Gala from tax relief alone. For all the reasons set out in section 15 of Part B and in the summary of our conclusions on the trade issue above, we consider that Mr Yusef/Invicta put the arrangements together with the purpose of ensuring that (i) Gala would realise a loss of around £112 million in the 2003/04 tax year for which members could claim tax relief, (ii) SPE would exercise the Call

Option at the first opportunity, on payment of an option price of £102 million, so that the arrangements would end on Gala receiving a sum sufficient to repay the principal of the SG loans of £102 million, in a form which would be taxable at the lower CGT rate (with the benefit of taper relief), rather than at the higher income tax rate (which would apply to the Minimum Amount), and (iii) therefore, the members would retain the benefit of a sufficient portion of the claimed tax relief to recoup their outlay under the transactions in excess of £102 million (of around £25 million) and for them to make a return from the claimed tax relief alone.

(b) Mr Yusef either knew that there was no realistic prospect of Gala receiving Gross Receipts sufficient for Gala/the members to recoup their outlay under the transactions in full by the time he intended and expected the Call Option to be exercised on or around the first exercise date or was indifferent to whether Gala had any such prospect. The lack of concern or disinterest is explained by the fact that his aim, intention and expectation was for members to obtain the tax benefit.

(c) Hence, Mr Yusef/Invicta ran Gala's activities (i) "with a view" to the transactions ending on or around the first exercise date and Gala receiving only the Minimum Sums which would be due before that time, and an option price of £102 million, payable by SPE on the exercise of the Call Option, and (ii) with no regard, concern or interest in whether Gala would receive any additional sums as a share of Gross Receipts under the waterfall. It is not disputed that the receipt of only such Minimum Sums and the option price of £102 million would not result in a profit for Gala (computed as the excess of income over costs).

(3) In making these conclusions we rely on all our relevant findings on the evidence in Part B as summarised above but we note, in particular, the following:

(a) We rely on all our findings in section 15 of Part B but note that the factors set out there demonstrate that Mr Yusef/Invicta designed the arrangements (a) to incorporate the Call Option on the basis that the first exercise date would fall just over 2 years after closing of the transactions, and (b) so that it was inherent in their design and operation that, from the perspective of both Sony and Gala, the arrangements would have run their course by the end of the 2003/04 tax year or thereabouts, and Sony would have every reason to exercise the Call Option as soon as possible thereafter.

(b) On his own evidence, Mr Yusef is a sophisticated and experienced businessman with particular expertise in structuring transactions in the film sector. For all the reasons set out in section 11 of Part B, it is implausible that such a businessman, who had an interest in Gala's prospect of making a profit and/or the members' prospects of making a return through Gala receiving a share of Gross Receipts (as opposed to through tax relief alone as described above), would consider, as Mr Yusef says he did, that Gala had a realistic prospect of receiving Gross Receipts sufficient for it and the members to recoup their full outlay under the arrangements and that the terms of the waterfall were a success from Gala's and the members' perspective for the reasons Mr Yusef gave. In particular, we note that the disadvantageous terms of the waterfall meant that (i) Gala had a right to a share of Gross Profits far removed from the 30/70 ratio for sharing them (in favour of Sony) which Mr Yusef asserted he sought, and (ii) as HMRC's calculations demonstrate, assessing the likely position on the basis that SPE exercised the Call Option

on or around the first exercise date, for Gala and the members to recoup their full outlay under the transactions, the exploitation of the transaction films would need to generate billions more of Gross Receipts than those actually generated or which Mr Yusef said Invicta/Gala considered at the outset were likely to be generated. That is the case whether or not the Minimum Sums are taken into account in the assessment as receipts of Gala.

(c) Mr Yusef's lack of intent to operate Gala's activities on an on-going basis and lack of interest in Gala's prospects of receiving Gross Receipts under the waterfall is further evidenced by the fact that he/Invicta/Gala did not make or obtain any meaningful financial appraisals of whether Gala had a realistic prospect of making a profit through its share of Gross Receipts prior to Gala's activities commencing, whether by reference to the level of likely Gross Receipts as at the first exercise date or otherwise (see sections 6 and 13 of Part B (in particular, [388] to [397]). In our view, for all the reasons set out in section 11, 13 and 15 of Part B, an experienced and serious businessman such as Mr Yusef, would not regard the HL letters as providing a satisfactory and adequate appraisal and would ensure that such an appraisal was carried out as regards the position at the first exercise date given that, on any view, it was entirely possible that SPE would exercise the Call Option then as well as for subsequent dates.

557. For the reasons set out in our conclusions on the trade issue above and in section 10 of Part B, we have held that the loan repayment arrangements have nothing to do with the exploitation of rights relating to the distribution of the transaction films. If that is correct, we cannot see that those arrangements could form part of any trade carried on by Gala and, (1) it follows that, at this stage of the analysis, the Minimum Sums should be left out of account in assessing whether Gala had any reasonable basis for a view that it had a realistic prospect of realising a profit from any trade, and (2) on that basis, even if (contrary to our view) Gala is taken to have carried on a trade during the 2003/04 tax year with a view to the transactions continuing beyond the first exercise date, it remains implausible that Mr Yusef/Invicta/Gala did so with "with a view to profit". As set out in section 11 of Part B, there is no reasonable basis for a view that Gala had a reasonable prospect of making a profit over the term of the DA and beyond if the Minimum Sums are disregarded.

Income taxable under schedule D case VI

558. On the basis that Gala did not carry on a trade at any relevant time, it is subject to tax on its income (the Minimum Sums received) under schedule D of Case VI. Gala simply stated that, in that case, the sum charged to tax is to be computed after deduction of a sum of £180,791.85 shown in Gala's account as "Administrative expenses-loan interest" comprising £92,152.01 paid to SG as an arrangement fee in respect of, and £88,639.84 of interest due on, the SG loans. We heard few submissions on this and were not referred to any guidance or binding authority on how a profit is to be computed for this purpose. However, in the absence of any other guidance, we consider that, as HMRC argued, it is reasonable to take a similar approach to that which applies for the purposes of assessing whether expenses can be deducted in computing taxable income from a trade (as to which see Part D). On that basis, (1) we consider that the arrangement fee is a non-deductible capital amount, and (2) (a) the interest cost is deductible only of it was incurred wholly and exclusively for the purposes of the activity that generated the income but (b) in fact, it is infected with the non-business purpose and object for which the SG loan was taken out, namely, to generate the loss and tax relief (and ultimately the tax benefit) (see Part D), and (c) the same analysis would apply to the arrangement fee if it is taken to be a revenue item.

Part D – Expenditure

559. This part addresses whether in computing its profits for corporation tax purposes Gala is entitled to deduct the Initial Expenditure, the Interest Margin, the Invicta Fees and the SG Fees on the basis that they were (a) laid out or expended, (b) they were laid out or expended wholly and exclusively for the purposes of Gala's trade, and (c) they were not capital in nature.

Was the Initial Expenditure laid out or expended/incurred?

560. As noted in section 2 of Part A, the parties both referred to the UT's detailed commentary in *Ingenious UT* on the meaning of "incurred". The UT considered the decisions in *Tower, BMBF* and *Ensign*, all of which concern whether the taxpayer incurred sums on the provision of an asset for use in its trade the purposes of the relevant capital allowances legislation (see [336]). Details of *Ensign* are set out in Part C.

561. In *BMBF*, in summary:

(1) The House of Lords held that a Barclays company, BF, could claim capital allowances on £91 million it paid to buy a gas pipeline from BGE, which it leased back to BGE on finance lease terms for 30 years in return for rents. BGE sub-leased the pipeline to its new UK subsidiary, BGE UK. BF borrowed £91 million from Barclays at a fixed commercial rate and this sum corresponded to the finance BGE had obtained for the construction of the pipeline. The lease included terms that the rents were subject to adjustment if specified assumptions were to prove incorrect, as based around the premise that BF would obtain capital allowances on £91 million. The sublease was on similar terms but the rents were not subject to such adjustment and BGE UK assumed direct liability to pay the rents to BF (but with adjustments in the payment arrangement where the rental adjustment under the lease was triggered).

(2) BF required BGE UK to procure a guarantee in respect of the rental obligations and (a) the guarantee was provided by Barclays, (b) Barclays required BGE UK to provide a charge over the funds of £91 million as counter security for its potential liability under the guarantee, and (c) for this purpose, BGE provided the sales proceeds to Barclays via a complicated set of arrangements, whereby it deposited them with a Jersey company and they reached Barclays via an Isle of Man Barclays company. The Jersey company undertook complicated obligations to make a range of periodical payments to BGE and BGE UK over the duration of the lease which totalled much more than £91 million, which was in part used to fund the rents and the rest, of some £8.1 million in net terms, was retained by BGE. The House of Lords noted (at [17]) that the benefit obtained by BGE was entirely attributable to BF being able to pass on the benefit of capital allowances claimed on the price of £91 million.

(3) Lord Nicholls said (a), at [39], that (i) *BMBF* illustrates the need for a close analysis of what, on a purposive construction, the statute actually requires and (ii) the "object of granting the allowance is to provide a tax equivalent to the normal accounting deduction from profits for the depreciation of machinery and plant used for the purposes of the trade", and (ii) in this context, the capital expenditure should have been incurred to acquire the machinery or plant for the purpose of leasing it in the course of the trade, (b) at [40], the statutory requirements are "in the case of a finance lease concerned entirely with the acts and purposes of the lessor" and "say nothing about what the lessee should do with the purchase price, how he should find the money to pay the rent or how he should use the plant", (c) at [41], so far as BF was concerned, all the requirements to qualify for allowances were satisfied. The finding of the Special Commissioners

that the transaction "had no commercial reality" depended entirely upon an examination of what happened to the purchase price after BF paid it to BGE but "these matters do not affect the reality of the expenditure by [BF] and its acquisition of the pipeline for the purposes of its finance leasing trade", and (d) at [42], that, in light of the purpose of the relevant provisions, on the facts of the case, the fact that there were pre-ordained arrangements and a circular movement of funds was simply not relevant to the analysis:

> "if the lessee chooses to make arrangements, even as a preordained part of the transaction for the sale and lease back, which result in the bulk of the purchase price being irrevocably committed to paying the rent, that is no concern of the lessor. From his point of view, the transaction is exactly the same. No one disputes that [BF] had acquired ownership of the pipeline or that it generated income for [BF] in the course of its trade in the form of rent chargeable to corporation tax. In return it paid £91m. The circularity of payments which so impressed Park J and the special commissioners arose because [BF], in the ordinary course its business, borrowed the money to buy the pipeline from Barclays Bank and Barclays happened to be the bank which provided the cash collateralised guarantee to [BF] for the payment of the rent. But these were happenstances. None of these transactions, whether circular or not, were necessary elements in creating the entitlement to the capital allowances."

562. In *Tower*, the taxpayers were LLPs set up as investment vehicles to raise funding for, MCashback ("**M**"), a software company:

(1) M approached the Tower group for funding to "roll-out" a complex software package. Under Tower's proposal, 4 new LLPS acquired part of M's software and a right to receive part of the fees derived from it ("**the fees**"). The court focused on an LLP which paid £27.5 million for software rights in return for a right to 2.5% of the fees. The members of the LLPs included both Tower personnel and outside investors. The question was whether the LLPs were able to claim first year allowances (under s 45 of the Capital Allowances Act 2001), on the price paid to M for the software rights.

(2) The investors financed the purchase of the rights through injecting capital into the LLPs using (a) their own funds, as to 25% of the price, and (b) funds obtained under non-recourse loans indirectly provided by M, as to the remaining 75% of the price. The non-recourse loans were for a 10 year period and:

(a) They were funded by M through arrangements with two banks but the Special Commissioner concluded that the function of the banks was "window-dressing" only.

(b) (i) In effect, the loans were interest free, (ii) capital repayments fell to be made out of 50% of the fees from the software, and only to the extent that the LLPs had the available cash to enable them to repay loans on behalf of the investors, and (iii) the balance of loans at the end of the 10-year period was effectively to be cancelled.

(c) In the transaction the court focused on, 90% of the fees were paid directly to the investors, of which 50% was to be used to repay the loans (subject to the non-recourse terms), and the rest was to cover the investors' higher rate tax on the fees. The LLP retained the remaining funds for division between the investors and the founding partners (3 employees of Tower) according to a formula.

(3) The price for the software was supported by a valuation but it was criticised by the Special Commissioner (see [2008] STC (SCD) 1).

(4) Lord Walker set out that the Special Commissioner made the following important findings on which he had concluded that the LLPs were entitled to allowances on only 25% of the amounts they asserted they had incurred on the provision of the rights (at [66]):

> "(1) the scheme was not a sham, but it was pre-ordained and designed as a composite whole…; (2) the market value of the software rights disposed of was "very materially below" the price ostensibly paid for those rights…; (3) the last minute decision to sell the software 'in bits' added to the artificiality of the valuations…; (4) there was little chance that the members' loan would be repaid in full within ten years; as much as 60% of the loans might be unpaid, and waived, at the end of that period…; (5) there was no commercial justification for the insertion into the scheme of the two banks; and (6) the consideration paid by the LLPs was not paid partly for 'soft finance'.."

(5) In the High Court and the Court of Appeal, the decision was made in favour of the taxpayer. The Supreme Court found in favour of HMRC.

563. Lord Walker explained, at [73], that counsel for HMRC argued that only 25% of the funds which the investor paid as the price for the software reached M. The remaining 75% funded by the non-recourse loans "went into a loop from which [M] received no immediate benefit at all. If in the future money were to flow back to [M] out of the loop it would be because of its own commercial success in generating clearing fees" and "whatever this was spent on, it was not spent on acquiring software rights from [M], because it never reached [M]".

564. At [75] he said that Henderson J was right to emphasise that the transaction was the subject of tough negotiation between M and Tower because:

> "[M] (unlike BGE in *BMBF*) really did need up-front finance in order to roll out its software and give effect to its business plan. It saw itself as parting with potentially very valuable rights indefinitely (the investor members dropped out after ten years, but the founder members did not) for only a modest part (just over 18% before fees and expenses, or just under 17% after fees and expenses) of the total capital apparently being raised. That was because 75% of the capital raised, although not simply a sham, was really being used in an attempt to quadruple the investor members' capital allowances. That is what the tough bargain which Tower struck with [M] enabled Tower to offer to its investor members."

In the same passage he referred back to the conclusions of Lord Goff in *Ensign* and said that the facts of that case were different, since in that case "there was not "in any meaningful sense" a loan at all" whereas here:

> "there was a loan but there was not, in any meaningful sense, an incurring of expenditure of the borrowed money in the acquisition of software rights. It went into a loop in order to enable the LLPs to indulge in a tax avoidance scheme…"

565. At [76], he said that Moses LJ was right in deriving assistance from *Ensign* as to the relevance of the terms of the borrowing (in *Tower* that it was interest free and on a non-recourse basis) but that he was wrong to concentrate on those terms as an indication of whether there was "real expenditure". Whilst the issue in *Ensign* was "no real loan, no real expenditure", here "the issue was whether there was real expenditure on the acquisition of software rights":

> "The transfer of ownership (or at least of rights) indicated the reality of some expenditure on acquiring those rights, but was not conclusive as to the whole of the expenditure having been for that purpose. Moses LJ was also wrong…in saying that in *Ensign* the loan never had to be paid, whatever success the film achieved…"

566. Lord Walker continued, at [77], to contrast the circumstances with those in *BMBF*:

(1) He noted that in *BMBF*, (a) the whole £91m was borrowed by BF from Barclays "on fully commercial terms (though they were companies in the same group) and [BF's] acquisition of the pipeline was on fully commercial terms", and (b) BGE had that whole sum at its disposal, and:

> "though it was disposed of at once under further pre-arranged transactions, those transactions were entirely for the benefit of BGE. BGE had no pressing need for upfront finance (which is not, contrary to what Park J supposed, an essential feature of a leasing scheme capable of generating capital allowances)."

(2) In *Tower*, on the other hand:

> "the borrowed money did not go to [M], even temporarily; it passed, in accordance with a solicitor's undertaking, straight to [the bank] where it produced no economic activity (except a minimal spread for the two Guernsey banks) until clearing fees began to flow from [M] to the LLPs (in an arrangement comparable, though not closely similar, to the arrangements between LPI and VP in *Ensign*)."

(3) Having concluded that only 25% of the claimed allowances were available he noted, at [80], that it was to be expected that commentators would complain that the court had abandoned the clarity of *BMBF* and returned to the uncertainty of *Ensign* but he would disagree:

> "Both are decisions of the House of Lords and both are good law. The composite transactions in this case, like that in *Ensign* (and unlike that in *BMBF*) did not, on a realistic appraisal of the facts, meet the test laid down by the CAA, which requires real expenditure for the real purpose of acquiring plant for use in a trade..."

567. The UT in *Ingenious* also referred to Lord Hope's comments at [88] and noted that in applying a purposive construction to the legislation, he stated that:

> "it required it to be demonstrated that the whole of the claimed expenditure was actually incurred on acquiring rights in the software, which was a factual enquiry, the extent and depth of which will always depend on the circumstances of each case."

568. The UT concluded from the cases, at [447], that (1) "the focus must be on the position of the taxpayer and whether it has incurred the expenditure in question", (2) the source of the funds can be a non-recourse loan, and (3) the existence of a legal commitment to incur the expenditure is important, but *Ensign* shows that it is not determinative. Instead, "the focus must be on the "reality" of the expenditure by the taxpayer, by reference to what asset has actually been acquired as a result of the expenditure". The UT added, at [448], that some care must be taken in applying these principles in this context, as (a) "the sole focus" in this context "is the purpose of the expenditure, rather than what the money is spent on", (b) "the context is also the determination of the profits of the trade", and (c) in this context, "it is clearly not the case that a legal commitment to make the expenditure is essential. A paradigm example is discretionary employee bonuses, being a class of expenditure which is generally deductible but is not incurred pursuant to a legal commitment." They concluded, however, that the emphasis in *Tower* "on whether there was "real" expenditure by the LLP is…highly relevant".

569. The UT set out, at [450] to [452], that in *Ingenious FTT* the tribunal decided that the LLPs had incurred only 30 on a film or game in reliance on its findings that: (1) the LLPs were not obliged under the relevant agreements to pay 100 but only 30, and in fact paid only 30; and (2) C was not obliged to make a capital contribution, although the parties intended that D's payment to the PSC would be treated as a capital contribution by C.

570. The UT referred to the tribunal's conclusion, at [882], that if, contrary to their view, the LLP was liable to pay 100, then the question is whether realistically it bore the economic burden of that liability in the sense of "what real economic burden, what outflow of value, affected the LLP" or "leaving aside the rights to the film, how were the assets and obligations of the LLP different after the liability to pay 100 was satisfied?" The answer was, the tribunal said, that:

(1) Each LLP (a) had "paid out 30 and lost 30 of cash", referring to the part of the LLP's expenditure funded by the individual members, (b) "agreed in some way to recognise a capital contribution", referring to the fact that the stated purpose of C borrowing 70 under the non-recourse loan from D was to enable C to make such a contribution but in fact that sum was paid direct by D to PSC, and (c) its "obligation to pay drawings to [C] had reduced".

(2) The tribunal had earlier noted, at [875] to [878], that (a) the liability of each LLP towards C as a member changed as a result of the relevant agreements but for the better: until the loan was repaid, the LLP was either no longer liable to pay drawings or liable only in a reduced sum, (b) the (possible) obligation to treat C as having paid up capital of 70 did not reflect the assumption of any economic liability by the LLP as it did not increase its liability to pay drawings or affect C's rights on a winding up. The only effect was that the LLP might have to make an accounting entry, and (c) if the LLP was to be treated as having incurred the obligation to recognise capital subscribed and as having assumed a liability, that was matched by the removal of almost all of the LLP's obligation to pay drawings to C. Thus "in reality that obligation, if it was incurred, did not relate to the business of the LLP, but related to its relationship with its members".

(3) At [882], tribunal concluded that of the above factors:

> "the payment of cash was a permanent and real economic burden; any recognition of a capital contribution had no economic effect, and the reduction in the drawings liability was not a benefit of its business. The only economic burden it suffered was the outflow of 30. That is all that was incurred."

571. At [454] to [457], the UT rejected the taxpayer's argument that, on the correct contractual analysis, the LLPs incurred 100 of expenditure on each film and agreed with the tribunal's reasoning and conclusion at [882]. The UT made the following main points:

(1) At [454], they noted that, in contrast to *BMBF*, where BF was contractually obliged to pay 100% of the purchase price of the pipeline which it discharged, the LLP was only liable for 30, and met the liability in that amount.

(2) They accepted, at [455], that the facts are different from *Ensign*, where there was a series of self-cancelling payments. The relevant payments were actually made from D to the PSC. However, 70% of the expenditure was not incurred by the LLPs at all, either contractually or as a matter of fact. D paid 70% of the cost of the production of the film direct to the PSC, and in return retained 70% of the gross distributable income. The 70% was never paid to, or in any sense was at the disposal of, the LLPs and payment of that amount to the PSC did not meet any obligation incurred by the LLPs.

(3) At [456] they said that in *Tower* the issue was what the expenditure was on but here the entire 100 was spent on the production of the film and the question is "what real expenditure was incurred by the LLPs: was it 100 or 30".

572. HMRC submitted that, on a realistic view of the facts Gala did not bear the economic burden of the Initial Expenditure as "expenditure". HMRC base this on the fact that, as we have accepted:

(1) As was part of the design of the structure from the outset, (a) the Initial Expenditure was a sum calculated under a formula to match the principal of the SG loans (b) there was virtually certainty that (i) Gala would receive from SPR/Barclays a sum equal to the Initial Expenditure/principal of the SG loans by no later than the end of 8 year term of the DA, as the Minimum Amount, or the option price if the Call Option was exercised, and, in the interim, sums calculated to cover interest due on that amount (at the rate applicable under the SG loans), and (ii) accordingly, Gala would have sufficient funds for the principal of, and interest on, the SG loans to be paid as the relevant payments fell due.

(2) As HMRC stressed, (a) the DA expressly provided that Gala would be under no obligation under it unless and until SPR procured the issue of the LC in favour of Gala, (b) the LC (in essence) guaranteed the return of the Initial Expenditure plus interest by securing SPR's obligation to pay the Minimum Sums, and (c) the LC was funded by the Deposit which, in effect, SPR was required to provide to Barclays for it to issue the LC to Gala.

(3) Gala's interest in the LC was assigned to SG and, in practical terms, SPR's obligation to pay the Minimum Sums/option price was satisfied by funds moving direct from Barclays to SG.

573. HMRC also noted that (1) Mr Yusef accepted that the LC was "critical" and he knew from the outset that Sony would fund it, (2) Mr Lewis agreed that, in economic terms, the Initial Expenditure was not genuinely available to Sony, and (3) Sony's view was that the relevant "expenditure" was not that of Gala, but of Sony as they referred to the relevant sums as "SPR Exploitation Expenditure" in the figures referred to in section 11 of Part B. However, we cannot see that the views of these parties are relevant to the required analysis.

574. Mr Vallat submitted, in effect, that HMRC's view impermissibly ignores the legal and commercial effects of the contractual arrangements. In his view, the reality is that, pursuant to the relevant contracts, capital flowed into Gala from the members and out of Gala as Initial Expenditure which Gala plainly incurred on approved Gala Expenses:

(1) He submitted that, as a contractual and legal matter, (a) Gala's capital included *all* the contributions made by the members, whether funded from their own resources or by SG loans; the MA deems all the funds advanced by the members to Gala to be partnership capital, (b) the SG loan provided to Gala (which was used to fund the licence fees) clearly increased its capital, and (c) it is plain that the contributions had the character of ordinary partnership capital given that, under the MA, there was a direct relationship between the size of members' contributions and (i) their resultant share of the profits, and (ii) rights to surplus on a winding up. Mr Vallat noted that, in *Ingenious*, by contrast, any such surplus was payable only to the individual members, and not to C, through whom the borrowed funds of 70 flowed.

(2) Mr Vallat added that this was not like *Ingenious* where, on abandonment of a film, the LLP was entitled to receive only the funding from the members' own resources (see *Ingenious (FTT)* at [138]). It is plain from the terms of the DA that if a transaction film was "abandoned", the intention was to put Gala in a position where it would (hopefully) receive comparable revenue at a similar time to that expected to arise in respect of the original film.

(3) Mr Vallat also stressed that, (a) in contrast to *Ingenious*, Gala's obligation to advance the Initial Expenditure to SPR could not be described as "contingent" on the receipt of prior funds (see *Ingenious (FTT)* at [129] to [138]). The DA provides that Gala would provide the funds immediately upon its acquisition of

each film pursuant to the LAs, and (b) as Mr Yusef said, the funding was not circular because it did not start from Sony. Gala was plainly entitled to all of the contributions as capital which it then used to fund the agreed Gala Expenses and Sony separately put funds on Deposit for the purposes of securing the payment of the Minimum Sums, and (c) that Gala had rights in relation to "Sequels" also demonstrates that there was not a mere pass-through of rights. The fact that capital was introduced in part by way of SG loans and that there were security arrangements in place to cover the interest and principal repayments is irrelevant to the proper analysis.

575. We accept the factual propositions and view of the effect of the relevant contractual arrangements set out by Mr Vallat in (1) and (2) above but not his other points. As HMRC submitted, to view Gala's obligation to put the Initial Expenditure in the expenditure account as a free-standing obligation is inaccurate according to the terms of the DA and is the type of blinkered view, which the courts have repeatedly found is not the right approach. As noted, as a contractual matter, Gala's obligations under the DA, including the requirement to provide the Initial Expenditure, were to take effect only if SPR procured the issue of the LC to Gala. As set out in section 10 of Part B, (1) it was part of Invicta's proposition from the outset that the studio would fund a letter of credit with a cash deposit, (2) whilst there is no mention of the Deposit in the DA, for the reasons set out in section 10 of Part B, that SPR would enter into a Deposit with Barclays was plainly part and parcel of the overall arrangements (see [300] to [307]).

576. HMRC said that Gala's assertion that there was no circularity is nothing to the point given that money is fungible. They said that, from Gala's perspective, it makes no difference whether the Deposit made by Sony involved the same money paid to it by Gala, or an equivalent sum – the circularity of the arrangements remains unbroken. We do not find consideration of the question of whether the movement of funds can be described as circular or not to be of assistance. It is clear from *BMBF* that the tribunal must make a close analysis of what, on a purposive construction the statute actually requires. The close analysis required is of whether Gala laid out or expended/incurred a cost, in that it discharged a liability, and bore an economic burden, in respect of the Initial Expenditure. We accept that the arrangements were designed to have the effect set out above and the question is, on the required close analysis, what bearing that has on this issue.

577. In our view, in putting the Initial Expenditure into the expenditure account in discharge of its obligations under the DA, Gala bore an economic burden and laid out or expended/incurred "real" expenditure. Unlike in *Ingenious*, Gala's rights and obligations as regards the relevant sum changed in relevant and material respects after the Gala arrangements were put in place. We note the following:

(1) As a factual matter, Gala was funded by the contributions and its SG loan and, therefore, had rights and obligations in relation to the loan and capital thereby provided to it as set out in the MA (see section 3 of Part A).

(2) Gala used £102 million of the funds it received to meet its obligation under the DA to put the Initial Expenditure into the expenditure account on the basis that, as the DA specified, those funds could only be withdrawn from that account to meet approved Gala Expenses. As set out above, Gala did not, as it asserts, provide the funds so that they could be used by, or on behalf of, Gala to meet approved Gala Expenses to be incurred by Gala, and they were not so used. Rather, in putting the funds into the account, Gala made them available to SPR, and it appears that, in practice, SPR used those monies to incur those expenses on its own account.

(3) As set out in full in section 10 of Part B and in our conclusions in Part C, Gala's purpose in providing the Initial Expenditure, and the effect of it doing so from its perspective, was to ensure that SPR would provide the Deposit and so that it would receive £102 million back again (plus interest) (as the Minimum Sums/option price/corresponding sums due under the LC) in order to realise its tax objectives. In effect, the provision of the Initial Expenditure (a) put SPR in a position where it could provide the Deposit without it incurring an overall economic cost in doing so (due to it being provided with the Initial Expenditure to use to meet Gala Expenses), and (b) on Gala's analysis, created a loss of £102 million for Gala without it/the members being at material risk of suffering an economic loss of that amount (due to the arrangements for the receipt of that sum back again plus interest on it so that the Gala loans could be repaid in full).

(4) However, in our view, the purpose for which Gala fulfilled its obligation under the DA to provide the Initial Expenditure is not of itself determinative of the issue under consideration in this section. The material point of relevance to the analysis is that, in putting the relevant funds into the expenditure account, Gala plainly made them available to SPR and, in doing so, took some, albeit limited, financial risk:

(a) Whilst there was a high degree of likelihood, there was not complete certainty, that Gala would receive from SPR/Barclays a sum equal to the Initial Expenditure (and sums equal to interest thereon) as the Minimum Sums/option price/corresponding sums due under the LC. Gala (and, ultimately, the members) had the risk that SPR and Barclays would not meet their obligations. The SG loans were provided on a full recourse basis so that ultimately Gala/the members remained liable for sums due under the SG loans in the unlikely event that the LC and Deposit arrangements failed. Whilst the risk of default by Barclays was relatively remote (and was not a speculative risk undertaken in the course of a trade of film distribution), it is nonetheless a commercial credit risk which cannot be ignored as part of the overall factual matrix of relevance to the particular issue under consideration in this section.

(b) Whilst SPR provided the Deposit to Barclays on closing, the funds in the Deposit and interest accruing on them were not immediately available to Gala. Under the terms of the relevant documents, they were available for release for the benefit of Gala only when Barclays was called upon to make a payment under the LC under the procedure set out in the LC. Hence the risk referred to above was extant for the duration of the arrangements albeit that, from the outset, Gala intended and expected that the arrangements would be relatively short lived, on the basis that SPE would exercise the Call Option as soon as it could (after around 2.5 years).

578. HMRC said that they accept that their stance on this issue is not consistent with the Court of Appeal's decision in *NCL Investments Ltd v HMRC* [2020] 1 WLR 4452, that, as they summarised it, the corresponding provision to s 74 relating to corporation tax (in s 54 of the Corporation Tax Act 2009) does not impose a two-stage test requiring expenses to be both (a) computed in accordance with GAAP, and (b) incurred as a matter of legal liability and/or involve the taxpayer bearing an economic burden in respect of them. However, the Court of Appeal's judgment in that case is under appeal to the Supreme Court and HMRC, therefore, asked the tribunal to make necessary findings in relation to this argument so that HMRC may, if necessary, rely upon this argument in due course. We have done that as set out above.

Was the expenditure incurred wholly and exclusively for the purposes of the trade?

Initial Expenditure and Interest Margin

579. We have set out the summary of the applicable principles as taken from *Ingenious FTT* at [839] in section 2 of Part A. HMRC submitted that the Initial Expenditure and the Interest Margin are not deductible for similar reasons to those they put forward as to why these sums were not laid out or expended/incurred in the first place: (1) this money was laid out or expended to put SPR in funds to place an equivalent sum on Deposit with Barclays to ensure that Gala and its members could repay the principal of, and interest on, the SG loans, and (2) with the purpose of inflating Gala's purported expenditure on approved Gala Expenses so that members could claim tax relief in the desired amount. They noted that it has been held in a number of cases, in particular, in *Icebreaker* and *Acornwood* that inflating expenditure by the circular movements of funds, in order to obtain tax relief for members of an LLP, is not a trade purpose.

580. *Acornwood* and *Icebreaker concern* whether a number of LLPs were entitled to the claimed trading losses where the individual members of the LLPs contributed funds apparently to finance a range of creative projects. As the UT explained in *Acornwood*, using simplified figures, at [6] and [8] to [20]:

> (1) Members contributed 100 to an LLP, of which they funded 20 from their own resources and borrowed 80 from a bank on full recourse terms; they were personally liable to repay 80 to the bank.
>
> (2) The LLP wished to acquire and develop and exploit some original intellectual property ("**IP**") and so acquired a licence from the creator of an idea (such as the acquisition from Sinead O'Connor of a licence of musical compositions written by her to enable the LLP to exploit master recordings of those compositions).
>
> (3) The LLP paid (a) 5 to a management company, in part as an "advisory fee" and in part as an "administration fee", and (b) 95 to "the principal exploitation company", which in the case of most of the LLPs was Shamrock. The LLP licensed the rights in the IP to Shamrock which agreed (i) to exploit them by producing and distributing a product (such as a music CD), and (ii) to pay the LLP a guaranteed income stream, supported by an LC and deposit as set out in (5) below, which in some cases was said to be in consideration of the right that Shamrock also had to assign a share of total revenue from the rights to third parties.
>
> (4) Shamrock agreed to pay a large part of the 95 (say, 90) to a production company which was responsible for producing the end product. The production company simultaneously agreed, under an assignment of revenues agreement, to acquire from Shamrock a share of the revenues from exploitation of the product, for a price of 80. The net effect was that Shamrock paid 10 to the production company, leaving it with 85 of the 95 paid to it.
>
> (5) Shamrock (a) put 80 of the 95 (or in one case 80 of its own money) on deposit as collateral for the issue of a letter of credit and (b) in effect, (i) the interest paid on the deposit was used to pay an income stream to the LLP which matched the interest payments which the members of the LLP were obliged to pay on their bank borrowing, and (ii) the 80 was used to pay a "final minimum sum" of an amount required to repay the principal amount of the members' bank borrowings.
>
> (6) The tribunal held that, of the 95 paid by the LLP to the principal exploitation company (a) 80 was not wholly and exclusively incurred for the purposes of the LLP's trade and was a payment of a capital nature not an income nature, but (b)

the balance of 15 was so incurred in the case of one of the LLPs and was so incurred in part in relation to the other LLPs.

581. At [20] of *Acornwood*, the UT summarised the tribunal's conclusions (as set out at [264] to [272] of their decision) on whether 80 was incurred wholly and exclusively for the purposes of the LLPs' trades as follows:

(1) Each LLP made a large payment to Shamrock (of 95) in return for which it received exploitation services and a guaranteed income stream ([264]).

(2) The description of the right to assign a share of the revenue as the consideration for the guaranteed payments was a pretence. If the agreements were taken at face value, the guaranteed payments exceeded the true worth of the right to assign a share of revenue by so large a margin that neither party could realistically have believed that one was a fair price for the other. The reality was that part of the payment by each LLP to Shamrock represented the price of the guaranteed income stream notwithstanding its description as something else ([265]).

(3) Once it was accepted that part of the payment made by the LLP to Shamrock was made to acquire the guaranteed income stream it followed that only so much of the fee as represented a payment for exploitation might represent an allowable deduction ([270]).

(4) The deposit which the LLP made, was made possible by the members' borrowings and invariably matched the "final minimum sum", which in turn invariably matched the amount borrowed, and the periodic payments invariably matched the amount earned on the deposit, which in turn exactly matched the interest payable on the borrowings. In those circumstances, there was no basis to value the consideration for the guaranteed payments at anything other than the amount of the deposit ([271]).

(5) It necessarily followed, so far as the deductibility for tax purposes of that sum is concerned, that the reality was that the borrowed money was only ever available for use as the price of the guaranteed payments, and not for the exploitation of IP rights, and it was as a matter of fact used only for that purpose. The payment could therefore not be brought into the calculation of profit and loss by reason of s 34(1) of ITTOIA ([272]).

582. The UT noted, at [22] to [24], that (1) in *Icebreaker*, in considering the similar issue that rose there, Vos J considered that the object of s 74 ICTA was to allow a deduction from taxable profits for revenue expenses incurred by the taxpayer for the purposes of its trade" (see [38]), (2) Vos J added: "There is no indication in these words that the ultimate use of the monies by the recipient is to be relevant to a determination of the purpose for which they were expended" and at [39]: "The starting point in this case is the purposive construction of s. 74, which points the tribunal towards a consideration of the use that was made of the disbursement in question in relation to the taxpayer's trade, and does not require consideration of how the money was ultimately dealt with by the recipient", and (3) Vos J concluded that the relevant sum was paid for the purpose of securing the "annual advances" and the "final minimum sum". That is not a matter of looking at what the recipient did with the money, but of looking at what Icebreaker paid the money for.

583. In *Acornwood* the UT concluded, at [85], that the key point is that 80 was not paid by the LLP for exploitation at all:

> ".….Not only was it not needed by Shamrock, it was not wanted by Shamrock who found it a nuisance. *It was not in any sense used by Shamrock in fact for exploitation. That last point of course does indeed look at what the recipient does*

with the money, but in circumstances where this is to the knowledge of, and indeed intended and required by, the payer. The borrowing of the 80 and its payment to Shamrock by the LLP was in short artificially designed to multiply the losses. There is no commercial difference between the members paying 15 for Shamrock's services without having borrowed 80 and without any rights to guaranteed repayment of the 80, and the members paying 95, of which they have borrowed 80 and are guaranteed to be repaid 80 (save for the extra costs in terms of margin and arrangement fees in the latter). The only practical difference is that in the first case the LLPs' expenditure would clearly be limited to 15 and that would be the most that they could argue qualified as a trading loss for tax purposes. In the artificial world, since the money that is actually paid over is 95 that enabled them to argue that the whole 95 amounts to a deductible trading loss. The conclusion that the 80 was injected into the system to increase the apparent size of the amount paid for the exploitation of the intellectual property rights (as the FTT said at [147]) is not the only one which they were entitled to come to, but was I think an inevitable conclusion from the facts that they found." (Emphasis added.)

584. In the same passage the UT commented on the caselaw cited, namely, *Ensign*, *Tower* and *BMBF*:

> "It seems to me to be comparable to the so-called loan in *Ensign* which was held not to be a loan in any meaningful sense at all; or to the expenditure in *Tower MCashback* where Lord Walker said (at [75]) [the UT cited [75] of *Tower* which is set out above]….
>
> Nothing in *BMBF*, or the factors which these cases happen to share with *BMBF*, can turn these wholly artificial and manufactured arrangements into a genuine commercial transaction under which 95 was really paid for the exploitation services. I therefore do not see any difficulty in rationalising the three decisions in *Ensign*, *BMBF* and *Tower*, nor do I find in *BMBF* any principle of law which would enable the Upper Tribunal to declare that the factual decisions come to by the FTT involved erroneous legal principles or impermissible reasons."

585. At [86] to [89], the UT considered the "subsidiary argument" that even if the tribunal was correct, or entitled, to find that the purpose of the payment by the LLP of 80 of the 95 was to secure the guaranteed income stream, that was still capable of being a trading purpose. At [87], the UT said there is nothing in this and noted that both Vos J in *Icebreaker* and the tribunal in the present case dealt with this point in similar fashion: (1) Vos J said in *Icebreaker,* at [64], "the equivalent of the 80 was paid for the sole purpose of investment and security and not for Icebreaker's film trade" and (2) the tribunal in *Acornwood* said, at [270], that "the LLPs' business was the exploitation of intellectual property rights, and not the acquisition of an income stream which was guaranteed irrespective of the success of that exploitation". The UT, at [89], entirely agreed with these analyses:

> "The trade in which the Icebreaker partnerships were engaged was the exploitation of rights whether…the exploitation of film rights, or…rights in the format for a book or for songs. Once the FTT had found that the purpose of the LLPs in paying 80 of the 95 was not for such exploitation but for the securing of the guaranteed income stream, it follows that it was not for the purposes of the trade. Mr Peacock at one stage in his submissions referred to the fact that certain institutions such as banks and other financial institutions may be engaged in the trade of purchasing income streams in the form of financial instruments of one form or another. That is no doubt the case, but I do not see how the acquisition of a guaranteed income stream on the facts of these cases can be said to be part of the LLPs' trade of exploiting intellectual property rights…"

586. HMRC also submitted that the decisions in *Ingenious* and in *Tower* are of relevance. They noted that:

(1) In *Ingenious* the tribunal held that the LLPs' purported expenditure of 70 was not incurred wholly and exclusively for the purposes of the trade because, amongst other things, the structuring of the arrangements was designed to deliver tax relief to the investors by inflating the LLPs' losses from 30 to 100. The purpose of the payment of 70 was to deliver an "enhanced tax loss" which is not a trading purpose (see the decisions of the tribunal and UT at [889] to [890] and [472] to [473] respectively).

(2) The decision in *Degorce* demonstrates that the decision in *Tower* can be applied by analogy for the purposes of s 74. It was held in *Degorce* that monies borrowed under a limited recourse loan, which went into a loop to enable the taxpayer to indulge in a tax avoidance scheme, was not expenditure wholly and exclusively incurred for trade purposes (see the decisions of the tribunal and the UT at [253] to [258] and [132] to[136] respectively).

587. We have concluded that, on the assumption that Gala carried on a trade in relation to the marketing and distribution of the transaction films, the Initial Expenditure and related Interest Margin amount were not incurred by it wholly and exclusively for the purposes of any such trade:

(1) As set out above, the statutory test requires the tribunal to consider the use that was made of the disbursement in question in relation to the taxpayer's trade, and not how the money was ultimately dealt with by the recipient. In other words, it is not a question of looking at what the recipient did with the money, but of looking at what the taxpayer paid the money for.

(2) For all the reasons as set out in full in section 10 of Part B and summarised in our conclusions on the trade issue in Part C (see [520] onwards), it is plain from the design and operation of this element of the arrangements, as viewed in the context of the design and operation of the overall transactions, that:

(a) Gala's purpose in providing SPR with the Initial Expenditure of £102 million pursuant to its obligations in the DA was not, as Gala asserts, for it to fund, or to provide SPR with funding for, approved Gala Expenses (and, in economic and financial terms, SPR did not receive any such funding).

(b) Rather Gala's purpose in providing the Initial Expenditure was (a) to secure that Gala would receive back from SPR/Barclays £102 million (and sums calculated to be sufficient to cover interest on the SG loans), regardless of the success of any activities which Gala or Sony undertook in relation to the distribution process and/or of the success of the transaction films, and (b) to generate an apparent "self-funded" loss of the desired amount, without Gala/the members being subject to any material risk of suffering an economic loss of £102 million, and ultimately to provide members with the tax benefit. These arrangements were not related in any way to activities which Gala asserts constitute a trade.

(3) In all the circumstances, it does not detract from this conclusion that, under the terms of the DA, SPR was required to, and it appears did, use the Initial Expenditure to meet approved Gala Expenses. That requirement was, in effect, simply a necessary ingredient in the fulfilment of Gala's purpose in paying the Initial Expenditure as set out above: (a) For Gala to induce SPR to provide Barclays with the Deposit so that SPR would procure the issue of the LC for Gala's benefit, it had to provide SPR with a sum equal to the Deposit, and (b) for Gala to be able to claim that, in providing that sum, it had created a loss in the conduct of a trade of film distribution, that sum had to be presented as tied in

some way to the funding of the type of expenses that a trader would incur in a such a trade.

(4) As HMRC submitted, Gala had essentially the same purpose as regards the payment of the Interest Margin, which was introduced into the structure in order to cover the mismatch between the interest payable on the SG loans and the interest receivable on the Deposit with Barclays.

588. Mr Vallat stressed that, at this stage of the analysis, the tribunal must assume that Gala carried on a trade of film distribution. It follows, so he said, that the same factors which show that Gala carried on such a trade demonstrate that the Initial Expenditure was incurred wholly and exclusively for the purposes of that trade. In that context, he emphasised that (1) the immediate reason for Gala incurring the expenditure was the discharge of its obligations under the DA with a view to Gala earning money from Gross Receipts generated by the transaction films; there was no other ancillary benefit to Gala, (2) HMRC's analysis does not apply to the portion of the Initial Expenditure funded by the cash contributions as it depends on an asserted inter-relationship between the SG loans and that expenditure, and there can be no difference in treatment according to how the Initial Expenditure was funded, (3) the loss/tax relief was merely a form of downside protection, and that Mr Yusef and the Referrers had an awareness of these factors does not alter the fact that the underlying purpose of the transactions was to carry on a trade in anticipation of a commercial return, and (4) for the reasons already set out, it was not the case that the Call Option was always going to be exercised.

589. We accept that the analysis at this stage depends on precisely what Gala's trade is held to constitute. Our analysis is based on the assumption that, even if, contrary to our view, some of Gala's activities constitute a trade, for all the reasons set out in Parts B and C, the loan repayment arrangements do not form part of that trade. If that is not correct, then this analysis would need to be re-visited. We have already set out in full in Parts B and C, why we do not accept Mr Vallat's points in (1), (3) and (4). In our view, that Gala funded some of the Initial Expenditure with monies it received as cash contributions does not detract from our findings on this aspect of the arrangements. Essentially, the point is that the provision of the Initial Expenditure and the Deposit and the repayment of the SG loans were inextricable linked as set out in section 10 of Part B.

Invicta Fees, SG Fees and sums paid by Invicta

Facts

590. The Invicta Fees of £8.364 million, comprised (a) £6,019,395 and (b) £2,344,842, for which Invicta submitted invoices to Gala dated 2 December 2003 and 3 February 2004 respectively. Both sums are described in the invoices as "Professional fees due for arranging the closing of the [first closing][second closing] by the Partnership and the subsequent arrangements".

591. It appears that the Invicta Fees were calculated under a formula in the MSA which calculates a "charge per Slate" acquired by Gala as various charges payable by Gala to Invicta as the aggregate contributions less (a) an amount equal to the net present value of the Minimum Sums and (b) any amounts (exclusive of value added tax) payable to the Operator and Placing Agent. HMRC noted that during their enquiry they were informed that Invicta charged Gala the Invicta Fees for the services provided "as per the [MSA]" and, whilst under the MSA Invicta was entitled to charge an amount equal to £9,250,330, on agreement with Gala Invicta reduced its fees.

592. The IM says the following about the fees payable by Gala:

"The provisions governing fees payable to Invicta, the Placing Agent and the Operator in respect of the Partnership are contained in the [MSA], Placing Agent

Agreement, and the [OA] respectively and the aggregate of such fees are expected to approximate to 8.2% of the capital raised. Out of such fees all initial costs of establishing the Partnership will be met, as will the general administration costs of the Partnership, and the cost of the US and UK distribution personnel (but excluding any extraordinary and currently unanticipated costs and expenses which may arise and also excluding legal costs and expenses in connection with enforcing the rights under the Transaction Documents and any costs or expenses in connection with any other legal proceedings). The fee payable to the Placing Agent will be up to £50,000 and a quarterly fee of £15,000 will be payable to the Operator (in each case exclusive of value added tax)."

593. In his witness statement Mr Yusef said that (1) the Invicta Fees were paid to it for its role in acting as Gala's agent, carrying out all of the arrangements necessary to conclude the transactions and overseeing the business generally, (2) "various fees that had to be paid by Gala were paid by [Invicta] from the amount it received", and he exhibited a breakdown of such payments, and (3) once those payments had been made, Invicta was actually paid a total of £3,384,000 (plus value added tax) (an amount equal to around to 3% of the contributions) which, he did not consider a particularly large amount (particularly when factoring in the overheads of Invicta's business), given the length of time it took to pull everything together and how long Invicta had to manage the business.

594. At the hearing Mr Yusef said that he could not remember how the Invicta Fees were worked out but the amounts were the subject of an audit and the auditors did not question the amount. He did not agree that (1) the Invicta Fees were "scheme fees" paid in return for Invicta setting up the structure and providing it to investors as a tax shelter package (as was put to him is shown in the promotional material such as the UBS document and Ms Challons' letters), or (2) Invicta paid the fees listed in his breakdown on Invicta's own behalf, as one-off payments, for the services it needed to enable it to sell the scheme to investors as a package. He said that Invicta would not have incurred these sums were it not for the fact that it was acting as the agent of Gala; all the relevant sums were incurred as direct result of the work Invicta did on behalf of Gala. It was not a payment to Invicta for that. Invicta's position cannot be looked at in isolation. Invicta did many things on behalf of Gala.

595. Mr Yusef accepted that of the total SG Fees, (1) of the sum of £652,645, £584,771.74 relates to the members' SG loans and £67,873.94 relates to Gala's SG loan and (2) of the sum of £233,447.14, £209,169.07 relates to the members' SG loan and £24,278.07 relates to Gala's SG loan. It was put to Mr Yusef that Gala has not claimed a deduction in respect of the aggregate of these sums (£793,940.81). He said that in fact Gala would have claimed a deduction for all of the expenses other than expenditure on the licence fees which constitute capital. HMRC noted that their understanding is that Mr Yusef's evidence was incorrect in this regard. It was put to him that, in any event, all of these fees were incurred by Gala for the purposes of arranging a loan in order to put in place a tax shelter structure. He noted that (a) SG addressed the letter relating to the fee due in respect of the SG loan to members to one of the designated members, and the fees were clearly due in respect of the loans made to the members, and (b) Gala needed to borrow the monies from SG in order to execute the transaction whereby it received the Rights.

596. Mr Yusef was questioned about the following items as listed in his breakdown:

(1) "Lending banks charges" paid to SG of £686,787.04 and £265,034.64 paid to SG:

(a) It was put to him that the letters between SG and Invicta dealing with these arrangements fees and breakage costs refer to Invicta agreeing to pay them.

For example, it is stated in one letter that "You agree prior to us making the loans available to pay us immediately available cleared funds [specified sums]" and in another "Invicta hereby agrees that it will provide SG with a non-refundable upfront fee". Mr Yusef said, in effect, that (a) the SG loans were made to Gala and the members; these charges would not have been payable but for those borrowings, (b) Invicta was simply acting as Gala's agent and "certainly" the lawyers were instructed that was the relationship, (c) the letters state that the payments were due in consideration of loans made to Gala and the members and make it clear that Invicta incurred the financial obligation on their behalf; that context has to be taken into account, and (d) Invicta had no commercial or logical reason to make payment on its own behalf.

(b) He did not agree that the purpose of the SG loans was to increase the loss and thereby the tax relief available for members. He said, in effect, that the principal purpose was to enable Gala to engage in a meaningful way with the studio given that, (a) the studio was not interested unless "we were able to provide a deal size that would make sense for them", and (b) the real benefit to the studio was that a significant amount of money was going to be put on the table to relieve it of a portion of its P&A commitment; a fee of £15 million would not have got them or any other studio to the negotiating table. That was the real purpose and the driver for the transaction. He said he was not speaking for Sony or any other studio; this was "the state of mind that existed on our side and what we needed to do to get Sony to the table"; as was clear from discussions with all the studios, "volume was king" and the only way the transaction would happen. For all the reasons already set out, we do not accept this (see section 10 of Part B and our conclusions in Part C).

(2) Stellar fees of £404,277.76 and £156,012.86: Mr Yusef agreed that these fees were paid by Invicta for SFP's role in helping Invicta pitch the scheme to HNWIs and IFAs and that they were incurred by Invicta to try to get the structure off the ground in the market.

(3) Fees due to Cameron McKenna of £50,138 relating to SG's costs of preparing the paperwork relating to the SG loans: Mr Yusef said that he had never come across a loan transaction with any bank in any jurisdiction where the bank pays its own legal fees. It is a standard commercial term that the borrower pays the bank's legal fees. The fact that Mr Hughes of Cameron McKenna was a longstanding friend of his is irrelevant and, as senior partner at the firm, he would have known that the payment made by Invicta was made on behalf of Gala in reality so that it could organise the legal transaction documents. He accepted that there are no documents in the bundle stating that Gala owed Cameron McKenna this sum. He did not accept that Invicta paid these fees to set up the tax shelter structure.

(4) Fees "due to K Lemberger – Vector Entertainment" of £185,458.78 and £71,560.70 paid as an introducer's fee: Mr Yusef agreed that this was paid to get Invicta in front of Sony but said it was also paid to have Mr Lemberger advise Invicta for the benefit of Gala. He accepted there was no document in the bundle saying that Gala owed Mr Lemberger a sum of money. He said (a) there would have been no reason to pay Mr Lemberger or even to talk to him if Invicta was not acting for Gala, (b) whilst he was in discussion with Sony before the MSA was entered into (i) that agreement was "really a culmination of work" that Invicta did on behalf of Gala and partly records work done before the formal agreement was entered into, (ii) it is quite standard in the film industry for people to do a lot

of work in contemplation and on the understanding that an agreement is eventually entered into when everything is locked in, and (iii) it would not have been possible to do the deal with Sony unless Invicta had done that preparatory work, and (c) all of that work and the work thereafter was done on behalf of Gala; he believed that most strongly. It was put to him that he made contact with the studios, including Sony, before Gala was even incorporated and it is impossible for an LLP to take on a debt before it exists. He said that the reality is that it is not possible, on day one, to execute documents required without a lot of work being done beforehand and that is perfectly normal and the payment itself can only make sense if it is made on behalf of Gala. There is no other reason why Invicta would make that payment. It is not for its own account.

(5) "IFA commission" of £1,615,221.12 + £604,051.43: Mr Yusef agreed that these were commissions paid by Invicta to IFAs to attract HNWIs to Invicta's scheme. He said that the fee to Invicta was a fee dealing with Invicta's work and what Invicta did with that money does not detract from the fact that it was payable to Invicta by Gala for its services as agent in connection with this transaction. If in time Invicta paid a part of that fee to a third party as between Invicta and Gala he did not think it is matter of concern to determine whether the expenditure of Gala was trading expenditure

(6) (a) Legals of £97,026.66 and £37,443.09, (b) "Ongoing running costs" of £242,566.65 and £93,607.70, and "Inland Revenue reserve/develop" of £340,000 and £131,050.80: It was put to Mr Yusef that there is no evidence as to what those amounts are for. He made the following main points:

(a) Whilst there is no documentary evidence, the legal expenses have to be looked at within the context of what Gala did and the legal consequences of that. Invicta had no reason to incur these sums other than on behalf of Gala for legal opinions and legal advice on the transaction documents which Gala entered into. It was put to him that in fact these costs were incurred for a structure to be used by more than one LLP and he was shown an IM for another LLP that was the same as the one for this transaction. He said Invicta's aim was to set up several transactions within the LLP but how that would happen was not bottomed out and, in any event, (i) these fees were all incurred specifically in relation to the Gala transaction, and (ii) he thought that the other LLP did not actually trade and that Invicta did not put in place any similar arrangements.

(b) Logically "the ongoing running costs" can only be related to the actual ongoing work of Gala and its agents. That work, from closing right the way through the distribution process until Gala in effect had no further work to do, was "substantial" and not "inconsequential or cosmetic" but "real". There were boxes and boxes of invoices directly addressed to Gala, the work that Mr Ackerman did was "substantial" and Invicta worked directly for Gala in this regard. The auditors would have asked legitimate questions about these costs and their examination was quite detailed. They were a reputable and not an inconsequential audit firm and went through the expenditure thoroughly as is a matter of public record. He could not recall after 19 years when that work ended. There was considerable on-going work over the years and even when there was no further engagement directly or indirectly with Sony, there was work to determine whether the transactions could be restructured and relating to HMRC's investigation. He accepted that the ongoing things he referred to include things that happened and running costs after 5th April 2004: "They include things that happened many years after 2004, but they would be

fees...consideration in relation to work that Invicta was doing on behalf of the partnership".

(c) The reserve cost was not a gift and the members of Gala would not have sanctioned it unless it was directly related to Gala's business and, viewed in context, it was made in connection with Gala's business.

597. HMRC argued that:

(1) Gala did not incur the Invicta Fees wholly and exclusively for the purposes of any trade whether they are viewed in isolation, as payments made by Gala, or account is taken of what Invicta did with them. In their view:

(a) Viewing them in isolation, Gala incurred them with the purpose of engaging Invicta to put together and operate a structure designed to generate the loss and secure tax relief, and ultimately the tax benefit, for the members.

(b) Further and alternatively, on the basis that Gala intended to put Invicta in funds to pay third parties, the Invicta Fees are non-deductible whether (i) it is found that Invicta engaged with those parties and incurred the relevant sums acting on its own behalf; plainly putting another party in funds to meet its costs is not a trade purpose or (ii) it is found that Invicta engaged those persons on behalf of Gala. The relevant sums were paid to those parties for services which would enable Gala to generate the loss/tax relief and secure the tax benefit for members. In other words, the fundamental purpose of the scheme, namely, to obtain the tax advantage, infects all of Gala's expenditure.

(2) The SG Fees, as fees paid for SG providing the SG loans, were necessarily expended for the same (non-trade) purpose as those loans were taken out, namely, to inflate Gala's expenditure for the purpose of maximising the loss and tax relief.

We have taken account of HMRC's further specific points on the evidence in our conclusions.

598. Mr Vallat said that, on the contrary, the Invicta Fees and SG Fees were clearly incurred in order to put Gala in a position to carry out its trading activity. They were ancillary to its trading activity and take their nature from it. The only alternative would be to say that some of the fees were ancillary to Gala's acquisition of the licences. In the real world, however, (1) Gala bought licences, which it paid for from its SG loan and exploited them using the contributions, and (2) it is clear that these fees are ancillary to Gala raising funds from the members, and that, without incurring those fees, Gala would not have been able to discharge its obligations under the DA. Moreover, the sums are plainly not capital given that the intention was that there would be further transactions for Gala albeit that did not happen due to unforeseen circumstances.

599. In our view, Gala did not incur the Invicta Fees and/or the SG Fees wholly and exclusively for the purposes of any trade conducted by it. It follows from our conclusion that the purpose and object of Gala in implementing these arrangements and in incurring the Initial Expenditure was to secure the loss and ultimately the tax benefit that (1) fees paid to Invicta, in return for Invicta putting in place all necessary measures to effect and operate those arrangements, and (2) fees paid to SG, essentially in return for SG providing the finance required to fund such arrangements are, as HMRC put it, infected with that underlying purpose and object.

600. We reach the same conclusion, that these sums are not deductible in computing Gala's profits from any trade it carried on, if it is relevant to take account of the fact that Gala may have intended to put Invicta in funds so that it could meet fees and charges due to third parties for the relevant services. We note that:

(1) Given the factors referred to below, it is reasonable to infer that the costs referred to below were incurred by Invicta on its own account. In effect, they were

spent on services Invicta needed to receive to enable it to carry out the function it was engaged by Gala to carry out, namely, putting the arrangements in place and operating them, and so to earn its fee for doing so:

(a) (i) The contractual documentation states that the liability for the lending bank charges fees was owed by Invicta and not Gala, and (ii) Mr Yusef accepted that there was no contract or invoice (or other written document) to the effect that Gala owed Cameron McKenna any moneys.

(b) Mr Yusef accepted, essentially, that the Stellar fees and IFA commission were "an Invicta cost" which were incurred by it for the services of SFP and a range of IFAs in promoting Invicta's structure and attracting HNWIs.

(c) There was no document to the effect that Gala owed Mr Lemberger a sum of money, and Mr Yusef's evidence was that this fee related to services carried out before Gala was incorporated.

(2) If these sums are to be regarded as incurred by Gala (on the basis that Invicta acted on its behalf in engaging and paying the relevant parties), they were paid to those parties for services which were required to facilitate Invicta putting in place and operating the Gala arrangements (on behalf of Gala) for the purpose of enabling the members to obtain the aimed for tax advantages.

(3) In any event, Gala has failed to particularise and evidence to the required standard what "Legals", "Ongoing running costs", and "Inland Revenue reserve/develop" relate to.

Was the expenditure capital in nature?

601. HMRC submitted that all of these sums are capital in nature. Whether expenditure is of a capital nature is a question of law to be determined in the light of all the relevant circumstances of a particular case: *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 ("*Tucker"*) at 804. Various principles emerge from the case law which assist in determining whether a sum is of a capital nature:

(1) A payment made to secure an enduring asset or advantage is of a capital nature: *Atherton v British Insulated and Helsby Cables Ltd* [1926] AC 205, 213-214; *IRC v John Lewis Properties* [2003] Ch 513 ("*John Lewis*") at [80].

(2) Expenditure on a capital asset to make that asset more advantageous is similarly capital in nature (see *Tucker*).

(3) A payment of a single lump sum is more indicative of capital expenditure whereas a series of recurring payments made at frequent intervals is more indicative of revenue expenditure (see *John Lewis* at [86]). The value of the asset acquired through the expenditure is a relevant factor (see *John Lewis* at [81].

602. HMRC also referred to *Acornwood*, where the tribunal said this in relation to the payment of 80 under consideration in that case:

> "277. The payment in these cases of a large part of what was described as an exploitation fee was one-off, and it secured for the partnership, and through it the members, a secured income stream followed by a capital payment which, in substance even if not in strict form, amounted to reimbursement of the payment. In our view it is quite clear that what was acquired was an asset of a capital nature, and the jurisprudence indicates equally clearly that the payment made in return for it too was of a capital nature.
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> 278. Our conclusion on this issue, therefore, is that in each case so much of the payment to the principal exploitation company made by each appellant partnership as matched the amount borrowed was the consideration for the acquisition of a capital asset, namely a guaranteed income stream."

603. In our view and, as HMRC submitted:

(1) Similarly to the situation in *Acornwood*, the Initial Expenditure and Interest Margin were one-off payments which ensured, for Gala and its members, a secured income stream followed by a capital payment which, in substance, amounted to reimbursement of those sums.

(2) The Invicta Fees were a one-off payment made by Gala from members' contributions, in effect, in return for Invicta putting together all that was required to set up the structure for presentation to investors as a package. A one-off fee paid in return for such a package is capital in nature (see the tribunal's decision in *Acornwood* at [295], [315], [317], [318], where it was held that the fee payable to IML immediately was payment for a package). Moreover, Invicta's work, and so the Invicta Fee, was incidental to the acquisition by Gala of capital assets, namely, the right to receive the Minimum Sums.

(3) All of the items of expenditure referred to in the "breakdown" above are capital in nature, as one-off payments made for the purposes of setting up the structure. The only exception to this are the unparticularised "ongoing running costs" but even if they are revenue in nature, they are not deductible in 2003/04 for the reasons given below.

(4) The SG fees are incidental to the SG loans, as fees paid to obtain those loans, which are themselves capital in nature, and are part of the costs of those borrowings. Such expenditure is typically capital in nature (see *Ben-Odeco Ltd v Powlson* [1978] 1 WLR 1093).

604. Mr Vallat said that (1) HMRC's stance is essentially based on the premise that the presence of a tax saving aspect is sufficient to infect and denature the expenditure incurred by Gala in the course of its trade, but (2) that is not correct as the tax saving element of the Gala opportunity was a "hook" to entice members to join in the initial stages of Gala, rather than the sole purpose for the transactions that Gala entered into. We have already set out why we do not accept this factual proposition in Parts B and C.

Was the relevant expenditure incurred by 5 April 2004?

605. Finally, HMRC submitted that, if the Initial Expenditure/Interest Margin and the Invicta Fees are deductible in computing the profits of a trade conducted by Invicta, Gala has not demonstrated that, on the balance of probabilities, they were incurred in the 2003/04 tax year and so are deductible in computing its profits for that year.

606. Mr Yusef was questioned on these issues and gave responses consistent with his comments on this in his second witness statement. It was put to him that (1) he had agreed earlier that "the ongoing running costs" referred to in his breakdown of costs included matters going beyond 5 April 2004, and, (2) this plus the facts that no further fees were paid to Invicta after February 2004, Gala remained in existence for a time, and the Call Option was not exercised until 2006, means that the Invicta Fees were partly a prepayment for future services to be performed after 5 April 2004. He said the fees were a prepayment for services that were contemplated by both parties at the time as it was clear that there would be ongoing work and that is what the figure in his breakdown reflected.

607. He did not accept that the Initial Expenditure was not in its entirety expended on Gala Expenses prior to 5 April 2004. It was put to him that Gala has not provided any evidence from Sony as regards what they did with the monies and the documents do not show when particular amounts were spent by Sony and it is inconceivable that the entirety of £102 million was spent by 5 April 2004. He said:

(1) This issue came up for consideration at the audit stage and there are "thousands and thousands" of documents seen addressed to Gala relating to

distribution expenditure, which HMRC have seen. There were (a) payment orders or requests that were dated on a certain day and an invoice for the relevant services, which would either predate or postdate that event, (b) invoices that post-dated 5th April in respect of services that were rendered pre-5th April and the opposite, and (c) invoices where the invoice is pre-5th April but the payment order is post 5th April.

(2) In all cases the expenditure had to be incurred before the theatrical release of each of the transaction films. It makes no sense to incur it after the release, because the function of the expenditure is to promote the film.

(3) He thought the expenditure was incurred in every instance prior to 5 April, and noted that all the transaction films except one were released before then. In the case of that one film, he remembers distinctly sitting in Moores Rowland's offices with Mr Bamford discussing this very point, and the conclusion was that all of that expenditure was incurred prior to 5 April 2004.

(4) The bulk of the invoices or payment orders pre-date 5 April as a matter of fact. The invoices that are not in the bundles were all made available to HMRC during the enquiry stage. A lot of the work of the agencies who booked the media spots (such as the TV advertising), would have been reserved and put to use so that the invoices could be rendered within that time period. So "it's totally, totally conceivable", that is what happened and it is a verifiable fact, which HMRC had the opportunity to independently observe. He said about 9 inspectors come to Invicta's offices at different times to look into this. The first assumed that there would be 1 invoice from Sony to Gala for £102 million. Invicta explained to him that there were boxes and boxes of invoices all issued to Gala. He organised to come back when Invicta had brought the documents out of storage and a conference room was set aside and "the aggregate of the documents you have here today would be a small fraction of the invoice boxes that we made available". He looked at them and took copies of the ones that he wanted to and the other 8 inspectors had the same opportunity:

> "HMRC had copies or had available to them the thousands of documentary evidence to show the invoices were either dated before 5th April, and to the extent that they were not, there were payment orders in relation to those services that are mentioned or referred to in the post-5th April documentation invoices. The payment orders relate to the services and those payment orders predate 5th April…HMRC had 9 different opportunities to square this point off and it is simply not correct to say that Invicta has provided no evidence. The evidence is there in thousands."

(5) The auditors, Moores Rowland, looked at the invoices issued after 5 April 2004 and ended up being satisfied that they were for services that were rendered with agencies that booked the Gala expenditure before that date and:

> "…it is inconceivable that a significant portion of the expenditure would occur after the release date. It is just not the way the film industry works. The objective is to put, as they say in America, bums on seats. So the bulk of it would be spent prior to the release of the picture, and although the date on the invoice may not always reflect that, the reality in the industry, the commercial logic, is that the bulk of that expenditure would be spent prior to the 5th".

(6) Any expenditure incurred after the release date is what is called "pick up expenditure" but it would not be a material amount. So he was confident that invoices dated after 5 April 2004 would relate to expenditure that necessarily would have been incurred before 5 April 2004 in relation to 5 of the 6 films as would the bulk of the expenditure in relation to the sixth film (around 90%),

which he thought was released in May 2004. As regards the sixth film, he thought that it is possible that up to 10% of expenditure would be "pickup" expenditure to deal with aspects of the post-release. He thought that given that 5 of the 6 films were released well prior to the end date the expenditure logically must have been incurred prior to that date and, in relation to the sixth film, the amount of expenditure that was not incurred prior to 5 April 2004 would be relatively small.

608. HMRC said that (1) Gala's case seems to be that the Initial Expenditure was incurred on Gala Expenses once Sony withdrew money from the expenditure account. Mr Yusef was unable to deal with the possibility that the sums might not have been expended within 2003/04. There is no reliable evidence to discharge the burden of proving that this money was so expended and HMRC put Gala to proof on this in their Statement of Case, and (2) the evidence establishes that at least part of the Invicta Fees was an upfront payment for services to be performed in future years.

609. Mr Vallat said that (1) the hearing was the first time that HMRC sought to put Gala to proof on this, (2) in any event, Mr Yusef's evidence and the documentary evidence suffices (a) to show that, on the balance of probabilities, Gala incurred all relevant sums before 5 April 2004 and it would be disproportionate to require Gala to do more in respect of individual invoices, particularly given that HMRC has not raised any specific concerns and has been provided with access to all of the invoices during the 11 year enquiry period, or (b) at least, to make a prima facie case such that the burden of proof passes back to HMRC to show what items are of concern, and (3) HMRC's accounting expert positively asserted that all the expenditure was incurred before 5 April 2004 (see Part F). HMRC responded that (a) their point on proof was made some 4 years before the hearing date, and (b) in any event, on its face, it is inconceivable that the entirety of the expenditure claimed to have been incurred by Gala on approved Gala Expenses was, in fact, incurred by the end of the 2003/04 tax year.

610. Plainly the tribunal cannot take account of invoices which Gala stated it has provided to HMRC during the enquiry period if they are not in the bundles provided to the tribunal;the tribunal must judge all issues in these proceedings only by reference to the materials which the parties have put in evidence before it. However, we accept that on Mr Yusef's evidence, on the balance of probabilities it is likely that all of the sums of Initial Expenditure which were used to meet Gala Expenses relating to the 5 transaction films which were released in the 2003/04 tax year and 90% of that relating to the transaction film released after the end of that year, were incurred on those expenses in the 2003/04 tax year (a) given that the relevant expenses by their nature related to the marketing and distribution of the films prior to their release, (b) Gala's auditors signed off on the figure for "cost of sales" shown in the accounts, and (c) the incurring of the Initial Expenditure in the 2003/04 tax year was absolutely essential to the success of this structure. Gala has not established that all or any part of the sum described as "on-going costs" was incurred in the 2003/04 tax year.

Part E – Referral

Loss relief

611. As set out in section 2 of Part A, the questions are, on the assumption that Gala was carrying on a trade in 2003/04, whether that trade was carried on, throughout that period, (1) "on a commercial basis" and (2) (a) "with a view to the realisation of profits in the trade" or "so as to afford a reasonable expectation of profit" for the purposes of ss 380 and 381 ICTA, or (b) "in such a way that profits in the trade could reasonably be expected to be realised in that period or within a reasonable time thereafter" for the purposes of s 381 ICTA.

With a view to the realisation of profits test

612. The parties were agreed that the "with a view to the realisation of profits" test is subjective, and that if it is found that the similar test in s 118ZA ICTA is not satisfied, it follows that this test also is not satisfied. Given our findings on this point in Part C, we conclude that this test is not met.

"Commercial basis" and "reasonable expectation of profit" tests

613. Gala said that if, as must be assumed at this stage of the analysis, the tribunal has found that Gala was trading with a view to profit, there is nothing in the legislation or caselaw to suggest that the "commerciality" test is not also satisfied. Mr Vallat said that whether assessed under a subjective or objective test, the members contributed capital to Gala in anticipation of a commercial return and made the following points as regards the evidence:

> (1) Gala carried out a significant number of activities in the course of its trade and made assessments of risk and reward such that it was carried out on a commercial basis and in a business-like way with a view to profit. For example, following receipt of the 2003 HL letter, the members had much discussion at the meetings in relation to the slate's profitability which satisfied them as to the terms of the agreements with the studio. By that time, the members were relying on months of investigation and discussion with Mr Yusef on Gala's approach and strategy. The members received much documentation, including the film files, which Mr Cadogan said he approved before the meeting. He also said that he spent hours going through the waterfall in the DA.
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> (2) The basis for the members' belief in Gala's profitability was the principals involved, the films chosen and that Gala had a team of people in Los Angeles who were experts in the field. Mr Mallett said that he had carried out research into the Spiderman and Terminator films and their predecessors which had made £1.4 billion, and on that basis, wanted to be involved in Gala. Mr Summers' evidence was that he regarded the HL letters as the opinion of a highly respected investment bank, what Gala was doing was sensible and that Sony was actively engaged in the process.
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> (3) The evidence from Mr Cadogan and Mr Mallett was they did not expect the Call Option to be exercised at any particular time. The Smith & Williamson letter to which Mr Mallet was referred should be viewed in context as a letter of due diligence that was not written by him.

614. HMRC said that the case law establishes that it does not necessarily follow that if the trading test is satisfied, the "commercial basis" test is also satisfied. They referred to the following passage from *Wannell v Rothwell* [1996] STC 450 at page 461, which is often quoted as the starting point or seminal text in relation to what this test requires:

> "…it was suggested that the best guide is to view commercial as the antithesis of uncommercial and I do find that a useful approach. A trade may be conducted in an uncommercial way even because the terms of trade are uncommercial (for instance the hobby market-gardening enterprise where the prices of fruit and vegetables do not realistically reflect the overheads and the variable costs of the enterprise) or where because the way in which the trade is conducted is uncommercial in other respects (for instance, the hobby art gallery or antique shop where the opening hours are unpredictable and depends simply on the owner's convenience). *The distinction is between the serious trader who whatever his shortcomings and skill, experience or capital, is seriously interested in profit, and the amateur or dilettante*." (Emphasis added.)

615. HMRC explained that this was expanded upon in *Seven Individuals v Revenue and Customs Commissioners* [2017] STC 874 (which dealt with the appeal against the member-level aspects of the *Acornwood* matters). In summary in that case:

(1) At [40], the UT rejected the argument that the "commercial basis" test is not concerned with profits at all:

> "As a matter of ordinary language to run a trade or business on a commercial basis suggests running the trade or business in a way that is at any rate designed to succeed as a commercial venture, that is, one which is worth doing from a financial point of view. It is true that this means that there is an inevitable overlap between the commercial limb and profits limb, but the alternative would be to empty the commerciality limb of any connection with profit or profitability when that's a central part of what would normally be understood by reference to acting commercially"

(2) Having referred to *Wannell v Rothwell*, the UT referred to the UT's decision in *Samarkand Film Partnership No.3 and anor v HMRC [2015] STC 2135* ("*Samarkand UT*") where, at [96]:

(a) The UT agreed with the tribunal's comment on the passage from *Wannell v Rothwell* (at 253) that: "It seems to us that the serious interest in a profit is at the root of commerciality".

(b) The UT said that whilst "commercial" and "with a view to profit" are 2 different tests, that does not mean that profit is irrelevant when considering whether a trade is being carried on "on a commercial basis" and the tribunal were right:

> "in regarding 'profit' in the context of commerciality as a real commercial profit, taking account of the value of money over time, and not simply an excess of income over receipts...[and] to conclude that the trade that involved transactions that were intended to produce a loss in net present value terms, with no compensating collateral benefits, was not conducted on a commercial basis. No-one who was seriously interested in running a business or trade on commercial lines would pay £10 for an income stream with a net present value of £7 unless there was some good reason to do so. Of course, in this case the reason why the partnerships were willing to do this was because they believed that tax relief would be available to the partners."

(3) The UT noted that, in the Court of Appeal's decision in *Samarkand CA*, Henderson LJ rejected the taxpayers challenge to this. At [90], he said that the passage in *Wannell* must be correct but:

> "it shows that considerations of profitability cannot be divorced from an assessment of commerciality of a business. In my judgment it is wrong to regard the profitability and commerciality tests in the legislation as mutually exclusive and they necessarily overlap to an extent which will vary from case to case. I therefore see no error of law in the approach which the FTT adopted to this question, and I agree with the observations of the UT in [96] and [97] of the UT Decision, quoted above"

HMRC pointed out that Henderson LJ added:

> "The availability of loss relief to the individual partners in their personal capacities cannot in my view be a relevant factor in assessing the commerciality of the partnership's business."

As HMRC submitted, it is plain from this that, in assessing the commerciality test, the fact that the Referrers might get tax relief and they might make a return out of that is not relevant.

(4) At [44] the UT, therefore, rejected the submission that the "commercial basis" test is only concerned with whether the way the trade is organised is commercial and has nothing to do with profitability. The UT also rejected, at [46], the taxpayers' differently phrased argument that, whilst whether a person is

interested in making a profit may be relevant to commerciality, how likely it is that profits will arise, is not relevant. The UT agreed that a trader can fail this test in different ways and that is what is said in *Wannell*:

> "So I agree that a trader can fail the commerciality limb either because of a lack of commercial organisation...or because of a lack of any interest in making money...but I do not think it follows that as long as the trade is sufficiently organised and the trader hopes to make a profit...that is always enough…A trade on commercial lines seems to me to be a trade run in the way that commercially minded people run trades. Commercially minded people are those with a serious interest in profits or, to put it another way, those with a serious interest in making a commercial success of the trade. If, therefore, a trade is run in a way in which no-one seriously interested in profits or seriously interested in making a commercial success of the trade would run it, that trade is not being run on commercial lines. That is in effect what we said in the Upper Tribunal in *Samarkand*, which has been endorsed by Lord Justice Henderson in the Court of Appeal. If that is right, it is not I think an answer to point to the hope of the trader that profits will nevertheless be made. In other words, the concept of trade carried on on commercial lines has an objective element to it and cannot be satisfied by proof merely that the trade is well organised and that the trader had a purely subjective hope or desire to make a profit."

(5) The UT noted, at [54], that, in the context of the "with a view to profit" test, in *Ingenious FTT* the tribunal said (at [475]) that "profit" means the excess of income over expenditure as a "cruder, everyday understanding" of profit but the mere fact that there is a realistic possibility of profit in this sense does not entail that a person is carrying on a trade on a commercial basis. The UT gave an example:

> "It may not make commercial sense to carry on a trade even if it is likely to make a profit in the crude everyday sense. A trade which lays out 100 in year one and recovers 101 in year 10 is a trade which makes a profit in the simple sense that its income exceeds its expenditure, yet it is unlikely that anyone with a serious interest in making a commercial success of the trade would regard that as a satisfactory return even if it were virtually certain to happen."

(6) The UT added that, most significantly, all the tribunal decided in *Ingenious* was that there should be some realistic possibility of a profit and whilst this "cuts out the extreme case where there is no realistic possibility of a profit" it "says nothing about how probable or likely such a profit needs to be", but "the likelihood of profit seems" to be "central to an assessment of" the trade's commerciality:

> "The question is whether the trade is being carried on in a way that a person seriously interested in commercial success would carry it on. Such a person would be unlikely to regard a trade which had a remote possibility of a small profit as worth carrying on as a commercial venture even though it could be said that there was a realistic possibility of profit."

(7) At [59], the UT noted that the tribunal decided that this test was not met on the basis of the absence of revenue predictions at the outset, the members' lack of relevant expertise and the fact that a loss in the trade was virtually certain and, at [61], that the taxpayers "accepted that the real finding was the third one". The UT also noted, at [63], that this should be read with the tribunal's earlier comments, at [370], that:

> "No business is certain to succeed and the making of a loss or only modest profit is not necessarily an indication that its proprietor has not pursued the trade on commercial lines. But if, as [HMRC] demonstrated it can be shown that at the moment the business was started the prospect of recovering the

capital invested even without a surplus was dependent on the realisation of an unrealistically high profit with the consequence that loss was, if not certain, then much more probable than not. It does not seem to us that it can fairly be said that those embarking on the trade can have entertained a serious profit motive and their claim to have intended to conduct the trade on commercial lines must at the least be doubtful. The amateur may be content to make a loss, since the pleasure of the activity is reward in itself. *The ordinarily prudent and commercial person would not enter into a partnership whose business was more likely than not to result in a loss*." (Emphasis added.)

(8) The UT commented that it might be possible to quibble with the highlighted sentence taken by itself. They gave an example of a person who invests 100 in a partnership, whose business consisted of a project which was only likely to be a success one-third of the time, but which, if successful, would be likely to return 500. They said that such a business would be more likely than not to result in a loss, as two thirds of the time the 100 would not be recovered, but a prudent commercial person might nevertheless think it worthwhile taking that risk for the one third chance of receiving 500. However, they thought it is difficult to take issue with the proposition that:

> "a person with a serious profit motive would not embark on a trade which was dependent on the realisation of an unrealistically high profit and hence where loss was much more probable than not..."

(9) At [64], the UT noted that the taxpayers said that the tribunal had not taken account of the fact that the LLPs did not transact for the prospect of receiving their percentage of returns from a reasonably successful project but for the "moonshot" possibility of a very successful act which would deliver their percentage of a very large number. The UT commented that the tribunal did not ignore this and referred repeatedly to the fact that only a small proportion of projects of the kind pursued by the Icebreaker partnerships can be expected to make significant profits, although any one project might make very large profits but:

> "The adoption of a limited number, typically fewer than six, of such projects necessarily limits the chances that a project with true potential has been identified. Projections produced later show that in the absence of outstanding success, no partnership could reasonably expect to recover the capital invested...the members of each partnership could have had no genuine expectation on joining that partnership that trading profits would be received."

(10) The UT added, at [66] and [67], that (a) the tribunal was well aware that it was possible that any one or more of the projects could achieve enormous success or very large profits, and that if it had done so, the trade of the relevant LLP would have been profitable and hence a commercial success, but "nevertheless concluded that such success was a rarity and speculative", and (b) it was not suggested that these factual findings were not open to the tribunal. The UT concluded that "once it is accepted that the correct test is whether the trade is being carried on in a way that commercially minded people might I do not see that their conclusion involves any error of law or is not open to them..."

616. As Mr Afzal submitted, the caselaw shows that (1) there are various ways in which a trade can be uncommercial, (2) there is an objective element to the test, (3) the likelihood of the business realising profits is important to the required appraisal, and (4) the fact that a trade is carried on in such a way that losses are virtually certain may be a key reason why that trade is not commercial.

617. Mr Afzal said that Gala did not have a sufficiently serious interest in profit to satisfy this test, because a loss was virtually certain to occur, and Gala's real aim was

to generate the loss and the related tax relief for the members. Essentially, he made the same points as regards the waterfall, the HL letters and the Call Option as HMRC made in relation to the trade and "with a view to profit" issues. He added that (1) much of the other evidence Gala refers to is not relevant to this objective test, as it relates to the members' subjective expectations, and (2) in any event, (a) the Referrers were very clear that their concern was whether they personally would make a return as opposed to whether Gala would do so, and (b) any expectations the members had of profit were fanciful and hollow and not ones that serious investors would hold; that the HL letters were deficient would be obvious to any serious investor genuinely concerned with whether Gala would make a profit. Fundamentally the terms of the waterfall drive the issue of whether Gala was likely to make a profit and not the principals involved or films selected. If an investor is investing large sums it is reasonable to expect him to review the relevant paperwork, and, that the members did not do so, reinforces that the real objective was to make money from the loss/tax relief.

618. Mr Afzal also noted that (1) in *Walls v Livesey* [1995] STC (SCD) 12 it was held, at [5] and [6], that the "view to profit" and "reasonable expectation of profit" tests are not the same: The first is a subjective test and the second is an objective test, and (2) this was approved by Nugee J in *Seven Individuals* at [49]. In HMRC's view, this test is not met essentially for the same reasons as set out above.

619. Mr Vallat responded that (a) both of these tests are focused on the way that the trade is carried on throughout the period, (b) whilst, in principle, there may be cases where a party carries on a trade "with a view to profit" but not commercially, the factors that HMRC rely as regards each of these tests are the same, and (c) Gala relies on the same evidence as it relies on in relation to the trade issue but notes the following further points:

(1) Overall, it is clear that the view of the Referrers when they entered into the transactions was that they/Gala had a reasonable expectation of making a profit. Whilst there was some certainty that the SG loans would be repaid as a result of the shortfall guarantee (which was a perfectly sensible commercial arrangement), (a) there was no cap on the sums which Gala could receive under the waterfall, and (b) the members believed, as the HL letters suggest, that it was possible for Gala and the members to make returns above the Minimum Sums. Mr Yusef believed Gala could and even would be profitable, and that these transactions would only be the starting point.

(2) HMRC sought to create a distinction in cross-examination between the Referrers' and Gala's prospects of making a profit. However, even if the Referrers accept that distinction now, there is no evidence that they had such a technical distinction in mind at the relevant time.

(3) For the reasons already given, it is plain that the members were interested in real commercial profit, not just the loss/tax relief. They knew about tax relief, but that was not the driver. At the time, there were other ways to achieve a pure tax result of that sort, such as under a sale and lease back.

(4) The members plainly put up capital in expectation of a return within a reasonable time-frame, whether the tribunal has regard to a 2 year period for some of the projections, or the term of the DA of 8 years, or the 3 to 4 years that Mr Summers referred to. There is no evidence suggesting that Gala expected a profit, but only after 10 or more years: Gala was aiming and hoping for a profit within that 8 year period or sooner, although obviously it was very far from guaranteed, and, as matters turned out, it did not come to pass.

620. HMRC said that (1) the question is whether profit could reasonably be expected as an objective assessment of how the trade was carried on, and under the test in s 381, if that is the case, within a reasonable time, and (2) that objective test is failed because, for the reasons set out in relation to the commerciality test, losses were virtually certain, and (3) as regards Gala's points, (a) Mr Vallat did not explain why he said there is a reasonable expectation of profit and he looked at matters in an impermissible subjective way by reference to the Referrers' or Mr Yusef's subjective view, (b) in any event, the same points apply as regards the Referrers' evidence as set out above. Moreover, it is notable that when it was put to the Referrers that scenario 3 was of no practical utility to a serious investor, (i) Mr Summers confirmed that he would not have been aware of the level of Gross Receipts required for Gala to make a return and said it was impossible to understand the validity of that scenario, and (ii) Mr Lewis confirmed he did not know what level of Gross Receipts were needed and more generally that, based on the IM, it was not possible to know which revenues Gala would get or how likely it was to generate revenues, and (c) Mr Vallat's view of the relevant period overlooks the fact that it was pre-ordained that the Call Option would be exercised after little over 2 years.

621. In reply Mr Vallat referred to the continuation of the passage in *Walls v Livesey* which HMRC cited, where it is stated that in considering the "reasonable expectation of profit" test:

> "..one has to bear in mind that the statute presupposes that losses could well be suffered for four years before an individual begins trade and, according to the nature of the trade and the economic circumstances, it may be that losses could well be suffered over a longer period of time and, if so, one has to consider whether profits could reasonably be expected to be realised within a reasonable time afterwards, *having regard to the way in which the trade was carried on*." (Emphasis added.)

622. Mr Vallat said that:

(1) This passage "brings one back to the individual concerned, how he set about trading and the reasonableness or otherwise of his plans at the time he took decisions". So this objective test is very much centred on consideration of what the taxpayer did in carrying out his business. It is not just a matter of looking at the profit and loss account or the pricing structure.

(2) *Livesey* is the only authority on this as, in *Seven Individuals*, Nugee J was taken to *Livesey* but did not expressly endorse it. *Seven Individuals* is focused on commerciality and on profit in that context and not on a profit test as some freestanding objective test. There is nothing in that decision that means that a trader can meet this test only if, objectively, there is a realistic possibility of profit. The UT was saying it may be a factor relevant to the commerciality test, in assessing objectively how the business was carried on.

(3) Moreover, HMRC's stance is wrong as it involves viewing profit as requiring a surplus of film receipts over not only distribution expenditure but also related fees and expenditure on the licences. There is no basis for including these sums given that profit means here a surplus of income over revenue expenditure, and (a) the licence fees are plainly capital sums, and (b) HMRC assert the Invicta fees are also capital items. On HMRC's analysis of the figures, either a reputable firm, HL, gave very bad advice (that there was a realistic possibility of profit) or something has gone wrong with the waterfall.

(4) In any event, the required objective assessment is of the conduct of the trade and everything about the trade was commercial and was aimed at what everyone understood to be a profit at the time. At the time, everyone was doing things directed to making a profit including engaging one of the best qualified firms to

advise on the possibility of Gala making a profit. The fact that some 20 years later HMRC assert there is a problem with the arithmetic does not affect the analysis; the focus is on the way in which, assessed objectively, the trade was conducted. It cannot be the intention of Parliament, as is the effect of HMRC's argument, to punish those who would otherwise be regarded as carrying on a commercial trade and who subjectively intend to make a profit and otherwise meet all the requirements, simply because there was an unnoticed mistake in their pricing model. The objective assessment requires the tribunal to look at the way in which the trade is carried on, looking in *Walls v Livesey* terms at the actions of the relevant individuals, and not to apply some freestanding test of the pricing model.

Conclusion

623. In our view, it is plain from all the factors highlighted in Part C that, during the 2003/04 tax year, Gala's activities were not carried on "on a commercial basis" and/or "so as to afford a reasonable expectation of profit" and/or "in such a way that profits in the trade could reasonably be expected to be realised in that period or within a reasonable time thereafter" as those tests has been interpreted in the caselaw set out above.

(1) As Mr Vallat appeared to accept, for the purposes of all of these tests, it is essential to examine how the relevant activity was actually carried on. We have made that assessment in Parts B and C and, it is determinative of the "reasonable expectation of profits" tests, that we have found that there was no reasonable expectation of Gala making a profit from any trading activity during any relevant period. On the authority of the decision in *Seven Individuals* this alone may also demonstrate that Gala's activities were not carried on on a commercial basis. However, that this is the case is reinforced by our other findings as summarised in Part C.

(2) We do not accept Mr Vallat's suggestion that the subjective views of Mr Yusef and/or the members on the likelihood of Gala making a profit are relevant to these tests. Mr Vallat seemed to accept that the "commercial basis" test is an objective test. The use of the term "reasonable" in the "reasonable expectation of profits" test plainly indicates that the tribunal is to assess what a hypothetical person, in the actual circumstances of the trader, would reasonably expect and not what the particular trade actually expected. On that basis, many of Mr Vallat's points on the evidence are not relevant and, in any event, we do not accept his view of the evidence he refers to and the conclusions to be drawn from it for the reasons set out in full in Parts B and C.

Interest relief

624. In our view, the members are not entitled under s 353 ICTA to claim relief for interest paid on the SG loans on the basis that a necessary condition for relief to apply is not met. The monies borrowed by the members and contributed to Gala were not "used wholly for the purposes of the trade" as required for relief to apply under s 362(1)(b): (1) For the reasons set out in Part C, Gala did not carry out a trade in the tax year 2003/04, and (2) if contrary to our view, Gala did carry on a trade, as set out in Part D, in any event, the relevant monies were not used wholly and exclusively for the purposes of any such trade. We do not consider it necessary to consider HMRC's alternative argument that relief is prohibited by s 787(1) ICTA.

Part F – Accounting issue

625. The issue is whether Gala's accounts for the 2003/2004 tax year comply with GAAP; in particular, whether the loss has been shown in those accounts and computed in accordance with GAAP. In short, HMRC's primary argument is that (1) the cash

funded by the SG loans was not an asset of Gala for GAAP purposes as Gala did not, in substance, have rights or access to the benefits which flowed from the cash and could not restrict the access of others to those benefits, and (2) it follows that Gala cannot have used the funds to pay for approved Gala Expenses and generate a loss.

626. The tribunal was provided with reports from Mr Luke Steadman and Mr Peter Donhue who both attended the hearing and were cross-examined. Mr Steadman is a partner in Alvarez and Marsal Disputes and Investigations and has over 25 years of experience as a forensic accounting expert. Mr Donhue is an advisory accountant in HMRC's Fraud Investigation Service and advises HMRC on GAAP.

Overview of GAAP

627. The experts were agreed that (1) the key accounting standard of relevance is Financial Reporting Standard ("**FRS**") 5, which is entitled "Reporting the substance of transactions" ("**FRS5**") and FRS5 should be read in conjunction with the Statement of Principles for Financial Reporting ("**the Principles**"). Both of these documents are produced by the Accounting Standards Board, and (3) in order to comply with GAAP, Gala's accounts must show a "true and fair view; this is a "foundational principle" as demonstrated by the introduction to the para 10 and 12 of the introduction Principles which state that:

> "The concept of a true and fair view lies at the heart of financial reporting in the UK…It is the ultimate test for financial statement and, as such, has a powerful, direct effect on accounting practice. No matter how skilled the standard-setters and law-makers are, it is the need to show a true and fair view that puts their requirements in perspective…
>
> It is inherent in the nature of the true and fair view concept that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed."

628. The following provisions in FRS5 are of particular relevance:

(1) The comments included in the introduction that:

(a) FRS5 requires an entity's financial statements to report the substance of the transactions into which it has entered.

(b) FRS5 will mainly affect those more complex transactions whose substance may not be readily apparent from its legal form. The true commercial effect of such transactions may not be expressed by their legal form and, where that is the case, it will not be sufficient to account for them merely by recording that form.

(c) Transactions requiring particularly careful analysis will often include features such as (i) the party that gains the principal benefits generated by an item is not the legal owner of the item, (ii) a transaction is linked with others in such a way that the commercial effect can be understood only by considering the series as a whole, and (iii) an option is included on terms that make its exercise highly likely.

(d) A key step in determining the substance of any transaction is to identify whether it has given rise to new assets and liabilities and whether it has decreased or increased the entity's existing assets or liabilities

(2) Para 1 which states that the objective of FRS5 is:

> "to ensure that the substance of an entity's transactions is reported in its financial statement. The commercial effect of the entity's transactions, and any resulting assets, liabilities, gains or losses, should be faithfully represented in its financial statements."

(3) Paras 2, 3, 4 and 5 which define:

(a) "Assets" as: "Rights or access to other future economic benefits controlled by an entity as a result of past transactions or events".

(b) "Control in the context of an asset" as: "The ability to obtain the future economic benefits relating to an asset and to restrict the access of others to those benefits."

(c) "Liabilities" as: "An entity's obligations to transfer economic benefits as a result of past transactions and events."

(d) "Risk" as: "Uncertainty as to the amount of benefits. The term includes both the potential for gain and risk of loss."

(4) Para 11 which stated that subject to para 12 (which excludes from FRS5 certain listed transactions/events), FRS5 applies to all transactions of a reporting entity whose transactions are intended to give a true and fair view of its financial position on the basis that the term "transaction" includes both:

> "a single transaction or arrangement and also *a group or series of transactions that achieves or is designed to achieve an overall commercial effect*." (Emphasis added.)

(5) Para 14 which described the substance based approach as follows:

> "A reporting entity's financial statements should report the substance of the transaction into which it has entered. In determining the substance of the transaction all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. *A group or series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole*." (Emphasis added.)

We refer to a group or series of transactions that falls within the final sentence of para 14 as "**a group of transactions**". Viewing the highlighted wording in the context of the immediately preceding words in para 14 and in light of para 11, it appears that that wording requires the substance of "a group of transactions" which the reporting entity has entered into, to be determined by viewing it as a whole by reference to its overall commercial effect.

(6) Para 16 which states that:

> "To determine the substance of a transaction it is necessary to identify whether the transaction has given rise to new assets and liabilities for the reporting entity and whether it has changed the entity's existing assets and liabilities."

We take this to mean that, to determine the substance of a transaction, which in light of paras 11 and 14, encompasses both (a) a single transaction or arrangement and (b) "a group of transactions", as viewed as a whole according to its overall commercial effects, it is necessary to identify whether the transaction (in that sense) has given rise to new assets and liabilities for the reporting entity and whether it has changed the entity's existing assets and liabilities (para 16).

(7) Paras 17 to 19 which set out how to identify an asset or liability:

> "17. Evidence that an entity has rights or other access to benefits (and hence an asset) is given if the entity is exposed to the risks inherent in the benefits, taking into account the likelihood of those risks having a commercial effect in practice."
>
> "18. Evidence that an entity has an obligation to transfer benefits (and hence has a liability) is given if there is some circumstance in which the entity is unable to avoid, legally or commercially, an outflow of benefits."
>
> "19. Where a transaction incorporates one or more options, guarantees or conditional provisions, the commercial effect should be assessed in the context

of all the aspects and implications of the transaction, in order to determine what assets and liabilities exist."

(8) Para 20 which sets out when an asset or liability should be recognised in the balance sheet:

"Where a transaction results in an item that meets the definition of an asset or liability, that item should be recognised in the balance sheet, if -

(a) there is sufficient evidence of the existence of the item, including, where appropriate, evidence that a future inflow or outflow of benefit will occur,

(b) and the item can be measured at a monetary amount with sufficient reliability."

(9) Para 29 which states that assets and liabilities should not be offset except in limited circumstances:

"Debit and credit balance should be aggregated into a single net item where and only where they do not constitute separate assets and liabilities, ie, where and only where all of the following conditions are met:

(a) The reporting entity and another party owe each other determinable monetary amounts denominated either in the same currency or in different but freely convertible currencies…

(b) The reporting entity has the ability to insist on a net settlement….

(c) The reporting entity's ability to insist on a net settlement is assured beyond doubt…"

(10) Under a heading "Assessing commercial effect by considering the position of other parties", paras 51 and 52 which state:

"Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some elements of the transaction has been incorrectly assessed.

It follows that in assessing the commercial effect of a transaction, it will be important to consider the position of all of the parties to it, including their apparent expectations and motives for agreeing to its various terms. In particular, where one party to the transaction sees a lender's return but no more (comprising interest on its investment perhaps together with a relatively small fee), this indicates that the substance of the transaction is that of financing. This is because the party that receives a lender's return is not compensated for assuming any significant exposure to loss, other than that associated with the creditworthiness of the other party, nor is the other party compensated for giving up any significant potential for gain."

References in this Part F to paragraphs in GAAP are to be taken as references to paragraphs in FRS5 unless there is a statement to the contrary.

629. As regards his alternative analysis, Mr Donhue relied on Application Note G ("**Note G**") which is appended to FRS5 and "deals with revenue recognition from the supply of goods or service by a seller to its customers and sets out basic principles of revenue recognition which should be applied in all cases" (see G1). This included the following provisions of relevance:

"G3 The following additional definitions apply in [Note G] -

Performance

The fulfilment of the seller's contractual obligations to a customer through the supply of goods and services.

Right to consideration

A seller's right to the amount received or receivable in exchange for its performance. This right does not necessarily correspond to amounts falling due in

accordance with a schedule of stage payments which may be specified in a contractual arrangement. Whilst stage payments will often be timed to coincide with performance, they may not correspond exactly. Stage payments reflect only the agreed timing of payment, whereas a right to consideration arises through the seller's performance."

"G4 A seller recognises revenue under an exchanged transaction with a customer when, and to the extent that, it obtains the right to consideration in exchange for its performance. At the same time it typically recognises a new asset, usually a debtor."

"G7 Revenue should be measured at the fair value of the right to consideration. Subject to paragraphs G8-G9 or other evidence to the contrary, this will normally be the price specified in the contractual arrangements."

"G8 Where the effect of the time value of money is material to reported revenue, the amount of revenue recognised should be the present value of the cash inflows expected to be received from the customer in settlement,…"

"G9 Where at the time revenue is recognised on a transaction there is a significant risk that there will be default on the amount of consideration due and the effect is material to reported revenue, an adjustment to the price specified in the contractual arrangement will be necessary to arrive at the amount of revenue to be recognised."

"G14 Statement of Standard Accounting Practice 9 'Stocks and long-term contracts' (SSAP 9) sets out requirements for accounting and disclosure under a long-term contract. [Note G] provides additional guidance on the recognition of turnover derived from such contracts, but does not amend the requirements of that accounting standard."

"G18 A seller should recognise turnover in respect of its performance under a long-term contract when, and to the extent that, it obtains the right to consideration. This should be derived from an assessment of the fair value of the goods or services provided to its reporting date as a proportion of the total fair value of the contract."

Overview of expert opinions

630. Mr Donhue's view was that Gala's accounts are not GAAP compliant. He said in his reports that FRS5 requires the transactions to be considered together as a whole "given the interdependence of all the agreements, as well as the fact that they were marketed as a package". He also noted, in support of this view that (1) income from the DA was determined across all transaction films, (2) the Call Option related to Gala's whole business, (3) the financing and security arrangements cover and were secured on Gala's whole business, (4) the licence fees and returns from the Rights were not determined by the budgets of the transaction films but solely by reference to the Initial Expenditure, (5) Gala could not acquire the licences without sub-licensing them to a member of the same corporate group as the licensor, and (6) the amount receivable by Gala under the waterfall of up to 60% of the Production Cost was exactly matched by a payable under the LAs which provided for those sums to be made direct by the sub-licensee and absolved Gala of any liability should the sub-licensee default.

631. On the basis of that approach, he concluded in his reports that the SG loans should not be recognised by Gala in its accounts at all and made the following main points:

(1) It is necessary to consider what happened at the time of the initial "group of transactions" and their commercial effect. He set out the "circular" effect of the loan repayment arrangements in similar terms to how HMRC put matters in their submissions. He noted that Sony exercised a substantial degree of control over the funds in the expenditure account under clause 6 of the DA.

(2) He concluded that on the basis of the effect of the transactions as he described them:

(a) in practical terms, (i) the members' cash contributions were applied in paying (A) the licence fees of over £15 million for which Gala acquired the right to a share in the Gross Receipts, and (B) other fees of over £10 million, and (ii) Sony received the licence fees for which it granted Gala the right to share in the Gross Receipts,

(b) the annual Minimum Sums had no commercial effect on Gala - they simply met the interest obligations on the SG loans,

(c) the members' only real return on their investment would be any excess Gross Receipts due under the waterfall, over and above the Minimum Sums, or the excess of market value above the Minimum Amount, if and when the Call Option was exercised.

(3) On that basis, the flow of the purported expenditure of an amount equal to the principal of the SG loans was "pre-determined" in that Gala was never under any obligation to incur this expenditure without also being certain of receiving the same amount back. There was no possibility of a gain or a loss; there was no element of risk for Gala in respect of the use of the monies provided by SG to Gala and the members. As such, the SG loans had no commercial effect on Gala or its members; the flow of funds was entirely circular. Therefore, there is nothing to recognise in Gala's accounts in respect of these funds (no asset, liability, gain or loss) and members' capital should also be reduced by a sum equal to the SG loans made to them:

> "in my opinion no loans should be reflected in any form in Gala's financial statements, as the cash flows in and out are predetermined and equal and opposite, with no overall commercial impact on Gala and its members"

(4) It follows that (a) the sum spent on approved Gala Expenses was made by Sony: (i) Sony put a sum equal to that on Deposit and (ii) the Initial Expenditure in the expenditure account was under its control and disbursed on Gala Expenses on its films, (b) the exchange loss shown in the accounts arose on the account from which the Initial Expenditure was paid and logically any currency risk belonged to Sony, (c) the "costs of sales" shown in Gala's accounts should be nil, as the Initial Expenditure on approved Gala Expenses was paid for by Sony for its own benefit, and (d) the professional fees were incurred mainly as part of the cost of acquisition of the Rights with possibly a small element for administrative expenses so far as they covered the day to day running of Gala.

(5) If, contrary to HMRC's stance, there was a genuine possibility of Gala receiving sums from Sony in addition to the Minimum Sums, whether under the waterfall and/or the Call Option:

(a) Gala acquired the right to a share in the income derived from the distribution of the transaction films and, unless and until the Call Option was exercised by Sony, it would also seem to have further rights once the DA ended, as the rights under the original LAs appear greater than those returned to Sony in the DA.

(b) This meets the criteria in paras 17 and 20 (i) to be an "asset", the purchase price paid by Gala being a sufficiently reliable measurement, (ii) which should be recognised in Gala's balance sheet at the time of acquisition together with the related costs and expenses, as expenses incidental to the acquisition of the asset.

(c) This asset should be recognised as a fixed financial asset, as the commercial effect of the various agreements is that Gala acquired a contractual right to receive cash from another entity. FRS 10 defines intangible assets as "Non-financial fixed assets that do not have physical substance but are identifiable and controlled by the entity through custody or legal rights" and FRS 13 relating to "Derivatives and other financial instruments" defines a "financial asset" to include any asset that is cash or a contractual right to receive cash.

(d) Under the Companies Act 1985 schedule 4.17, subject to any provision for depreciation or diminution in value, the amount to be included in respect of any fixed asset must be its purchase price. He was not in a position to say whether a provision for diminution in value should have been included.

(6) If there was no genuine possibility of Gala receiving such sums from Sony, Gala would have had no access to benefits and so there would not be an asset to recognise in its accounts:

(a) This would only be the case if it was commercially inevitable that Sony would exercise the Call Option on the basis that the market value could never exceed the Minimum Amount so that Sony would re-acquire the residual rights for effectively nil consideration and the SG loans would be cleared by the release of the Deposit.

(b) In that case, having regard to paras 51 and 52, (a) the commercial effect would be that the members would have paid over £25 million to obtain tax relief of over £44 million, Sony would have received over £15 million for agreeing to enter into the transactions and presumably share limited information and Invicta, Chiltern and the banks would have shared the balance of over £10 million for their part in the arrangements, and (b) the accounts would recognise members' capital of over £25 million and an equal expense and loss of that sum as a payment in anticipation of tax relief.

(c) Based on the IM, the commerciality of this would only be maintained for members if Sony exercised the Call Option so that the members would, as set out in the IM be taxed at a lower rate (as in scenario 2) giving them an overall 42% positive tax return.

(7) He had not attached relevance to the E&Y letter rather his reports are based on his own detailed review of the agreements.

632. In his reports, Mr Steadman initially principally focused on particular transactions arising under the LA and DA, and only considered "the wider implications" of FRS5 at the end of his analysis. He found that Gala's accounts were compliant with GAAP as follows:

> "i) Gala has correctly recorded, as an intangible asset, its distribution Rights over the Films; those Rights were purchased from funds provided to Gala by SG, by way of a loan;
>
> ii) The SG Loan represents a liability (as that term is defined in UK GAAP) of Gala since Gala had an unavoidable obligation to make payments of interest and capital to SG under the loan agreement;
>
> iii) Gala incurred expenditure in the course of its operations – this included expenditure on prints and advertising, pursuant to the [DA]. Such expenditure represents a sacrifice of resources in one period (a loss) to obtain an economic benefit in that, or a subsequent period (again). Gains and losses may be excluded from the profit and loss account only if they are specifically permitted or required to be under an applicable accounting standard, or in the absence of such standard, by law. Expenditure on prints and advertising would not qualify for

"capitalisation" on the balance sheet, save as relating to a prepayment or an accrual, and therefore is correctly recognised by Gala in its financial statements as an expense.

iv) Gala's incurred expenditure was, in practice, funded from members' contributions. Members' contributions were in the form of capital (i.e. equity contributions) because, once in the hands of Gala, a Member could not oblige Gala to return that contribution. The financial statements correctly record members' contributions within Members' Interests.

v) Amounts received by Gala from members' contributions are therefore assets of Gala. That Members' contributions were funded, in part, by loans taken out by those Members does not, in my analysis, change anything. Such financial arrangements relating to Members' capital, in particular, where a Partnership such as Gala has offered security over its assets in respect of personal loans of its Members, is covered by contemporary (and current) accounting guidance. Thus, the means by which the Members funded their capital contributions (whether by own resources, a bank loan, or otherwise) does not affect the accounting for Members' capital, which was appropriately treated as equity. Similarly, the fact that the LLP may have agreed to remit funds from Members' interests to SG, to repay the loans and interest does not impact on the accounting for the initial contribution."

633. Mr Steadman added in his reports that, in his view, (1) as Gala had (a) the unavoidable obligation to transfer economic benefits, and (b) control of the rights or other access to future economic benefits in respect of its SG loans, those loans and the intangible assets purchased from them are correctly recorded as liabilities and assets of Gala respectively, and (2) as the SG loans to members were used to fund their contributions in the form of equity, Gala had control of these funds (as well as of the funds from the cash contributions) and the rights or other access to economic benefits from the deployment of that cash and was correct to recognise the cash and the use of the cash.

634. Mr Donhue said in his reports that if, contrary to his view, the commercial effect is to be determined by considering each agreement separately, as Mr Steadman did, Gala's accounts are still not compliant with GAAP:

(1) On the assumption that all expenditure on approved Gala Expenses was for services performed in the period and, if they were considered to be Gala's expenses, it would be appropriate to include them in the accounts, subject to the proviso that some of the invoices are dated after 5 April 2004 which suggests that some expenditure might fall to be recognised in the following period.

(2) Under G4 of Note G the accounts should contain income and a debtor for the present value of the expected cash flows because (a) the only conditions required for Gala to obtain the right to secure the Minimum Sums seem to be to take out the SG loans and deposit certain sums in the expenditure account, (b) those conditions were apparently satisfied by 5 April 2004, and (c) there do not seem to be any further performance obligations on Gala's part.

(3) As the "royalties" are set exactly to cover the interest on the SG loans and the Minimum Amount represents the final repayment of the principal, it would be reasonable to conclude that "the present value of the cash inflows expected to be received" which must be recognised as revenue under G8 of Note G is equal to the principal amount of the SG loans of over £102 million. Since funds had been deposited by Sony to secure the LC there was no risk of default.

(4) This appears to be the appropriate treatment whether or not the funds were disbursed on distribution costs in 2003/04. As Gala's performance obligation seems to be merely to deposit funds in the expenditure accounts in order to qualify

for the Minimum Sums and that took place prior to 5 April 2004, this income would be recognised in the period then ended, even if some of the expenditure met from those funds might be recognised in a later period. The income figure might be higher if the present value of the cash inflows expected to be received under the waterfall were greater than the Minimum Sums. However, it appears from later accounts that no such income accrued.

(5) On this approach, the cash contributions would be recognised as liabilities of Gala rather than as capital because commercially Gala controlled all aspects of the loans: (a) the members never received any monies - it went direct to Gala, (b) Gala was responsible for drawing down the funds, disbursing amounts, collecting the Minimum Sums, and settling interest and capital due, (c) the loans, by way of calculation of the Minimum Sums, determined amounts due to Gala, and (d) the members were never at any risk of default - repayment was secured by the LC issued to Gala. Even if these sums are treated as liabilities of the members, they should not have been disclosed as part of the members' equity but as "loans and other debts due to members – members' interests that are debts of the LLP" since Gala was contractually bound to repay these amounts.

Evidence of Mr Steadman – overall approach

635. In his second report Mr Steadman said that Mr Donhue's interpretation of FRS5 is not valid under GAAP on the basis that (1) the impact of FRS5 is that transactions cannot be ignored, (2) that one transaction may be connected with another does not preclude the individual determination of whether each transaction gives rise to new, or changes in existing, assets or liabilities; FRS5 requires each transaction to be separately considered, and (3) Mr Donhue's analysis ignores the entity basis of reporting and fails to recognise the rights and obligations that exist/fall due on Gala specifically, as a result of the transactions.

636. It was put to Mr Steadman that his approach, of starting with 2 particular matters (the LA and DA) "puts the cart before the horse"; the process required by and purpose of FRS5 is to identify as the end point what "the transaction" is, as defined in para 11 to include "a group of transactions":

(1) He said, in effect, that (a) reading para 11 in context, a transaction is defined for the purposes of FRS5 in terms of whether, in substance, it gives rise to assets or liabilities, (b) FRS5 was introduced to deal with the specific issue of "off balance sheet finance", but its application is to all transactions, and (c) one is required (i) to start with identifying the event or transaction entered into by the reporting entity (para 11), (ii) then to consider the substance of that transaction (para 14), by assessing whether the transaction has given rise to assets and liabilities (or changes in them) (para 16), and, in doing so, to consider the commercial effect of the transaction, the context and all the aspects and implications (para 19), and (iii) if the conclusion is that the transaction does not give rise to any assets or liabilities (or changes in them), not to account for any assets or liabilities.

(2) When pressed, he emphasised that (1) FRS5 follows the transactional basis of accounting as he had described it, and (2) in carrying out the required exercise, one does not account for "a group of transactions" as a single transaction. Rather:

> "You take each point and you decide if there are assets and liabilities that arise from each step of that. That is a fundamental principle of accounting. You do not offset asset and liabilities and/or collapse transactions. You account for each individual transaction, but in doing so, in looking at the substance, it is important to consider not just the transactions of the entity, but transactions that impact on that as part of this overall commercial effect."

(3) He said that it is absolutely correct that, notwithstanding that there is "a group of transactions", one subsequently unpicks them to try to deal with the individual elements of the group and:

> "If you have a series of transactions, you consider them as a whole for the purposes of identifying the assets and liabilities caused by the transactions…you do not aggregate transactions that give rise to different assets or different liabilities. You do not offset assets and liabilities. So if A borrows from B for the purposes of lending to C, there are two transactions to account for there and you would consider the assets and liabilities depending on the overall commercial effect, but you would not necessarily offset any of those assets and liabilities unless very specific requirements apply…and in the context of doing so you would consider that overall commercial effect as to whether it gives rise to assets and liabilities, but you don't collapse transactions. The transactional basis of accounting doesn't do that…a reporting entity's financial statements should report the transactions in which it has entered into. So that means that you effectively account for each individual transaction...That's what we call the transactional basis of accounting."

(4) He added that FRS5 does not change the transactional basis of accounting as he had described it. It says that, in order to account for the substance of transactions:

> "you might need to look at in the case of complex transactions the overall commercial effect and the question of whether assets and liabilities have arisen as a result of those transactions, but you don't collapse all the transactions down to a single sort of consolidated matter…That is because… paragraph 29 won't allow us to offset assets and liabilities…"

637. He agreed that, in assessing whether a set of arrangements are designed to achieve an overall commercial effect, one is not straitjacketed into ignoring a link in the chain, a particular arrangement or element, which the reporting entity itself is not a party to. He added that:

(1) The judgment that matters is that of the preparers of the financial statements, but they are not "straitjacketed" in the context of understanding the commercial effect, as distinct from accounting for the transactions - they only have to look at the transactions that the entity is involved in and consider the series of linked transaction as part of the commercial arrangement which that transaction is a part of in order to understand the substance of it.

(2) FRS5 looks at the difference between the economic substance of a transaction or "a group of transactions" and their legal form and if the substance is commercially different to the legal form, one accounts for the commercial substance to the extent required under FRS5. The key is to identify the assets and the liabilities and to do that one needs to look at commercial effect.

638. He acknowledged that it follows from the guidance in paras 51 and 52 that, in assessing the commercial effect of a transaction, it is important to consider the position of all of the parties to it, including their apparent expectations and motives for agreeing to its various terms. He added that "you are looking at it from the perspective of the preparers of the accounts here. It is their judgment and their knowledge."

639. He did not comment at all on the LC and Deposit in his first report but in the second said that (a) the LC provides security to Gala if SPR did not fulfil its obligations under the DA but such security, which, in effect, lowers the risk of default, goes to the measurement of assets and liabilities and not their existence, and (b) if an entity's performance under a contract is guaranteed by a third party, the entity's obligation remains regardless of whether the guarantor may perform the obligation if the entity

does not and the credit risk vis a vis the entity and the guarantor will likely be different. When asked why he had not referred to this in his first report, he said:

(1) The way in which a transaction is financed and the security attaching to that finance is not relevant to this analysis. As a matter of fundamental principle: "We account for the liabilities as a whole and we account for the assets as a whole…What we don't do is offset…" The LC is part of security arrangements which are not relevant to whether or not there is an asset that arises from Gala's acquisition of Rights. One does not account for security arrangements but for the assets and liabilities. Whether the Rights are secured or not does not change their nature as assets or liabilities. The Deposit might be relevant to the value of the assets or liabilities in terms of recoverability, but not fundamentally to the transactions themselves, because it is part of the security:

> "They could be relevant on the question of valuation in the same way that a bank has collateral for a loan. It doesn't put that collateral on its balance sheet. The loan is on its balance sheet up until the point that the bank calls on the collateral and then it puts the collateral on the balance sheet and takes the loan off. So from an accounting perspective pretty much as a general principle the security arrangements are not accounted for. They are sort of separate. So the fact there's [a LC]….a fixed and floating charge and all of those sort of legal and security arrangements, they are not part of the accounting."

In summary, therefore, you take into account all aspects of "a group of transactions" and you look at the commercial effect on the parties but you do not take into account the security framework of transactions.

(2) It was put to him that his view is at odds with para 19. He emphasised the same points as made above and said security is not relevant unless "of course it is evident that the security is where the real value is". So as regards the example of a bank obviously if the underlying loan was not worth anything, then one would look to the collateral. When pressed he said:

> "Where a transaction incorporates a whole gamut of different things you have to take into account those things and the commercial implications and…what the likelihood of exercise or calling on those guarantees or options would be…That will lead you to determining what assets and liabilities exist…the general principle is you don't account for the general security arrangements that support a transaction. You account for the transaction."

He added that para 19 is saying something slightly different, namely, that "if the transaction incorporates a whole gamut of things, then you need to consider those…Subject to exceptions depending on the commercial reality…".

640. He did not agree that assessing primarily 2 transactions is the wrong approach because it necessarily pre-judges the matter. He said it is the correct starting point "because those are the transactions of the entity" and, for example, "we don't account for the [LC], because the [LC] is not a transaction of Gala" albeit that in deciding how to account for Gala's transactions, the LC, the security arrangements and the option may be relevant. An entity can only account for the transactions into which it has entered. If those transactions, because of other transactions, give rise to different assets and liabilities from their legal form, then there is a possibility that you need to account for them, but there is no accounting for a LC here, because the LC is not a transaction of Gala.

641. In re-examination, Mr Steadman explained the general position as regards a bank loans and collateral: (1) a loan is an asset of the bank which appears in its balance sheet as the amount that the bank expects to receive, (2) if there is a doubt about the ability of the debtor to pay the sum owed, a downward adjustment may be required but if there

is security, such as collateral or letter of credit, those concerns may be allayed, (3) whilst the bank does not account for any collateral unless there is a default, in deciding how to measure the recoverable value of the loan, it will have in mind that it has collateral of a particular value, (4) on default, the bank may cease to recognise the loan and may recognise the value of the collateral once it has taken control of it.

642. In some of his comments Mr Steadman appeared to suggest that, (1) as a matter of principle, the only permitted approach under FRS5 is for the substance of each individual transaction a reporting entity enters into, as identified by its legal form, to be assessed individually albeit that his view is that, whether and to what extent it gives rise to new or, changes in existing, assets/liabilities, is to be assessed by reference to the wider context, including the other elements of "a group of transactions", and (b) a failure to carry out such an element by element analysis necessarily involves the impermissible setting-off of assets and liabilities. That (if it is what he meant) conflicts with Mr Donhue's approach and we cannot see that his view is justified according to the plain terms of FRS5:

(1) In paras 11, 14 and 16, FRS5 plainly envisages that an assessment of the substance of a set of arrangements, which can properly be viewed as "a group of transactions", is to be made by determining whether and to what extent the reporting entity's assets and liabilities arise or are changed under those arrangements, viewing them as a whole, according to their overall commercial effect.

(2) Depending on the circumstances, such an assessment could involve one or more particular elements of the overall arrangements being ignored, for example, if it has no commercial effect. That is simply a consequence of making the required assessment by reference to the overall effect of "a group of transactions" viewed as a whole which does not engage para 29.

Evidence of Mr Steadman - Accounting for the Rights and the SG loans

643. In his reports, Mr Steadman said that:

(1) Gala recognised the Rights as an intangible asset in its 2004 accounts and the total licence fees paid by Gala agrees to the historical cost of the intangible asset (before depreciation) recognised in the accounts. On the basis that the purchase was an arm's length transaction, the Rights had a fair value on acquisition of around £15.1 million.

(2) In determining whether Gala's approach is consistent with GAAP, under FRS5 (see paras 17 and 20) one needs to consider: (a) identifiability of the intangible asset, (b) likelihood of flow of economic benefits - the flow must be virtually certain for an asset to be recognised, as otherwise there is a contingent asset only (see paras 32 and 33 FRS12), and (c) the value at which Gala recorded the asset.

(3) The Rights were identifiable as an asset on the basis that they gave Gala the potential to earn economic benefits through their exploitation and the amount Gala could earn was, to an extent, dependent on the success of the films. Gala intended to earn a profit from the Rights, which had a historic cost of 15.1 million through (a) the Minimum Sums, and (b) the waterfall. Gala also had some certainty about its level of income given the existence of the shortfall guarantee. This is supported by the fact that HL opined that there was a reasonable expectation of profit and Mr Ackerman said the films had excellent prospects of commercial success.

(4) Having regard to paras 19, 50, 61 and 62 (which relate to options) and based on Mr Yusef's evidence in his witness statement, the Call Option does not appear

to represent a commitment by (or obligation of) SPE to repurchase the Rights. There was no clear commercial need on SPE's part to repurchase them nor was the exercise price sufficiently attractive that it was certain it would exercise. Hence, it was appropriate under GAAP for Gala to recognise the LAs as an intangible asset in its accounts as though the Call Option would not be exercised.

(5) In determining whether Gala was correct under GAAP to account for its SG loans as liabilities it is necessary to consider essentially the same factors as set out in (1) (see paras 18 and 20). This was correct on the basis that (a) once funds were remitted to Gala, Gala had an obligation to make payments of interest and capital to SG under the loan agreements, (b) the obligations and restrictions placed on Gala under those agreements and the fact that the Minimum Sums were to be assigned to SG for it to use to repay the loans provides evidence that Gala had a liability and that an outflow of economic benefits would occur in respect of the loans, (c) as the amount of the loan was known, the liability was capable of reliable measurement, and (d) the liabilities were appropriately categorised as long-term because the balance was due for repayment after more than 1 year.

Recognising the Rights as an asset – relationship between the LAs and DA

644. Mr Steadman explained that, in order to recognise an asset at a particular value, there has to be a likelihood of economic benefits, which requires assessing what the entity does with the asset. He said that:

(1) Gala exploited the Rights under the DA, and the LAs and DA are "linked" in that the LAs "anticipate" the DA. His statement later in his report that the LAs and the DA "are separate transactions in terms of their economic substance" is correct. They are separate in that the LAs concern the acquisition of Rights and the DA concerns the exploitation of those Rights. However, for the purposes of measuring the asset that arises under the LAs, it is relevant to look at the substance of the transaction, namely, that the contractual matrix provides for exploitation of the Rights under the DA. So they are distinct but linked. That does not make them one transaction. They must still be considered separately as well, because the assets and liabilities that arise under the LAs are different from those that arise under the DA albeit that, in deciding how to identify and measure those assets and liabilities, one takes into account the economic substance and that the agreements are linked. They have to be accounted for separately even though they are part of a contractual framework, because FRS5 requires consideration of the assets and liabilities that arise in each case. Therefore:

> "we need to do it once for the [DA] and once for the [LAs]. We don't do it in sort of one… go…We don't offset assets and liabilities. We don't combine assets and liabilities. We simply look at assets and liabilities under that transaction…"

(2) In other words, to ascertain economic substance one has to look at the LAs and DA together but, for accounting purposes, there is not 1 transaction with 1 composite economic substance. There are 2 transactions that share "a common matrix or a common economic substance or a common contractual substance" and "we need to account for the transactions under one and the transactions under the other."

Recognising the Rights as an asset – assessment of "economic benefit"

645. It was put to him that Gala had complete certainty that sums sufficient to repay the SG loans/Initial Expenditure (and interest thereon) would come back to it. He said that:

(1) In his comment that Gala had "some certainty" he was referring to the timing of when the funds are paid; as the shortfall guarantee comes into play at the end of the 7-year period, there is certainty as to that sum but not as to the timing or pattern of receipts or the cashflows. There is "some certainty" as to levels but what happens in the intervening period depends on the success or otherwise of the films and ultimately, the final Minimum Amount, would be reduced by the amounts that were paid in the interim (as provided for in the DA). From an accounting perspective there is certainty in the long run, subject to credit risk and all of that.

(2) He agreed that the fact that Gala would receive the Minimum Sums means that over the 7 years it would receive back every penny. He noted, however, that accounting is done annually and "we have no idea" in 2003/04 "as to what the pattern of cashflows will be over and above the [Minimum Sums] at all..". The "royalties" are only part of the income and if there is a successful film, there might be a large amount received in year 2 which would reduce the Minimum Amount in year 7. So whilst Gala knows it will get the "royalties" and that there is a Minimum Amount, which it will receive as the shortfall guarantee, in 2003/2004 it did not know what the pattern of cashflows would be at all.

(3) He agreed that £102 million would necessarily come back to Gala because of the shortfall guarantee.

646. It was put to him that (a) in forming his view on the likelihood of expected economic benefits from exploitation of the films, he relied on the HL letters and Mr Ackerman's letters, (b) the HL letters are not meaningful and reliable (for the reasons put to Mr Yusef) and Mr Ackerman's letters do not deal with the films resulting in a flow of economic benefits into Gala, and (c) those letters do not form a basis for his view and, whether Gala would receive an economic benefit depends on the terms of the waterfall which he did not take into account:

(1) He agreed he relied on the HL letters but said that all he took from them is that a reputable firm considered that there was a reasonable expectation of profit and that suffices for his purposes. He stressed that the flow of economic benefits is not tested as an overall measure of profit but in terms of revenue. Given HL is a reputable firm their expectation of profit is sufficient for him to be satisfied on this and he takes comfort that a reputable firm issued this opinion. He added that "if there's a cash inflow, that is an economic benefit. It doesn't have to exceed a previous cash out flow" and HL's opinion suggests that there is a likelihood of such a flow. If HL thought there was a profit, it follows there must be an inflow of economic benefit; a profit is a net position which measures the difference between an outflow and an inflow and what is left is the profit or loss.

(2) He viewed the HL letters as reliable, because they are from a reputable firm of advisers who his firm compete with and he would not expect HL to give an opinion without doing some work behind it. He thought it reasonable to take their opinion at face value. He said, however, that it is a fair enough point that their letter is entirely out of kilter with the facts given it does not refer only to the transaction films. He said he did not read them in that way before and he had not appreciated that there was some conditionality. He did not know when HL did the underlying work of course.

(3) That Mr Ackerman said in his letters that the films have excellent chances of commercial success which would generate box office receipts means that there would be economic benefits under the DA. He seemed reluctant to accept that whether such success would translate into anything for Gala depended on the

terms of the waterfall. When this was put to him, he noted that all Mr Ackerman was saying was that the films had a good chance of commercial success and accepted that there is a separate question of whether that would have any consequence for Gala but added that:

> "all of the money from commercial exploitation flows through the waterfall after the cinema cut. Everything else flows through the waterfall. So it is of consequence to the LLP, depending on…the construction of the waterfall."

(4) When pressed, he acknowledged again that there is a separate question about the terms of the waterfall, but noted "we are not talking about profit here" or Gala's overall position but about "cash or economic resource flowing through the waterfall" and "there's no money that doesn't flow through the waterfall" and Mr Ackerman was looking at prospects of commercial success and "that translates to a flow under the waterfall".

(5) He did not agree that the HL letters and Mr Ackerman's letters do not support his view and the basis for his view is illusory. He said that, as clearly anticipated by these letters, the transaction films would have a theatrical release, and that would generate income at the box office that flows through the waterfall. In accounting terms, that means there is a flow of economic benefit or the receipt of an economic resource by Gala. He again seemed to accept that whether Gala actually received any economic benefit depends on the terms of the waterfall but said that the issue is: "is there a flow - expected flow of benefits from these films into the LLP, into the waterfall". When pressed, he said that one must not look at a profit or loss position and, if there are economic benefits that flow to Gala, Gala may be obliged to account for them even if 100% is then paid out to Sony.

(6) He was asked if it would surprise him to hear that $1 billion of Gross Receipts would need to come through the waterfall for Gala to get a penny. He queried whether counsel meant an overall profit and said that care must be taken in accounting not to offset assets and liabilities and what flows ultimately to members of an LLP is not necessarily the economic benefits received by the LLP or paid by the LLP to others.

(7) It was put to him that given the thinness of Mr Ackerman's and the HL letters it is not possible to say that it is "virtually certain" that there was going to be an inflow of economic benefits under the waterfall. He reiterated that economic benefits flow into the waterfall as a result of box office receipts and, provided the films are released, those receipts will flow. Whilst there is this "separate point" as to the operation of the waterfall, for the purpose of this test:

> "the only test is whether there will be an inflow of economic resources into the waterfall.you can't recognise an asset on the basis of possible. It has to be something more than possible."

(8) When it was put to him that there was no certainty that there would be an economic benefit flowing into Gala on the basis of the release of the films. He said "you need to talk about and define what you mean by economic benefit to the LLP" and there is certainty that if the films are released, somebody would go and see them and there would be some level of box office receipts which would enter the waterfall and certainly there will be income coming into the waterfall:

> "I don't see how you can say there's no possibility that the LLP won't receive economic benefits. I agree with you on profit but on economic benefits there is cash coming into the waterfall."

(9) He seemed to agree eventually without qualification that the success of the films does not determine whether an economic benefit will flow into Gala, and said that he was talking about allocation under the waterfall which starts off, with

a distribution fee taken by SPR and then the balance going to Gala and then being allocated in various different ways.

647. In re-examination it was put to him that HL refer indirectly to the waterfall as they refer to the term sheet which included reference to the waterfall. He thought this meant they had clearly, as part of their opinion, reviewed the terms of the waterfall. He added that HL are a reputable firm who have issued an opinion and it is reasonable to presume they have done some work to support that opinion, but he had not seen the work that they did.

648. He was asked why he did not seem to consider that these arrangements fall within para 52. He said it is important to take into account all of the circumstances and (1) it appears to him that income was to be generated through box office sales which needs to be accounted for, and (2) this is not a straightforward financing transaction at all, because the mechanism for the revenue generation is the exploitation of the films. He takes the point that, if the benefit of all that exploitation all goes to Sony under the waterfall, then you are only left with the "royalties", but he did not think that is the case.

649. It was put to him that Gala should have recognised in the relevant accounts that Gala had an entitlement to the Minimum Sums as their receipt was certain. He said that the "royalties" arise and are accounted for on an annual basis; one accounts for the transaction in the year in which it arises and does not recognise the whole of the annual royalties on day 1, because they are "earned" over the period of the agreement under the "accruals basis of accounting". So whilst, there is certainty that, subject to a small credit risk, Gala will receive the annual "royalties", that is not sufficient to then account for them upfront because "income is earned over the lifetime of a contract. You don't recognise it all upfront unless you are Enron or something like that." Mr Steadman was questioned on this topic repeatedly. He was consistent in his response that the Minimum Sums or Minimum Amount should not be reflected in the accounts as an asset/income but, in our view, did not give a satisfactory explanation of why that is the case, in particular, in light of the terms of Note G.

650. He was questioned on the value at which to record the Rights as an asset. He was referred to para 51 and it was put to him that no bank would lend £100 million to an entity which only has assets of around £15 million only in the form of the Rights; that lacks commercial logic. He said that (1) from SG's perspective there is adequate security on their loan, and (2) there is a disconnect between (a) the accounting position, which requires valuation by reference to virtually certain income due to the concept of prudence, and (b) the position that a bank might take in deciding whether or not to make a loan. The accounting valuation is not strictly or necessarily relevant to the bank's valuation of its lending and security.

651. He said that he relied on the Minimum Sums as meaning that the Rights, as an asset, is not impaired; it has a recoverable amount equal or greater than the asset. He agreed that the Minimum Sums underpin the Rights. It was put to him that the Minimum Sums amount to £102 million and not just £15.1 million and that mismatch indicates that something has gone awry in the analysis. He noted that: "Gala was required to pay the licensor from the exploitation of the rights amounts up to 60% of the production cost of each film, less the licence fee…", so the licence fee was only part of the consideration paid for the Rights and that may explain the mismatch.

652. He was referred to para 12 of the Principles and it was put to him that a reader of Gala's accounts would have a reasonable expectation to know about Gala's right to receive £102 million regardless of film performance. He said that "may well be" the case, but "the question is whether that needs to be accounted for" and that has nothing to do with the valuation of the £15 million and:

(1) The existence of the guarantee or Minimum Sums may be a matter for disclosure, but it is not necessarily a matter for accounting. One does not recognise a future or a contingent asset but does recognise a potential liability and "that mismatch is what we call the concept of prudence".

(2) Gala had no obligation to account for the £102 million receivable because it was "earned" over the life of the contract; it is a backstop that comes in at the end if insufficient monies have been earned through the operation of the business. He had not considered whether it should be disclosed as that was not part of his instructions but that is a "possibility".

653. Mr Steadman was asked a number of questions about the disclosure point he had raised:

(1) He accepted that if there is a material item that should have been disclosed in the accounts, the accounts would not be "true and fair". He said, however, in effect, that he had not considered whether the shortfall guarantee should have been disclosed and, if so, whether the omission is material, as he did not view that as part of what he was instructed to consider.

(2) He did not seem to accept that, if the shortfall guarantee should have been disclosed, the accounts do not show a true and fair view. He said there is a question of materiality and this is a complex question. When asked if he meant that a right to receive £102 million is immaterial, he said he was not making a determination one way or another but it is a significant sum and is likely to be material on a quantitative basis.

(3) He was taken to the Principles headed "The qualitative characteristics of financial information" which state that:

> "Information provided by financial statements needs to be relevant and reliable…Information is relevant if it has the ability to influence the economic decisions of users…..Information is material to the financial statements if its misstatement or omission might reasonably be expected to influence economic decisions of users."

He seemed to agree that information on the shortfall guarantee is "relevant" and "material" for this purpose. He said that (a) there was no right in respect of the shortfall guarantee that existed, which was to be accounted for when the accounts were drawn up, albeit it may well be relevant to a user of them to know about it, (b) the fact that the right to it was granted within the 2003/04 tax year does not necessarily make it an asset that arises in that year, (c) Gala was granted the right to exploit the film income throughout a period, and (i) one accounts for that when the income arises in each tax year during the period, depending on the performance of the films, and (ii) at the end, there is a Minimum Amount referable to the difference between the initial amount and the amount of those receipts.

(4) He agreed that the right to the shortfall guarantee could be material but said he had not looked specifically at that issue. He had considered notes to the financial statements insofar as they apply to breakdown certain assets and liabilities and income and expenditure and had not considered the adequacy of disclosure or of the accounting policies notes.

(5) He was referred to the Principle that: "Whether information is material will depend on the size and nature of the item in question, judging it on the circumstances of the case…". It was put to him, in effect, that the Minimum Amount is material given its size and that its nature is a benefit to Gala which it received by virtue of the LC on day 1. He said this is not an "exchange

transaction" whereby Gala exchanges something in return for an LC. Rather Gala entered into LAs and a DA whereby the exploitation of the films would generate revenue for Gala over a number of years. On that basis:

> "Since the Minimum Amount is unknown, and is in the future, there is no obligation to account for it; it is not a receivable that…comes into being on day 1 but an amount that will be payable contingent on what has happened in the 7 years between, but there will always be a minimum amount of income earned over that period…revenue arises when it is earned. Revenue arises either over the life of the contract or it is incurred as it is earned over the contract from the exploitation of the films. So there is no obligation to account for that sum as a receivable as at the accounts date. It would be material if there is an obligation to account for it, but there is no obligation to account for it…there may well be an obligation to disclose it, but that doesn't change the opinion that I have given as related to the accounting."

(6) It was put to him that it must be material for a reader of the accounts to know about the right to receive back £102 million; there is nothing contingent about it given it was a necessary pre-condition to Gala having to do anything under the DA that it received the LC. He said that (a) the issue is whether the Minimum Amount to be accounted for and not the LC as such (as that simply guarantees the obligation of Sony as regards those sums). The right to that sum may well be relevant to a user of the accounts, but it is not something that needs to be accounted for, (c) if the financial statements do not contain a disclosure that is required under GAAP, then they do not comply with GAAP, but that does not necessarily change either the financial position, the cashflows or the profit/loss as reported. It is:

> "what we call in accounting terms a disclosure issue. I am not belittling it or saying it is less important but it is a disclosure issue as opposed to a misstatement issue. There is no obligation to account for the 102 million in the balance sheet of Gala in 2004".

654. He agreed that for a set of financial statements to be complete they must contain notes and if the notes do not contain something that is required under GAAP, then they are not compliant with GAAP.

655. When questioned further about whether Gala should have accounted for the shortfall guarantee up front given that Gala was "guaranteed" to receive it, Mr Steadman said:

(1) He viewed the LC as a sort of a fall back that comes into play if the primary obligation under the DA is not made. He accepted that, if the circumstances specified in the LC arise, Gala has an entitlement to the sums referred to in it but said that those sums are primarily or initially obligations on SPR under the DA whereas the LC simply guarantees those obligations by Barclays.

(2) When it was put to him that the Minimum Sums are bound to come back (whether under the DA or LC) and should be accounted for in year 1, he again said that this is not accounted for on an "exchange basis" and:

> "This is not an exchange…that takes place on a particular date where I exchange something, consideration for an asset that pays up over X period of time…It…involves Gala entering into a transaction whereby its income over the next X number of years arises because of the Box Office performance of the films and there's a Minimum Amount that will make Gala whole…at the end of 7 years. It is not an exchange of a right to receive sum A, sum B, sum C, sum D, sum E, because those sums are dependent on the performance of the films at the Box Office, because those amounts come off the minimum guarantee".

(3) He agreed that Gala was guaranteed to receive the Minimum Amount plus interest which necessarily comes back, whether under the DA or LC, even if not a single ticket is sold.

(4) It was put to him that it does not make sense to talk of an outflow of economic benefit for Gala which ignores Gala's right to receive back sums equal to principal of and interest due on the SG loans, in light of (a) how the loan repayment works, (b) it was a pre-condition to Gala's obligations under the DA taking effect that Gala received the LC, (c) Mr Yusef referred to the LC as a key term of the transaction and as critical and a foundation stone, and (d) the need under FRS5 to focus on substance and overall commercial effect. He said that (i) there was a legal obligation on Gala to repay the relevant sums so its SG loan has to be accounted for, (ii) if there is an inflow and an outflow, one has to account for them both separately; one does not offset assets and liabilities, (iii) Gala was legally liable for the SG loan and there was an outflow of economic benefits required to settle it, (iv) even if there was an equal and opposite receipt they are separate. That is a fundamental point of accounting. There are exceptions in para 29 where an asset can be off-set against a liability but that does not apply here. So if there is an outflow of resources, however those resources are financed (whether from a different loan, equity or profits), that is accounted for separately, even if it is part of a framework of transactions because the definition of a liability is something where there is a legal, constructive or commercial obligation.

(5) He said that the point is that there is no asset of £102 million to reflect in the balance sheet as an asset does not arise at the point of the contract. Rather:

> "It arises either over the life of the contract or it arises in the difference in…the shortfall guarantee, because the primary way that assets arise is through the exploitation under the [DA]…So….before the minimum royalty is paid, it becomes an asset and then it's paid and the asset is replaced by cash…So you don't recognise the minimum royalty until the minimum royalty has been…earned in year 2, year 3, year 4, year 5. So you will have a mismatch potentially of assets and liabilities, but that's accounting."

(6) He added that a liability under a loan is recognised upfront even if it is payable over time. There is an imbalance between the recognition of an asset and of a liability due to the fundamental concept of prudence:

> "You recognise a loan. You do not recognise an asset necessarily on the same basis. So the right…to income in the future is not an asset now. The obligation to make payments in the future is a liability now but may be categorised as a current liability or non-current liability."

(7) It was put to him that the concept of prudence applies where there is uncertainty but here there is no uncertainty as regards the receipt of the Minimum Sums. He said that if there is complete certainty, then you would not apply prudence. He was taken to para 38 FRS18 which states: "However, it is not necessary to exercise prudence where there is no uncertainty….". He said that is called conservatism and you are not allowed to do it.

Evidence of Mr Steadman - Income and expenses

656. Mr Steadman was questioned on the section of his report dealing with "Gala's income and expenses" where:

(1) He referred to para 13 of FRS3, which explains that all gains and losses earned by an entity should be shown in the profit and loss account, subject only to limited exceptions and to Note G. He said that following Note G and taking account of Gala's stated business purpose (that its principal activity was the acquisition and exploitation of distribution rights), (a) it was appropriate for Gala

to recognise the income associated with the distribution of the films as turnover in the accounts, and (b) that is consistent with the recognition of the Rights as an intangible asset as the income represents economic benefits flowing to Gala in respect of the Rights.

(2) As regards the Initial Expenditure, he referred to Mr Ackerman's comments in his witness statement where he explained (a) that he reviewed the Plans which included the Gala Expenses and the invoices for the actual expenditure and compared them to the Plans, and (b) how films are distributed and how the Plans would be revised, and that part of his role was to review and agree revisions to the Plans. He noted that under para 13 of FRS3 Gala was required to recognise expenses incurred in generating its turnover, the various breakdowns of expenditure he had seen are consistent with accounting for the costs as incurred in respect of distribution activities, and the approved Gala Expenses were incurred in generating the turnover earned from the exploitation of the Rights. In his view, had Gala recognised the turnover without the associated expenses, the accounts would not have complied with GAAP.

657. He accepted that the profit share under the waterfall was ultimately in the ratio 334:1. He said that Gala earned income under the waterfall from day 1 really because it was to receive sums under "the recoupment phase", which under the LA it then had to pay over to the licensor. It was put to him that is not correct given that the proviso to the waterfall enabled SPR to retain the funds. He said that he understood that but from an accounting perspective the income is still "earned" under the waterfall. The fact that it is withheld by SPR does not change whether the income is "earned" or not. He was questioned on this further as set out below.

658. It was put to him that his analysis does not reflect the whole story because the Initial Expenditure was matched by the same amount (plus interest) coming back to Gala and it does not give a true and fair view not to recognise that. He said that:

(1) Whenever there is an outflow of cash one has to consider whether that involves incurring an expense (something that reduces the relevant ownership interest) or the creation of an asset (something that makes no difference to ownership). So if a person spends £100 buying an asset worth £100, his net assets before and after the transaction are unchanged; he just has an asset instead of cash.

(2) Gala expended money with third parties and there is no sense that it purchased an asset and, as the expenditure is a necessary component of the right to exploit the films, the revenue that Gala will earn under the contract needs to be matched with the expenses that Gala will incur with it, but there is a mismatch of timing so that the revenue is earned over future years and the costs are expended on that. There is an open question as to whether one should recognise an asset and:

> "I think the nature of these costs, being expenditure with third party, does not lend itself to qualifying them as an asset…So the question here is the expenses are incurred in 2003/2004 and the income is earned over the life of the contract up to 2011. So income is earned over a future period. Expenses are incurred in a current period. The nature of those expenses does not lend themselves to being capitalised because there's no asset that comes with it. So I think the accounting is entirely permissible in recognising the expense and income in the future years…the right to the income arises in subsequent years."

659. He agreed that Gala's right to the receipt of the Minimum Amount existed on day 1 and Gala had no obligations under the DA until and unless it received the LC but said that (1) from an accounting perspective, the income arises in subsequent years, either

through the "royalties", the success or otherwise of the films under the waterfall or from the Minimum Amount, and (2) Gala did not need to recognise in the accounts income that had not been "earned" at that point; the income is "earned" in subsequent years. It may well be relevant to a user of the accounts to know that there is a minimum guarantee, but there is no obligation to account for it until that "guarantee arises, itself dependent on the intervening period and the amounts payable or receivable".

660. It was put to him that Gala did not need to do anything further to "earn" the Minimum Sums after day 1 when it transferred the Initial Expenditure to the expenditure account. He said:

(1) He was not entirely certain but thought that is right, because the costs are expended at the beginning of the films' cycle and, once the expenditure was incurred, Gala did not have to do anything else "because the films will perform as the films will perform and the Minimum Amount will become payable depending on what has happened in the interim".

(2) He accepted that the Minimum Amount is received whatever happens with the transaction films but said that "the actual timing and the actual amounts in the intervening period may depend on the success of the films". He agreed that it is guaranteed regardless of what happens at the box office, it always comes back and there is nothing after day 1 for Gala do to ensure that it comes back.

(3) The Minimum Sums should be accounted for over the period between 2003/2004 and 2011 when the minimum guarantee is triggered. He again referred to this as not being an "exchange transaction in return for an asset in future years". It is a transaction that gives rise to rights under a DA that runs over multiple years.

661. It was put to him that if Gala had fulfilled all of its "performance" obligations within year 1 then it should account for the income it has a right to receive (the Minimum Sums) at that point. He seemed to accept that Gala had fulfilled all such obligations but maintained that it did not have to account for the Minimum Sums, again, because the income is "earned" over the life of the DA. He said that:

(1) "Performance" obligations are not relevant at this point. Gala's obligations under the contract were to pay the money into the expenditure account and for Gala to expend that money with third parties. After that is complete, the films are released and the monies will flow and there are no further obligations that Gala needs to do but:

> "the income is earned over the lifetime of the contract…There's no obligation to recognise…those sums until they are earned. There is a question as to whether the cost should somehow be spread over the life of the contract as an asset…."

(2) In an "exchange transaction" where something is exchanged at a point in time counsel's point is right, but here the income is "earned" over the period of the DA. He gave a general, non-specific example. He said that if you have the right to receive income over the next 5 years from something that is "earned" over those 5 years, accounting does not require one to recognise all the income in year 1; it is "earned" over the period of the contract. It may well be relevant, and maybe could have been disclosed in the notes to the accounts, but it does not change the accounting for the assets and liabilities as at the balance sheet date, "because to do so is to recognise a future profit you are not entitled to".

662. It was put to Mr Steadman that Note G requires Gala to account for the Minimum Sums, as Gala obtained the right to those sums in exchange for its "performance" on day 1 when it paid the Initial Expenditure into the expenditure account. He suggested that Note G is not in point because, as he had said a number of times, this is not an

exchange transaction; it applies in the context of an exchange transaction where "I buy something, I sell something, I exchange a sum of money in return for something else" but this is not that situation. He asserted again that here revenue is:

> "earned over a number of future periods and arises or may arise at different points along the way. The revenue and the corresponding asset are recognised as they arise…I recognise those at the point that they are earned and they become assets at that point…."

663. It was put to him that Note G sets out basic principles of revenue recognition which should be applied *in all cases*, and it is plain from Note G, therefore, that, on his "disaggregated" analysis, one needs to recognise an asset/income in respect of the Minimum Sums. He again maintained that the relevant income was not "earned" in year 1:

> "You need to recognise an asset when the asset arises. The asset arises when the income is earned and that income is earned at a future point in time. An annual royalty for year 2 is earned in year 2 and you recognise the asset and the income in year 2. It doesn't matter about the performance obligations, because they are earned over the lifetime of the contract…I didn't say when the money comes in, important point. When the money is earned and that earning takes place over the life of the contract. It is not saying it is when the cash arises. It is when it is earned. So if there is a royalty at the end for year 1 and year 2 and year 3 and year 4, that income is earned in year 1, in year 2, in year 3 and in year 4. It's not all recognised upfront."

664. He was referred to G4 in Note G which refers to staged payments. He seemed to agree that Gala had "performed" all its relevant obligations in year 1 for the purposes of Note G but maintained that "the right is still earned over the lifetime of the contract" and one would not recognise "future income at the immediate period". In his view, G4 refers to the narrow issue found in construction contracts under which there may be staged payments throughout and the accounting does not follow the timing of the staged payments; the income is spread out over the life of the contract. When pressed on the point that as "performance" had occurred in this case, Note G requires the Minimum Sums to be accounted for, he said:

> "No. It is not. It has to sit there for the next X number of years earning revenue throughout the lifetime of that contract. You don't recognise all of that revenue upfront. It is not paid upfront. Even if it was paid upfront, you wouldn't recognise that revenue upfront. That revenue would be recognised over the lifetime of the contract…There is time. Gala sits there for the next 7 years and in year 1 revenue arises, year 2, revenue arises, year 3 revenue arises and it recognises that revenue at that point, because its income is earned over the lifetime of the contract…As I understand it, there's nothing else that Gala needs to do except wait and earn revenue over the lifetime of the contract."

665. He accepted, therefore, that Gala had "performed" its obligations in year 1 but still maintained that Gala had not at that point "earned" the Minimum Sums because Gala had to sit and wait for the revenue to arise. When pressed again, he said in effect that (1) notwithstanding "performance" one does not recognise "all of the income of a multi-year contract upfront, because it's earned over the period of the contract", and (2) while Note G is of general application, it "is written in the sense of the sale of goods or the provision of services" and does not deal with "a multi-year contract" and one does not recognise future income until that income has been earned. When it was put to him that Note G does not say that it does not apply to multi-year contracts, he suggested that is the case because it applies to "an exchange of goods or services in return for consideration" and noted that long-term contractual performance is dealt with under a different standard (SSAP 9) as is apparent from G14. When it was put to him that he

seemed to mean that Note G is to be read as not applying to an arrangement which lasts for more than 1 year, he said "to an extent that is right" but:

> "it is not that it's more than 12 months. It's that revenue under a contract is earned over the lifetime of that contract. You don't recognise everything upfront. You just don't…the accounting practice and everything else is that revenue arises over the lifetime of the contract, because of the impact of time. If there is an annual royalty for year 3, that arises in year 3 because the contract is 3 years old, it arises and is recognised in year 3. You don't recognise it all at the beginning, because that overstates profit…it recognises things that have not happened yet. It recognises revenue that has not been earned yet."

666. When asked if he meant that that this note only applies to a situation of less than 12 months, he said:

> "In part, yes…Application notices are of general principle. There are other principles that apply to the recognition of revenue over a longer period of time. SSAP 9 is one of them. Leases is another. [Note G] does talk about performance obligations in the context of an exchange transaction. It is applicable as general principles, but it is not determinative, if you like, of how to account for transactions over a long period of time where the revenue arises over a number of years or in different accounting periods…you do not recognise all of the revenue over a multi-year contract in year 1. You just don't. The reason for that maybe is you get to year 2….something is cancelled and you then have to reverse it in some way. As a general principle of accounting you…attribute [income] over the life of a contract. You don't recognise it all upfront...certainly…you shouldn't recognise any revenue in year 1, because none has been earned."

667. He was referred to G18 which requires "a seller to recognise turnover in respect of its performance under a long-term contract when, and to the extent that, it obtains the right to consideration". He maintained one should not recognise any revenue in year 1, because none has been earned:

> "You don't actually know what the fair value of the revenue is going to be in year 1. All you know is that there is a minimum amount that will be earned over the next 7 years or so. So, no, you wouldn't recognise all of that upfront. You would recognise that as it was earned over the contract, but I wouldn't know what number to put into for the first year…You recognise it over the lifetime of the contract as it is earned…the annual royalty arises in year 2, year 3, year 4, year 5 and the correct time to recognise that is year 2, year 3, year 4, year 5."

668. He said that he did not mean that you only earn £x when you receive £x. So in year 2004/05 one would recognise the first year's annual royalty irrespective of when it is actually received; it would form part of the revenue and accrual for that year. He could see an argument that one ought to take a little bit of that royalty into 2003/04, because the contract started in December and February, but the bulk of it will arise in the following year: "You don't get entitlement to twelve months of royalty when there's only one month of a financial year."

669. When asked in re-examination to explain the interaction between long-term contract accounting under SSAP 9 and Note G, he said that FRS5 has general application but where there is a more specific standard, the more specific standard applies. He confirmed that he was not relying on SSAP 9 in any of his views.

670. It was put to Mr Steadman that Gala's right to the Minimum Sums constitute an asset for the purpose of FRS5 and that the right to these sums arose as a result of past transactions or events. He said that:

(1) A royalty is "accrued" when it comes to that point of the process and, as he had already said, it is permissible under GAAP to recognise the income from the exploitation of the films under the DA in accordance with the accruals basis and

"in the context of an accrual…the benefit or the event that arises is through effectively the passage of time".

(2) There are a number of measurement points to take into account. If an entity enters into a transaction that will result in a royalty being earned in years 1, 2, 3 and so on, "then that royalty, under the accruals basis of accounting, is effectively earned each period," and the event that occurs in that analysis is "the passage of time":

> "So you would not recognise all of the future income on day 1, because the income is earned over the period of the agreement…Each individual right arises over the passage of time and that passage of time will be an event in that definition….Event is in the passage of time. Royalties are accounted for on the accruals 3 basis and the accruals basis says that the income arises over a particular period."

(3) FRS5's definition of an asset is consistent with the Principles and with the accruals basis of accounting. The right to future income arises under the transactions that Gala enters into but, as is consistent with FRS5, the recognition of that income as an asset occurs as that income is "earned" or when the income arises. The key point is that the individual assets come into play each time there is an event over that period - which can be the passage of time. This is the accruals concept.

(4) One has to think about what the nature of that asset is and how and when it should be recognised. Clearly, where income arises over a number of accounting periods, the income arising creates an asset at each one of those accounting periods. The accounting policies will inform the preparation of the financial statements as to when that asset is recognised, typically at the end of each period. There is then the separate question as to whether the making of expenditure can give rise to an asset - the nature of these expenses does not lend itself to recognition as an asset.

671. It was put to him that the conditions in para 20 (as regards asset recognition) are met as of day 1 as regards the right to the Minimum Sums. In line with his previous comments, he maintained that an asset was to be recognised only in the year when each "royalty" was paid. He said:

(1) Absolutely, in that, as regards an annual royalty, when you get to the relevant year, an asset arises before the royalty is necessarily paid which is recognised at that point. If, for instance, a dividend is declared it becomes an asset at that point and, when it is collected, the asset is replaced by cash. It is the same principle here. Gala has, as it says in its accounting policy, the income arising from the exploitation of the DA which arises "over the performance of the [DA] over a factor of time. Therefore, income arises at different points. Each time income arises, an asset arises". He emphasised that the principal activities of the business, as defined in the accounts, is the acquisition and exploitation of distribution rights and the income arises through the exploitation of those rights under the DA and the LAs.

(2) It was put to him that the £102 million plus interest is not based on the exploitation of a licence right as it comes back to Gala irrespective of whether the films realise a single penny. He said that the point is that if these films were wildly successful, it would come back quicker. The guaranteed sum is a long stop and when the accounts are signed there is a right of exploitation under the contract to be accounted for and there is a minimum amount. The question is how does one account for the exploitation of the films. If the films were hugely successful, then

the money would come back through a different mechanism; there would be significant income to Gala in the earlier years.

(3) He accepted that if there was a simple exchange, a sum of money for a promise to receive that sum in 7 years' time, counsel's analysis is correct. So, "if you are saying that the substance of this is that Gala handed over some money with a promise that in 7 years' time they would get that exactly back, and there's nothing else to it, then…that is an exchange transaction with everything that is complete at the date. That's not my understanding of the [DA]." He emphasised that, although there is a guarantee that a minimum amount will come back, the timing of what happens in the interim period and the way in which the income is earned by Gala depends on the DA, as the contract under which the rights are exploited.

(4) When counsel raised again the importance of the LC and that the amounts and the dates of payment of the guaranteed sums are specifically set out in the LC, he said counsel confused security with the substantive transaction. The fact that there was a legal need to enter into the LC for the DA to arise does not mean that the LC is accounted for; the requirement is to account for the income that arises under the DA. The LC is a security arrangement that guarantees the obligations of parties under a contract and: "we have to account for the primary transactions that the entity is involved with. So if the security comes into play because of the default, then you would account for it at that point". He accepted that one would account for such sums if the monies come back irrespective of any default but noted the annual accounting is for the results/assets of Gala at particular dates. When it was put to him that timing of the payments is not the key; substance is the key, he said that is right for "an exchange transaction, sale of goods, provision of services".

(5) The financial statements of Gala make it clear that income is to be earned from the exploitation of films and, so, that income is recognised as those films are exploited:

> "There is a minimum amount that comes into play. The timing of that amount is known or those amounts are known. The amount of those amounts are not known, because it does depend on, as I read and understand the [DA]…on the success of the films. You are right to say in the event that no tickets are sold, the minimum amount will apply exactly as it does. Therefore, there is an issue as to whether that right should be disclosed in the financial statements…There is no disclosure of that minimum amount."

(6) He accepted that (a) if, in fact, the DA does not operate as he states, that would be relevant, and (b) if, as counsel put it, on the proper analysis of the contracts the economic inflow is not based on the films and is based on something else, a different conclusion would be needed.

672. It was put to him that the term "earned", which he used repeatedly, is not a criterion that appears in FRS5 or other relevant accounting standards. He said that (1) the Principles talk about matching of revenue and receipts associated with the passage of time but there is no definition of "earned", and (2) the concept of matching over a period is at the heart of accounting. He seemed to agree that timing of a payment is not relevant to when it is accounted for and there can be a complete and extant right to receive a sum prior to its actual receipt. He added, however, that:

> "if I have a right to receive royalty income over a number of years…I may…need no more to do anything, but I would not recognise all of that royalty income in one go…royalties are measured using the accruals basis of accounting…if that right arises over multiple years, you account for it in those multiple years…That's how

accounting works, because to do otherwise I am not reporting the financial performance for a particular accounting year. The accruals basis of accounting is about matching revenues when they arise…"

673. In re-examination he said that, if contrary to his view, the right to the Minimum Sums is to be treated as an asset, the security arrangements are relevant to the measurement of that asset:

> "Like all assets, you would measure it at the estimated recoverable amount, and to the extent that there is security in place that would inform the amount which you would carry it at. If it's covered by [the LC] it means, in essence, the valuation is backed by Barclays rather than Sony. So any relative credit difference between Sony and Barclays you would take account of, but, as I say, fundamentally the income arises and the assets arise through the exploitation of the rights, and then there is this - I described it as a note in the accounts that might be necessary."

Mr Steadman's evidence - Gala's members' interests

674. Mr Steadman essentially said in his report that Gala's recognition of the contributions as equity in the accounts is in accordance with GAAP:

(1) He quoted from a Statement of Recommended Practice ("**SORP**") for accounting by LLPs which was issued by the Consultative Committee of Accountancy Bodies in May 2002 ("**the 2002 SORP**") and from a later SORP which applied to accounting periods ending on or after 30 March 2006 ("**the 2006 SORP**"). In his view, these draw a distinction between members' equity interests and a debt owed to members by the LLP and he noted that the 2006 SORP states that: "a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to deliver cash or another financial asset to another party" (para 32).

(2) He said it is clear from the SORPs that the proper accounting treatment for the contributions depends on whether they meet the definition of a "liability", as that term is defined under FRS5. He noted that (a) under the MA, a member's ability to dispose of his interest in Gala was limited, (b) the circumstances in which a member could expect a return of their initial capital were limited to (i) insufficient contributions being received from subscribers, (ii) expulsion of the member by the LLP, and (iii) winding up of Gala, and (c) Gala's accounts stated that new members were required to subscribe capital at a level agreed with the designated members and no member had the right to make any drawings or withdraw part of their capital without the prior agreement of all other members. He concluded that, on that basis, a member could not oblige Gala to return his contribution and, therefore, the contributions did not meet the definition of "liability" and were properly categorised as equity in Gala's accounts.

(3) He also noted that (a) it was stated in the members' SG loans that the security offered by Gala to SG did not affect the liability of members in respect of their loans, and (b) set out the following guidance in paras 85 to 88 of the 2002 SORP on how to account for circumstances where a partnership has offered security over its assets in respect of loans of its members:

> "**If the LLP has entered into any guarantee or indemnity with respect to the borrowings of a member or members personally, the existence of such a guarantee or indemnity where material should either be disclosed as a note to the accounts (where it is unlikely that the guarantee or indemnity would be called) or provided for in the primary statements where there is an actual constructive liability as defined under FRS12 and it is probable that the guarantee or indemnity will be called.**

It is common practice within partnerships for partners to borrow to fund their capital and similar interests in the firm. Such arrangements may involve the firm entering into guarantees, indemnities or undertakings toward the lender concerned. Broadly similar arrangements may occur with regard to members of LLPs and the LLP itself.

Of itself, the extent to which members' interests have been financed by lenders who have lent funds to the member or members is not a matter for disclosure. Similarly any undertaking that the LLP may give as agent for the member, in remitting funds from members' interests to a lender or other third party, need not be disclosed.

A provision would be required where, for example, an LLP has undertaken to repay a loan of a member, such that the LLP is under a legal or constructive obligation to ensure that the full liability to the lender is settled, and it is more likely than not that the guarantee will be called upon. Where a provision of this nature has been made in relation to a member who is a related party…, further disclosures should be given in accordance with FRS8." (Emphasis in original.)

(4) In FRS 12, constructive and legal obligation are defined as follows:

"An obligation that derives from an entity's actions where, by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and: (b) as a result the entity has created a valid expectation on the part of the other parties that it will discharge those responsibilities".

"An obligation that derives from a contract whether in explicit or implicit terms, legislation or other operation of law."

(5) He concluded that, on the basis of the guidance in the SORPs, the accounting for the contributions as equity is not affected by the means by which the members funded the contributions or by the fact that Gala agreed to remit funds from member' interests to SG to repay the members' SG loans.

(6) He also said that (a) the security which Gala granted SG under the debenture was a contingent liability; Gala had a possible obligation to SG only on the occurrence of an uncertain future event, the default of the member, (b) the fact that there was no disclosure in the accounts presumably indicates that the contemporary view was that the prospect of the security being called on was remote, and (c) the amount shown in the accounts in respect of drawings reflects payments made by Gala in respect of members' loans which is permissible under GAAP. He cited in support of this view para 5 of FRS12 which states:

"A contingent liability is either (i) a possible obligation arising from past events, whose existence will be confirmed only by the occurrence of one or more uncertain future events, not wholly within the entity's control; or (ii) a present obligation which arises from past events, but is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability."

675. It was put to Mr Steadman that Gala plainly had an obligation in relation to the members' SG loans as (1) the agreements provided that (a) SG would use Gala's income (the Minimum Sums) to pay the sums due under the loans, and (b) Gala was required to sign various security documents, and (2) Gala agreed to provide the debenture to SG in consideration of SG agreeing to make available loans to the listed members, and under the debenture covenanted with SG to pay and/or perform: "All present and future obligations and liabilities of the [members] or any of them, to [SG] in respect of any of the [members' loans]." He said:

(1) Gala had an obligation to the members and to SG, to do what it said it was going to do with the Minimum Sums, but it did not borrow from SG. The members borrowed from SG, as is common, to fund partnership capital and the loans are their liability. The SORPs support his view that the mere fact that Gala agreed to remit funds to pay the members' loans does not make Gala liable to SG for them. The SORP provides that it is only when security for members' borrowings is called on, and the LLP becomes liable, that it is accounted for. Similarly, if "the LLP has agreed to remit my taxes to HMRC, they're still my taxes. The fact that my LLP is remitting them on my behalf doesn't make them a liability of the LLP".

(2) For the Minimum Sums to be applied to the members' loans, they have to be allocated or distributed to the members. There is a process for that in the accounts and one must not confuse the cash and the accounting. He did not accept that there is no process as the loan agreements simply state that SG will use the Minimum Sums to pay sums due under the members' loans. He said there absolutely is a process: when Gala received the relevant sums, it debited cash and credited income and when it accounted to SG on behalf of the members, it credited cash and debited distribution or drawings to members.

(3) This situation falls within the para in the 2002 SORP which refers to an LLP acting as agent for a member in remitting funds from members' interest to a lender. Gala did not have a primary obligation under these loans but it certainly agreed to distribute the funds in a particular way, as is entirely normal. That is to be accounted for as an appropriation of profit, not as the discharge of an LLP's liability; there is no such liability as the loans are capital of the members. He agreed that, if the correct legal analysis is that Gala was subject to a primary obligation, then it would be necessary to provide for that in the accounts but said again that is not what he sees here. It is:

> "certainly not within the four walls of the…SORP. Capital of members is capital, regardless of how it is funded. The recipient of capital is not liable…to repay that amount unless there is some default or some obligation that arises…such as that the LLP is under a legal or constructive obligation. I don't see what you have described to me as constructive. I think it is just an appropriation undertaking to remit funds on a particular basis…the only obligation that I can see here is the obligation to remit funds. I don't see how the LLP becomes liable for the whole amount, certainly not as an accounting obligation. If it fails to remit funds…that doesn't make it liable to the bank for the primary amount."

676. He understood that the tribunal will decide on the correct legal analysis. He said that he reads the debenture as a security document; Gala's liability under it would arise only if there was an event of default and it is only at that point that an accounting liability may arise on the LLP. When pressed again to accept that the members' SG loans were a liability of Gala because it was obliged to pay them back, he said:

> "What I see is capital being subscribed by the members. It's accepted that the source of that capital - it says so in the SORP - is not a matter for disclosure. It only becomes a matter if there is an obligation on the LLP to become liable for the principal amount. All I can see is an obligation to remit funds, and if it doesn't remit funds, then there's a consequence that flows that could lead to a liability."

677. He agreed that whether a contribution made by the members to an LLP constituted capital or debt was a matter of construction of the intention of the parties. When pressed again, he said, in effect, that an undertaking in a contract that an LLP

will remit the funds in a particular way is not something that he had observed here or in numerous similar scenarios as making the LLP liable for the principal amounts.

678. It was put to him that this case does not fall within para 5 of FRS 12 as "it was all set in stone what would happen and when". He said that (1) there is uncertainty as regards the occurrence of one or more relevant uncertain future events, namely, whether Gala would default in its payment undertakings under the debenture; that is what would make Gala responsible for the members' SG loans, (2) for the security "to be booked as a provision", it would have to be reasonably certain that Gala would ignore those payment undertakings, (3) his approach here follows from his view that no liability arises until there is a default on security arrangements and that one takes account of whether it is likely that the guarantee will be called - it is not likely, and (4) as the security is not disclosed in the financial statements, presumably the preparers of those statements considered that they were going to comply with the payment undertakings.

679. It was put to him that the accounts state in a note that Gala "is liable to settle the loans on behalf of the members from the royalty income received over the term of the 21 year licence period". He noted that the accounts also state that: "Drawings reflects amounts paid *on behalf of members* in respect of the members' loans". He added, in effect, that, in accounting terms, this "on behalf of" wording means that the LLP has an obligation to the members, and not to the lender and it "puts us in accounting territory firmly and squarely within the capital or ownership interest of the business" and Gala had an obligation to the members and to SG only to remit the funds in a particular way. As an accountant, he did not read the note as having anything to do with the contingent liability that exists under the debenture which arises when there is an event of default as a result of the LLP not paying the relevant amounts on behalf of members or at all. He suggested that the intention in including this note was to indicate that the prospect of the payments not being made was remote.

680. He was taken to paras 18 and 19 and it was put to him that on this footing, the security should plainly be recognised here. He disagreed and made similar comments to those set out above. He agreed that the tribunal will want to consider whether Gala had an obligation to SG to repay the members' loans. HMRC noted that, in any event, their case is the SG loans have no ultimate commercial effect on Gala and should not be recognised in Gala's accounts but if they are to be recognised, HMRC's view is that Mr Steadman's approach is incorrect.

Evidence of Mr Steadman - wider implications of FRS5

681. Mr Steadman was taken to the section of his report where he considered "whether the wider implications of FRS5", specifically of para 11, require his previous conclusions "to be revisited". In this section of the report he considered whether the LA and DA should be considered "a group of transactions". He said that:

(1) There is no doubt that the LA and DA are mutually dependent on each other; neither would have been entered into, or could be effected without the other. The effect of the agreements was that (a) under each LA, Gala paid a licence fee and was obliged to pay a share of Gross Receipts it received under the DA to the licensor, (b) under the DA, Gala contributed to distribution expenses for each film up to an agreed amount and received the Minimum Sums and an agreed share of the Gross Receipts some of which, under the LAs, it was liable to pay to the licensor, (c) Gala had the benefit of a shortfall guarantee which, at a date in 2011, effectively reimbursed Gala for any distribution expenditure incurred that had not been recouped by that date, and (d) the licensor and sub-distributors were connected parties.

(2) A transaction under the agreements can give rise to or change both an asset and a liability. For instance, where Gross Receipts are earned under the DA (creating an asset for Gala) there is, to the level of a certain threshold, a concomitant liability created under the LA, to pay a share of Gross Receipts to the licensor.

(3) The factors referred to above do not change the accounting. As a general principle, transactions between different parties are not combined, nor netted off, except in specific circumstances. While FRS5 talks about transactions that need to be considered together, none of these are applicable to the present circumstances. The circumstances which FRS5 discusses are narrowly defined and limited to items listed in it which he set out.

(4) While the LA and DA are linked, they are nonetheless separate transactions in terms of their economic substance. That the payment under one triggers a liability under the other does not mean that the substance of these transactions should be disregarded as a payment by the distributor to licensor. That would be impermissible under GAAP as it ignores (a) the recognition of the payment as an asset of Gala, and of the cost to, and liability of, Gala, and (b) that Gala could fail to satisfy the obligation to the licensor because of other claims on its assets although the licensor's risk in this respect is protected in the LA. While:

> "I consider that the Agreements are linked, and that they have an overall commercial effect, viewed as a whole the substance of the transactions arising under the Agreements are separate".

Two stage analysis

682. He agreed that FRS5 does not state that there is a two-stage process of (a) a provisional analysis, and (b) then consideration of the wider implications of FRS5. He said that he had considered as a starting point only whether the LA and the DA should be considered "a group of transactions", because the transactions that need to be considered for accounting purposes are those arising under those agreements. He did not accept that FRS5 says that determining what the transactions are is "where you arrive at rather than where you start from" and reiterated his view of how it works.

683. He agreed that FRS5 is of general application and the listed items he referred to are examples only which are not exhaustive and it is not narrowly defined and limited. He said it is important to understand, however, that FRS5 was brought in to address cases where an entity's financing liabilities do not appear on the balance sheet, such as under debt factoring, hire purchase and lease arrangements. FRS5 does not change the nature of transactions that an entity enters into but requires one to have a care to consider whether the transactions are such that accounting for them on their legal form does not give the full picture:

> "FRS5 was dealing with the issue of are the liabilities of an entity properly reflected, and the solution to that was substance. All of the examples on FRS5 are dealing with question of liabilities that do not arise because of their legal form, but nevertheless should be accounted for because of the substance. So that's the point. It's not about redefining transactions. It's about bringing on to the balance sheet liability which prior to that date had been left off, but it is of general application."

684. It was put to him that having listed out those examples, he then uses them as a spring board for the conclusion that: "In the present matter, none of the above apply." He agreed, however, that the items listed are only examples and therefore whether they apply or not is not the point.

Accounting for Minimum Sums

685. It was put to him that his conclusion in [681(3)] makes no sense in light of the points in [681(1)]. He said this comes back to whether the Minimum Sums should be reflected in the accounts as an asset - his view remains that they should not. His understanding is that they are not dependent on the success or otherwise of the films, in the sense that they will always be received, but the timing of the revenue that arises and, in fact, the size of the Minimum Amount would so depend. If these films were wildly successful, then more income would be received towards the start of the contract and there would be a smaller Minimum Amount. If they were unsuccessful, there may have been no additional income at all.

686. He was asked to clarify what he meant in his suggestion here (and elsewhere) that there was a lack of certainty as to the income that Gala would receive and as to the size of the sums:

(1) He said he was referring to the payments that go through the waterfall to Gala, in particular, the sum Gala was to receive, under the fourth provision, of an amount equal to 60% of the Production Cost less total licence fees, which under the LAs it was to pay to the licensors. When counsel suggested he must mean sums due under the sixth provision of the waterfall, he said that, for accounting purposes, sums arising under both of these provisions are receipts of Gala. He agreed that any sums due under the fourth provision go straight back to the licensor and that Gala authorised SPR to pay them directly to the licensor. He said that, however, "we don't account for the cash" and the cash is not relevant to and not determinative of the accounting. So it did not concern him or change the accounting that the payment is made in that way.

(2) It was put to him that there was no uncertainty as regards the receipt of the Minimum Amount because, under the proviso to the waterfall, Gala would retain the relevant sums otherwise due to Gala under these provisions and simply pay the Minimum Amount in due course. He said, in effect, that if those "receipts" arose under those provisions they would still be recognised as revenue receivable irrespective of whether Sony held on to them or not under the proviso to the waterfall:

> "…that's the cash. That's not a question of income. There is different concepts there. If the films, for whatever reason, generated Box Office receipts…sufficient to work their way through the waterfall,…that income should be recognised by Gala. The timing of when it gets the cash is what you are referring to. So Sony has the option to keep the cash. That's not determinative of the accounting for the income. Yes, I see the proviso, but it wouldn't affect how income is recognised. It would affect timing of the receipt of that income."

(3) When asked if a reader of the accounts would be surprised at his way of accounting for this, he said (a) the reader would see income that was not matched by a cash receipt, but the balance sheet would show a receivable for all monies that Sony held on to, (b) box office receipts are the driver in generating the income, and, ultimately, the timing is driven by the timing of the Gross Receipts. If the Gross Receipts give rise to income under the waterfall, then that is recognised in the accounting period in which that income arises. If the receipts are held by SPR, and not paid over, then there would be a receivable representing those receipts to be received in the future. So it would be credit income, debit receivable:

> "…the timing is driven by the Box Office receipts…The funds are Gala's funds under the fourth and sixth provisions and the accounting takes place under those provisions…if that income is not received in cash, it is….a receivable

that would sit on the balance sheet. So…if receipts arose under 9.1.4 or 9.1.6 and…SPR chose to retain those receipts…you wouldn't wait until the end and account for it all at the end. There is an entitlement that arises under 9.1.4 and 9.1.6, and there's a receivable that arises under the proviso…"

(4) He was asked if he was really saying that he would treat sums paid under the fourth provision as belonging to Gala given they were to go direct to the licensor. He said:

> "There is a corresponding…liability under the [LA] to pay that money to the licensor. So the money arises under one contract and is paid for under the other contract. You don't offset assets and liabilities. So they are, to all intents and purposes, part of the same arrangement, but they are separate transactions, one giving rise to the other."

687. It was put to him in re-examination that Mr Yusef's evidence was that the fourth provision in the waterfall should have referred to payment being made to Sony and he was asked if that affected his evidence. He said that he had always seen it as being mirrored under the relevant provisions in the LA he had referred to in any event.

688. It was put to him that he said earlier that he would take security into account if that is where the real value is, and it is not credible to make no reference to the LC in this part of his report dealing with economic substance. He said, in effect, that (1) the LC is part of the security arrangements that wrap around the DA and the LA. It is those which are accounted for, (2) the LC is not where the real value is. As in a case where a bank has collateral for a loan, the LC guarantees and give comfort that the relevant payments (the income under the DA) will be made so it goes more to measurement rather than the existence of something and reduces the credit risk attaching to those sums. It goes to credit risk and valuation, and (3) the key is the assets and liabilities that arise under the DA. There is no asset or liability that arises under the LC.

689. He seemed to agree that it is not right that the LAs and DA are separate transactions but again stressed the "important point" that, as a general principle, transactions between different parties are not combined nor are transactions netted off except in specific circumstances set out in para 29. He referred to his earlier comments and said that the point is that, although the transactions are linked, there are a separate set of assets and liabilities under those transactions that fall to be accounted for separately. What FRS5 says is:

> "you can't offset assets and liabilities…You have to consider whether there are assets and liabilities that arise effectively in addition or as a consequence of the linked nature of the transactions. So there's no muddle here...We have assets and liabilities with separate counterparties that arise under these 2 agreements and we have to account for them…we have to recognise that Columbia and Screen Gems and [SPR] are different counterparties. We can't combine the transactions. That's not what FRS5 is telling us to do."

690. When pressed he stressed again, in effect, that FRS5 requires one to identify whether there are assets and liabilities to be accounted for and:

> "You look at the overall commercial effect and you decide: does that give rise to assets and liabilities in addition to or as well as other assets and liabilities? I have said you don't offset them, and a transaction may give rise to a legal obligation and it may give rise to another constructive obligation. So are there more assets and liabilities that arise from the commercial situation? There's no muddle here. It is not the end point. The end point is the substance of the transaction giving rise to assets and liabilities that fall to be accounted for."

691. When pressed by the tribunal on how he views para 11, he said it is the primary objective of FRS5 to identify whether the transaction has given rise to assets and liabilities, and that is where the reference to "a group of transactions" comes in:

"…do I have to recognise assets and liabilities because of a group or series of transactions…? As an entity…in fact, I am only entering into one transaction, but does that transaction give rise to assets and liabilities?...the transactional basis of accounting is about recognising an asset, a liability, an income or an expense or capital. That's it. We don't recognise transactions. We recognise assets and liabilities. This is why FRS5 was so important, because it was saying that if you enter into a transaction that gives rise to a liability, then you need to account for that liability. If you enter into a transaction that gives rise to an asset, then you would have to account for that asset, subject to…the rules of prudence and things like that. The fact that it's a transaction that's part of a chain that you may not be directly involved in, but it is nevertheless part of this overall commercial effect, doesn't give you the ability…to say: "Well, I don't need to account for that". So I account for the transactions that I enter into and I consider whether the overall commercial effect of which those transactions are a part require me to recognise assets and liabilities."

692. When pressed on the point by counsel he said there is more than FRS5 in play here and:

"We have assets and liabilities. We can't offset assets and liabilities. So in the circumstance where there is a transaction with Sony and there is a liability to Columbia, and there's another transaction with Sony, you can't combine those assets and liabilities. So we have to have separate accounting for the assets and liabilities. All FRS5 does, it says: "Find all the assets and liabilities and account for them."

693. He referred to para 29 and said that "we have to account for transactions separately" and:

"We may see those transactions as part of an overall commercial effect, and we have to account for the assets and liabilities that arise from that overall commercial effect, but we cannot collapse transactions down and offset assets and liabilities…We have to account for each step. So to your point we have to start with the transactions, because those are the transactions that fall to be accounted for. If we hunt for and identify some other transaction, we are effectively netting off assets and liabilities, and we are not allowed to do that."

694. We note that our comments at [642] on Mr Steadman's general approach also apply to the evidence he gave set out in this section.

Accounting for the loans

695. He also considered in this section whether, under GAAP, the SG loans should be considered together with the LAs and DA. He said they should not because (1) separate entities are involved, and (2) whilst the LA and DA can be considered together, their commercial effect is independent of the transactions between SG, Gala and its members; their commercial effect is unaffected by how Gala or its members are funded, or how the licensing of the transaction films or the payment of the approved Gala Expenses is funded: "Cashflows under the agreements would be the same, dependent, for the most part, on the success, or otherwise, of the Films."

696. It was put to him, in effect, that this is not correct because (1) looking at substance requires considering the position of other parties (see para 51) and (2) in fact, the cashflow is the same independent of the success or otherwise of the films. He said that his understanding of the DA is that cashflow would be different depending on the success or otherwise of the films and whether or not the Minimum Sums are exceeded or not met and that has nothing to do with the funding of the contributions. He noted that:

"We measure accounting over single accounting periods. We account for things on an annual basis…my understanding of the [DA] and [LA] means that those

> cashflows could be wildly different over each one of those years. So I don't think that the cashflows would be the same independent of the success or otherwise…the Minimum Amount is reduced by the amount that has been received prior. So if there are…payments under the waterfall, those come off…the minimum amounts. So Gala is guaranteed a minimum amount back, but the cashflows that may arise in any one year may be different."

697. He did not agree with Mr Donhue's conclusions on the loans: (1), as he had explained, the factors Mr Donhue referred to are not determinative of the accounting, and (2) there is always a risk of default. Sony is not an AAA rated, zero credit risk, sovereign organisation. The risk of default is relatively small, and the LCs reduce that level of risk, but there is a level of credit risk that applies in all transactions. Therefore, to say there is no risk of default is not quite right.

Mr Steadman's evidence - comments in conclusion

698. He was taken to the following statement in the conclusions in his reports:

> "FRS5 makes clear that an entity should account for a transaction based on its perception of changes in its assets and liabilities…Gala's financial statements will, if true and fair, reflect the contemporarily perceived substance of the transactions it entered into...However, I have also considered the extent to which the contemporary assessment is correct…"

699. It was put to him that the term "perception" does not appear in FRS5. He said that accounting standards are directed to those who prepare the financial statements. FRS5 directs them to account for the substance of transactions and, whilst it does not state from whose perspective commercial substance is to be addressed, the only relevant perspective is that of those persons, as those who select the accounting policies and set out what the objectives of the entity are. Accounting standards put everything incumbent on those persons and "when we talk about true and fair, we're talking about the context of true and fair at a particular time, the time that the accounts were signed by the directors or approved for issue".

700. It was put to him that the perception at the time of the relevant parties weigh against his analysis given that (1) in 2004/05, Mr Yusef's perception, on his evidence, was that he considered there to be one transaction, and (2) the notes of the financial statements refer to Gala having a liability to repay the SG loans. He said he was not sure he agreed:

> "You do not account for a transaction as a single unit of account, in the sense that Mr Yusef is describing the transaction. It is like an acquisition or a deal or something. You might get to the same place…But we also have to consider the transactions that legally have been entered into and whether we need to account for those as well…That's why I said that the whole thrust of FRS5 was going beyond the legal form of a transaction and hunting for additional assets and liabilities that were created because of the commercial arrangements. It doesn't mean you can ignore the legal aspects of a transaction. Now there may be, you know, another transaction that has an effect on that, and then you consider how to account for it, but it's not one transaction, because the LLP entered into a number of transactions, and those each have to be accounted for."

701. He was referred to following comments in his report:

> "It follows from FRS5 that if the substance of certain transactions was that Gala did not have any obligation to transfer economic benefits in connection with the SG LLP loans on the one hand, or control of the rights or other access to future economic benefits on the other, it would not have an obligation, or an asset respectively, since the obligation to transfer, and rights or other access, are part of the definitions of liabilities and assets under FRS5."

> "FRS 5 does not require an entity to recognise the obligation to spend the cash for a specific purpose, prior to the cash being spent on that purpose. While it might be a breach of the terms of the loan for a company to spend that cash on something else, the cash controlled by the entity could be spent in any way it wishes. Similarly, interest that is payable on the loan is not recognised until that interest arises."

702. It was put to him that it is peculiar, in carrying out a realistic, substance-based, true and fair analysis, (1) to ignore the basis of the SG loans and the arrangements for their repayment, and (2) place reliance on the idea that Gala might hypothetically have done something fundamentally at odds with what it had contracted to do. Mr Steadman said that if a person takes out a loan for a particular purpose, such as to acquire an asset, he has a loan and an asset. The asset does not belong to the lender; such a specified purpose does not mean that the asset is controlled by the lender. If the person decided to do something else with the loan funds, that is the nature of business; a business is free to act in a way that it wishes. It is the business' money up until the point it is used, and then it is exchanged for an asset or its expended:

> "we do not account for the purpose of a loan. We account for the loan and the proceeds of the loan as they are then applied for the assets. There's no matching of one against the other. The entity controls the asset and it has the liability. So the intended purpose of the loan is not accounted for…we are carrying out substance, but we are also concerned with the rest of accounting principles and standards, assets and liabilities, not offsetting assets and liabilities, the separation between assets and the funding of assets, the separation between capital and the use of capital…"

703. It was put to him that para 14 requires him to give greater weight to those aspects of arrangements more likely to have a commercial effect in practice and that it is not likely that Gala would breach the founding principle of the loan arrangements which underpins the entire structure. He agreed but said that does not matter as the loan and the asset are accounted for separately. The point he made in his report about breach is just to illustrate the difference between the assets and the funding of the assets, or between capital and the use of that capital. Those are separate considerations. It is not that one collapses into the other. He was not saying anything about whether Gala will or will not breach the terms of a loan: "We account for how the money is actually used."

704. It was put to him that Gala did not control the SG borrowed monies, because looking at the arrangements as a whole, the flow of the SG loan funds was pre-determined. Gala was never under any obligation to pay the Initial Expenditure without also being guaranteed to receive the same amount back. So, ultimately there was no risk to Gala. He said:

> "But we don't account for risk. We account for assets and liabilities, income, expenditure and capital. There doesn't have to be an expectation of gain or an expectation of loss. So the question of good commercial, bad commercial risk/reward are not…of determinative relevance. If I enter into an arrangement whereby I enter into some transactions, and those transactions have some other consequences, then we account for those transactions as they arise. We don't have to step back and say: "Do you know what? There is not enough risk in this transaction or account." Put simply, we don't account for risk…"

705. It was put to him that his view is incorrect in light of para 17 which states that there is evidence that an entity has an asset if it is "is exposed to the risks inherent in the benefits". He said, in effect, this does not mean risks are accounted for:

> "We are accounting for the assets and liabilities that arise even if there is no risk attaching to them. Money in a bank account or a government bond is risk-free, but it's still accounted for."

706. It was put to him that absence of risk, in the sense of, absence of a chance to make a gain or a loss, matters because, if none of those things are present, then there is no commercial effect on Gala and FRS5 says one has to give effect to the commercial effect. He said he is not sure that is what we are dealing with.

> "There are levels of gains. There is increase in ownership interest happening from the exploitation of the films. We don't have to look at the overall picture to decide: "Well, there's not enough risk in there. Therefore, we can't account for it like that", because risk is mitigated through security arrangements. In a scenario whereby there is a simple exchange of £100 for £100 to be received in the future, there may be no risk in that transaction, but I would still account for the receipt and…the loan an….the receivable. I still have to account for the transactions, irrespective of the risk or lack of it."

707. HMRC said that the above evidence exemplifies Mr Steadman's unsatisfactory approach to the matter before him and that it does not reflect generally the nature of business in the real world.

708. Finally, it was put to him that the difficulties counsel saw with his evidence were also a feature of the evidence for the LLP in *Ingenious FTT* where he also gave evidence and the principles of FRS5 were in point. We have not set out further details of this as we consider it is not instructive to examine in detail the evidence given in a different case.

Evidence of Mr Donhue- overall approach

709. Mr Donhue agreed, in effect, that (1) he formed his own view of the contracts and of the facts from reading the documents and the witness statements (2) if his view of the legal effect of contracts, the commercial aspects of what happened and/or of the relevant facts is wrong, his conclusions would need to be revisited, and (3) he is not a film industry expert and it is not within his expertise to assess potential returns under a film waterfall and he cannot say with authority what is and is not commercially relevant in the context of a film.

710. It was put to him that his analysis is "topsy-turvy"; one needs to understand the the legal position under the contracts first, and then ask whether that adequately reflects the commercial effect:

> (1) He said that he had tried to understand the legal position and, whilst one looks at it as a whole, the legal position is fundamental but he did not think that FRS5 says that "you look at the legal position and then come back to it".
>
> (2) He agreed that (a) it is clear from FRS5 that (i) one starts with the legal form of transactions and it is only if the commercial effects of the transaction are not adequately expressed by that, that one has to recourse to something other than legal form, (ii) he could not ignore aspects of the commercial arrangements if they have material effect, and (iii) the fact that "a group of transactions" should be viewed as a whole does not mean that one can simply collapse connected transactions or net off connected debts, (b) under para 29 there is a very high threshold for setting off and there is nothing which permits the off-set of matching liabilities between one entity and another entity or of liabilities between A and B against liabilities between B and C, and (c) one does not take an overriding or global perspective; one looks at the entity's perspective and the starting point is the legal form of the transactions and one cannot start with the commercial effect although he said they are "entwined".

711. When it was put to him that the fact that one must look at the overall effect of "a group of transactions" does not mean one can ignore individual transactions, he said: "Only to the extent that their commercial effect is bound up with others or indeed they have no commercial effect". He agreed that one has to assess the commercial effect of

the individual transactions in the proper context of "a group of transactions" and, in doing that, it is key to identify new, or any change in existing, assets or liabilities as accounting is concerned with the effect of transactions on assets, liabilities, income, expenditure, capital and in a sense profit.

Evidence of Mr Donhue – Main analysis

712. Mr Donhue was questioned on his view that SPR had a substantial degree of control of the expenditure account:

(1) He acknowledged that under the terms of the DA (in clause 6) it appears that SPR did not have an unfettered right to withdraw funds. However, he read the DA as meaning that SPR could sign on behalf of Gala for any Gala Expense that was in the Plans, approval of those Plans was a pre-requisite of everything being entered into so that, effectively, provided the expense was within the agreed budget, "then Sony could make both signatures" required for the withdrawal of funds.

(2) He did not accept that the funds in the expenditure account were available to discharge Gala's liability. The funds were made available to pay for distribution expenses and Gala could not use them to pay any of its liabilities. Whilst "it appears" Gala was liable for the expenses, as invoices were made out to Gala or SPR as Gala's agent, he did not know whether sums could be paid out of the account for an expense in the Plans if an invoice was addressed to SPR which did not mention Gala and SPR said it was acting as Gala's agent. He agreed that, on the face of it, the DA allows for sums to leave the account where invoices are addressed to Gala or SPR as agent of Gala and that the Plans were liable to change with Gala's approval.

(3) He viewed the expenditure account as *substantially* under Sony's control because the money in it could only be used for Gala Expenses for Sony's films and, if Gala did not approve any expenditure or the invoices, that did not prevent Sony from taking the relevant sum out of their budget and any unspent funds in the account had to be loaned to Sony. So Sony was either going to get the money as Gala Expenses or get it transferred to it by a certain date. He then agreed that the fact that Sony could incur expenditure which was not funded from the account, had nothing to do with the issue of control of the account. He added that no money could be spent from the account without Sony's approval and any money that was left in it beyond a certain date was to go to Sony. He agreed that the primary use of the account was to meet expenditure within the Plans.

(4) He agreed that (a) the expenditure account can be described as a blocked account, generally, such an account would probably be an asset of the account holder although it depends on the terms, and where the account is designated to pay for a liability of the account holder, the account holder would show both the asset and the liability in its accounts, (b) the account into which SPR made the Deposit can be described as a blocked account, that account remained under SPR's control albeit it was reserved for discharging certain liabilities and SPR did not pay the funds deposited to Gala immediately, and (c) therefore, there was one payment by Gala to the expenditure account to fund expenditure in accordance with agreed Plans, as paid against invoices, and another payment by Sony to its different account to secure Sony's obligations under the DA.

713. In re-examination, he noted that (1) Sony had access to the significant majority of the benefits of any film income as a result of expenditure on Gala Expenses because of the restrictions on what the monies could be spent on and what would happen to any unspent monies, (2) whereas Gala's benefits were very much restricted in terms of the

top slice of the waterfall, and (3) Gala was not in a position, effectively to restrict Sony's access to the benefits of the money in the account; any money that was left in it had to be transferred to Sony.

714. It was put to him that it is not correct that, as he said in his report, "Sony received a further £15 million from Gala, who in turn became entitled to receive a share of income under a waterfall agreement"; the payment of the licence fee did not give rise to Gala's rights under the waterfall. He acknowledged that the waterfall is provided for in a separate agreement but said that (1) it was part of the same transaction. The agreements refer to each other and themselves as the transaction documents. There is a single whole transaction of which the different agreements are part, (2) £15 million is what Sony received in excess of the £102 million it deposited in one account and received in another, and (3) Gala received the rights under the waterfall in exchange for this transaction. He said, in effect, that in legal form £15 million was paid by Gala for something other than for rights under the waterfall (for the acquisition of the licences which Gala was required to sub-licence) and it was not paid to SPR. He said that he reached his conclusion that the various Sony entities should be treated as one and the same from the documents.

715. As regards Gala's SG loan:

(1) Mr Donhue agreed that on the face of the documents the licence fees were funded by Gala's SG loans and they were a liability of Gala. He said that (a) under the concurrent agreements, Gala assigned its right to all of the receipts under the DA and directed Sony to pay them into a bank account, which only SG could withdraw from, to satisfy the SG loans, (2) so "the substance" is that the loans were Sony's liability because, in effect, Sony had to make the loan repayments on paying sums into an account with SG from which the loans would be settled; effectively, Sony legally assumed the liability, because it agreed to pay sums equal to the Minimum Sums into that account in order to discharge the loan liability. It was put to him that Sony had only agreed to discharge the relevant liability and had not assumed it. He said, in effect, that was the case on the face of it but, for the reasons he had already given, in substance it was Sony's liability. He agreed he had not identified any aspect of documentation under which Sony assumed the liability.

(2) It was put to him that the SG loans must be shown in the accounts as a liability of Gala, and they cannot be linked to or treated as incurred in funding other expenses, in light of the facts that (a) the term sheet and the loan agreements specified that the purpose of the borrowing was to fund Gala's acquisition of rights under the licences, (b) Gala duly spent the funds on the licence fees, and (c) the liability under the loans was not assumed by anyone else. He accepted that the legal position seemed to be that the loans were a liability of Gala. He noted that the SG loans were paid into the expenditure account and the funds for the licence fees came from the account that received the contributions, so the borrowings are in fact linked with other expenditure, and the loans are all part of the wider transaction. He did not agree that, whatever the cashflow, a loan taken out for a stated purpose which is allocated for that purpose by an LLP should be treated as linked to that purpose. He said that, if Gala's SG loans were totally separate and distinct from the members' SG loans, Gala's SG loans must have had a very high interest rate (given how the interest rate was to be determined in the documents). He thought that the members' SG loans were paid direct into the expenditure account and their cash contributions were paid into a separate account, from which some funds were transferred to top up the expenditure account and some were used for Invicta's Fees. He agreed that the term sheet

states that the contributions were to be used as to 91.5% to fund Gala Expenses and otherwise to meet fees.

716. It was put to him that (a) under the commercial structure, as reflected in the term sheet and the contracts, Gala bought capital assets, the licences, using its SG loans and derived an income from those assets by incurring the Initial Expenditure, and that income was secured by Sony, and (b) it is only by re-characterising this deal that he finds the basis to re-write Gala's accounts as he has done on his main analysis. He said:

(1) That is what the term sheet says was to happen, but he looked at the substance of the transaction in terms of where Gala was before and just after the documents were all signed. He had not studied the term sheet in any great depth, principally because it was non-binding, and rather he looked at the contracts and at the IM. He did not look at all the non-binding sources and probably did not understand an awful lot of the binding sources; he did not go through all of the waivers, indemnities and debentures and guarantees to cross-reference them.

(2) He made his assessment by standing back and looking at the substance of what happened. However, even if one breaks it down into the transaction components, Gala's view cannot be correct, because it does not take account of the shortfall guarantee.

(3) He agreed that he had done a sweeping re-characterisation of the accounts and had taken almost everything out except a single asset which he treats, effectively, as representing members' capital (and some other small assets). When it was put to him that, in his analysis, he does not take account of any ongoing obligations of Gala under the DA, he said that he could not see any such obligations.

717. In re-examination, he said there are lots of clauses and lots of documents, but FRS5 requires one to stand back and look at the substance of the transaction when it is quite as complex and interrelated as this and that is what he tried to do.

718. He was questioned on the role of the different persons involved in Gala and the significance of their and Gala's activities:

(1) He agreed that (a) looking at the MSA, Invicta advised on the commercial transactions, (b) to understand the allocation of functions between Invicta and Chiltern one has to look at that agreement and the OA together and at how things operated in practice, (c) it was his impression that Invicta, not Chiltern, was in charge of the business side of things (d) he agreed that major decisions would be made or at least ratified by members of Gala at a partner's meeting, and (e) the identity of the operator is not really relevant to anything of substance whereas what Mr Yusef and Invicta did is central.

(2) It was put to him that he had not mentioned Mr Ackerman in his reports but his role is obviously fairly important for understanding what Gala did in its dealings with Sony and that what Gala did was important. He said (a) if one looks at the DA, Gala's involvement does not appear to be very much beyond depositing monies in an account, and (b) he was concerned both with the contracts and what happened on the ground, as that inevitably has an impact on one's perception, but from what he could discern, particularly from the contracts, Mr Ackerman had little relevance and, under the DA, all Gala had to do was deposit some funds into some accounts and countersign some cheques. When pressed, he said he did not detect any relevance in what Mr Ackerman did in terms of the commercial effect; he could not see any relevance of his actions to Gala's obligations under the contracts. He agreed he does not know about the film industry and could not say with authority what is or is not relevant to it and he

had dismissed Mr Ackerman as irrelevant on his understanding of the contractual position.

(3) He said, in effect, that (a) he could not detect any ongoing aspects of the DA, (b) whilst it seems that Gala had material obligations under it which had contractual consequences, the DA says effectively that SPR controls everything, and (c) the DA required all expenditure to be incurred by 5 April 2004 and, once it had been spent, Gala had no ongoing responsibilities under it.

(4) It was put to him that Mr Ackerman remained active after that date and that Gala continued to incur expenses in relation to him and there were invoices from 2006. He said (a) he did not see any other expenditure in the accounts for later years, (b) Gala did not pay Mr Ackerman in later periods and he thought that it was more likely that Mr Ackerman rendered services to Invicta, and (c) there was no pre-payment of expenses out of the Invicta Fees and there did not seem to be any carry forward. If Gala paid for 8 years of services, he would expect a prepayment to be carried forward. It was put to him that Gala claimed a deduction for the payment of the Invicta Fees and what Invicta then did with those funds is a separate and secondary question. He said:

> "Well, not if Gala was paying Invicta for providing ongoing services for 8 years. You wouldn't expect it all upfront…if they were paying for 8 years' worth of services, I would expect a prepayment to be carried forward…if you paid 2 years' rent upfront for the lease of a property, you would spread that payment over the following 2 years."

(5) He said, in effect, that the accounts do not reflect that there were ongoing administrative expenses in later periods and, if and to the extent that such expenses were paid out of the Invicta Fees, that element should have been prepaid. He agreed that it does not matter to his analysis whether the correct position is that Invicta paid other parties' fees on its own account or on Gala's behalf. He confirmed he had ignored Mr Ackerman and the provisions in clause 7.3 in the DA because, in substance, they do not seem to have any effect on Gala's activities in relation to this transaction.

719. Mr Donhue accepted that (1) there are circumstances in which SPR could terminate the DA and the licensors could terminate the LAs, and (2) there was no guarantee that these arrangements would remain in place. It was put to him that, therefore, there was no guarantee that the Minimum Amount would be paid. He said that he would have to unravel all of the "and if this happens, then this" in order to answer that question properly. He worked on the fact that it was called a guaranteed minimum payment and, if the Call Option was called, it would still be received. He was not sure whether or not it would be paid if the agreements were terminated for some other reason. It was put to him that if there is a risk that the DA would fail and that the Minimum Amount would not be paid, he could not say that the net present value of that sum should have been recognised in the accounts on day 1. He said that would depend on why the requirement to pay the Minimum Amount could fall away; there would be a risk assessment and, if there was a real possibility that that money might not be received, that would have to be factored into the valuation. He thought that he must have not recognised any significant risk when he read the DA. He gave much the same response in re-examination.

720. As regards his view on the SG loans:

(1) It was put to him that one cannot treat debts from A to B and B to C as a debt from A to C. He said it depends on the terms of the loans and one can "if the substance is that C has lent to A. B doesn't record anything." When it was put to him that is not correct if in fact there are 2 loans he said: "That's why I say it

depends on the terms of the loans. So without knowing what the terms of the loans are then I can't just say". He agreed that there can be no set-off (a) if there are 2 loans in substance, and (b) where a debt is due and payable on day 1 between A and B, and a debt from B to A is due and payable at the end of year 2.

(2) It was put to him that Gala's right to the Minimum Sums is separate from Gala's obligation to repay its SG loans; the relevant obligations are owed between different parties. He said that in substance, he disagreed. He agreed that the loans were legally separate and that there is a difference between assuming and agreeing to discharge a person's liability under a loan. However, he understood that Sony assumed the obligation under the SG loans; that is the effect of the LC and related deposit instructions which say, in effect, on every payment date: "Take money out of the deposit and pay it into the account from which SG pays its interest". It was put to him that where there is such a direction to discharge a liability, the liability remains that of the original borrower. He said:

> "that might be the legal position, but the substance of it is that the monies deposited by Sony can be, were directed to and were used to repay the loans from [SG]…They were used to repay the loans…That seems to me to be the substance of what happened."

(3) It was put to him that the payment direction under the Deposit did not change who was legally liable for the SG loans. He said that it deals with the substance of the transaction and the legal position may be different. When asked if the payment instruction affects the identity of the borrower, he said that he is not a lawyer and the sorts of differences counsel spoke of and the effect of all the debentures, waivers, indemnities and guarantees are all legal matters on which he is not qualified to comment. The substance of it from an accounting perspective is that the money on Deposit at Barclays was and had to be used to repay the SG loans.

(4) When asked to explain the legal difference between someone agreeing to discharge another's liability and assuming that liability, he said:

> "Where the person to whom the money is owed…accept them as assuming the obligation, then to my mind that is different to something they don't know about or something that happens behind the scenes".

(5) He then said, in effect, that, in substance, the arrangement between Sony and Barclays and the payment instruction, amount to Sony assuming the liability of Gala and the members to SG under the SG loans. When it was put to him that legally that is not right (and that the legal position is the starting point) he said he did not know whether Sony legally assumed the liability. He disagreed with Gala's stance.

721. Mr Donhue agreed that that one cannot in general collapse a balance sheet or a profit and loss because there are matching equal and opposite obligations and that Note G does not change that; Note G is about revenue recognition in the appropriate period. He agreed that a bank which makes a secured loan for a fixed term or a person who enters into a profitable contract with limited ongoing obligations, does not bring the entire profit or the net present value of the revenue in as revenue on day 1 but added that that is the case only if the person had not completed all his obligations under the contract. He agreed that it is clear from G14 that Note G is subordinate to SSAP9 as regards accounting for long-term contracts; it does not amend the requirements in SSAP9 but provides additional guidance and so does not radically change accounting for such contracts.

722. As regards whether the sums in the expenditure account were an asset of Gala:

(1) He agreed that, in broad terms, he said in his report that the Initial Expenditure was not incurred by Gala because it was paid to Sony and matched by the amount of the Deposit. He said that (a) he did not mean that Gala was not out of pocket but that the expenditure was not incurred by Gala because it was incurred by Sony, (b) the expenditure account was substantially controlled by Sony and, therefore, the sum was to all intents and purposes paid to Sony and the funds in it were not Gala's asset, and (c) the definition of an asset requires control and the ability to enjoy the benefits and, in referring to para 54, he added:

> "where we are looking at control of access to benefits, the funds that were in the [expenditure account] were not only - couldn't be withdrawn without Sony's permission, potentially could be withdrawn without Gala's permission provided they were within a budget, and any economic benefits or substantial economic benefits that arose from the expenditure of those funds accrued to Sony, then they don't appear to me to be an asset of Gala."

(2) He was referred to the following comment in para 54 and it was put to him that the fact that Sony could act as agent for Gala does not of itself give Sony control of the account:

> "Control can be distinguished from management, and although the two often go together, this need not be so. For example, the manager of portfolio securities does not have control of the securities, because he does not have the ability to obtain the economic benefits associated with them. Such control rests within the person who delegated to the manager the right to take day-to-day decisions about the composition of that portfolio."

He said that if anything, the management aspect is Gala's countersigning of cheques within the budget but did then accept counsel's proposition.

(3) It was put to him that (a) it is clear that Gala derived an economic benefit from the Initial Expenditure because it was used to discharge Gala's obligations under the DA which are linked to Gala's entitlement under the waterfall and to the Minimum Sums, and (b) it does not detract from that that Sony also derives an economic benefit; the nature of commercial transactions is that both sides can benefit from them. He said that the expenditure account was not Gala's asset; Gala did not have control of it, it could not do anything with the funds and/or withdraw the money and spend it on anything.

(4) He agreed that, (a) as he had accepted earlier, such a blocked account remains the asset of the account holder where the funds must be applied for his benefit, even if they cannot be freely applied by him, and (b) if Gala is right in its analysis, namely, that payments out of the account are made in discharge of Gala's invoices pursuant to Gala's obligations under the DA, and that gives rise to Gala's entitlement under the waterfall and to the Minimum Sums, then Gala gets a benefit from those payments and the account is Gala's asset.

(5) It was put to him that, on his analysis, he netted off obligations between different parties and events that happen at different times, given the Initial Expenditure was put into the expenditure account in December 2003 and February 2004 and the right to the annual Minimum Sums (and to the corresponding sums under the LC) accrues annually. He said he had excluded various items from the accounts as they did not appear to him to be Gala transactions and the timing of those payments is secondary. It was put to him that para 29 makes it clear that timing is important. He said (a) that deals with offsetting amounts whereas "my exclusion is not offsetting. It is excluding because they have no economic substance" and (b) payments from the

expenditure account were not payments by or on behalf of Gala, and his reasoning is that the whole thing is a circle. So:

> "Sony deposited 102 million at Barclays, which is paid out over time…which was security for [SG] to put 102 million into an account under the control of Sony, which Sony could pay out subject to counter signatory by Gala. So Sony put 102 million in one account and had 102 million in another account…That is the substance of what happened…They could spend that 102 million straightaway and then the interest on the 102 million just pays off the interest on the [SG] loans."

He did not think that SG would have lent £102 million without the Deposit.

723. He agreed that it would be wrong for Gala to assume in the accounts that the Call Option would be exercised without virtual certainty it would be and it is a contingency outside their control. He said it is not their call and the market value is the market value, and it is a contingent asset.

724. As regards his 2 alternative conclusions on his main analysis:

(1) He agreed that (a) as on his first alternative, he views Gala as having an investment of £25 million, he does not treat the transactions as effecting a pure pass through of the relevant rights. He said that, after the event, Gala retained an asset; the rights to "top slice" or "latent" income under the waterfall and/or the excess of the market value over the guaranteed Minimum Amount, and (b) Gala had different Rights under the LAs to those it granted under the DA (as regards the term and the lack of rights to "Sequels"). It was put to him that it is odd that, on his view, none of the other aspects of the transaction are relevant to the accounts. He said none of the other aspects had any commercial effect on Gala's position. Gala had a right and whilst he knows how much it cost the valuation of it is outside his scope of expertise and, so far as he could see, Gala did not derive any income from it. He agreed that he dismissed the Minimum Sums as referable to another element of the transactions on the wider view of the overall commercial substance of the transactions, comprising not just those between Gala and SPR, but more widely between SPE, Columbia, Screen Gems, SG and Barclays.

(2) He agreed that his second approach is that if there is no such asset, because there is no possibility of income, then things can only be justified by the members' tax treatment. He said that was his understanding from the IM and:

> "If there's no asset, if it was inevitable that Gala would only ever get the minimum payment…if the market value could never exceed the guaranteed minimum payment, then Sony commercially would always exercise [the Call Option] because it would cost it nothing. It would just release its funds from Barclays. So the net effect for Sony is zero. So that is why it would always exercise the option, which would then leave Gala having to write off its investment…they put their money in…102,800,000 whatever was deposited at Barclays…And 102,800,000 whatever has been disbursed on P&A on Sony films…if the market value could never exceed the minimum, then commercially Sony would always exercise the option…Because all it would be doing is releasing funds that it had already paid out…Sony was never going to get them back…The only way they would get them back is if they had paid them in a different way under the waterfall by settling the guaranteed minimum amount…"

(3) In re-examination he said that, if it was commercially inevitable that Sony would exercise the Call Option, effectively there would be no asset, because Gala would have spent its £25 million and have no prospect of anything else coming in other than enough money to pay off the loans, which were not its loans in the first place. So it would have just spent 25 million on the arrangements

725. It was put to him that if the receipts from the films were such that under the waterfall Gala became entitled to more than the Minimum Sums, Sony would get its money back, one way or the other. He said:

> "If there were sufficient receipts Sony would only have to pay the excess, because the rest could come out of the Barclays account to pay off the minimum guarantee and then Sony would have to pay surplus out of the waterfall. Sony is paying the guaranteed minimum plus the excess if the films is successful… whether that guaranteed minimum has come out of the Barclays account or from Sony and then Sony gets the money back from Barclays does not make any difference, but Sony will always pay 100 million [the assumed minimum] plus potentially an excess."

726. He agreed that if Gala's share of Gross Receipts under the waterfall is 110 million and the shortfall guarantee is 100 million, the effect mathematically is that either (1) Sony could pay Gala 110 million under the waterfall and take back 100 million from the Deposit, or (2) Sony could pay 100 million out of the Deposit and only pay 10 million extra under the waterfall. It was put to him that under the DA there is a sharing out of receipts and Gala's share belongs to it; it does not get paid to Sony and then get paid to Gala. He said the first 100 belongs to Gala under the guaranteed minimum so Gala earns its 10 million more and Sony only pays 10 million out. He agreed that under the waterfall as money arises, it is shared between Gala and Sony and if Gala's share is more than 100 million, then one way or another Sony will get back the amount in the Barclays account back.

727. He agreed that the essence of his view as regards the members' SG loans is that they should be ignored on the basis that they are effectively paid to and later discharged by Sony. He was taken to the 2002 SORP:

(1) He agreed that (a) the precise legal arrangement between Gala and the members in relation to their SG loans is important, and (b) in his main analysis, he treats these loans as if they are made to Sony (and so as an asset of Sony with a corresponding liability to a third party), although they were in legal and commercial substance made to the members to fund their contributions, the relevant funds were put into an account in Gala's name and the loans were subsequently repaid on behalf of the members by Gala. He said this is certainly unusual.

(2) He agreed that (a) in saying that the arrangements have very little substance he meant that, when one stands back and takes a view of the overall effect of the contractual arrangements, some of their provisions have no material commercial impact, and (b) part of the basis for his analysis is that Sony controlled the expenditure account and, if the tribunal accepts that the account is controlled by Gala, that part of his analysis collapses. In that case, he would view the members' loans as loans of Gala because Gala had the obligation to discharge them but the Initial Expenditure would be Gala's expenditure.

(3) He agreed that the prima facie effect of the legal documents is that the members' SG loans are repaid by Gala on behalf of the members out of payments made by Sony. He said that he had not seen any specific document where, as a matter of law, Gala assumed liability to SG for these loans as opposed to assuming a liability to the members to discharge them.

(4) He accepted that the LC is a security arrangement and the minimum guaranteed payment is just that. He said, in effect, that the shortfall guarantee does not (as counsel said) sit behind rights under the waterfall but before them in that it is a *minimum* guarantee; the rights to the waterfall cannot be less than that minimum. He agreed that it ensures that Gala gets at least a certain amount under the DA. It was put to him that the accounting standards do not permit, let alone

require, these legal realities to be ignored. He said FRS5 says that, if the substance of a transaction does not follow its legal form, then one follows the substance. It is about giving a true and fair representation of what happened.

(5) He agreed that members' drawings from an LLP are conceptually distinct from profits. He confirmed that his view, as set out in his report, is that (a) the payments of drawings by Gala may be a breach of the MA and Gala's loan agreement with SG, due to the provision that SG would use the Minimum Sums it received to pay sums due from Gala under its SG loan; the effect of this provision is that all Minimum Sums have to be applied in discharging that loan and so cannot be used by Gala to make drawings in order to discharge the members' SG loans, and (b) all of the SG loans should be considered as one loan to Gala, because Gala received the Minimum Sums and Gala discharged the outflows. When it was pointed out that the members' loans contain a similar provision, he agreed that, on one reading, each provision prevents the use of the Minimum Sums to discharge the other loan. He did not seem to agree that the sensible approach is to interpret these provisions on the basis that the intention was for the Minimum Sums to be used to discharge the loans pro rata.

Evidence of Mr Donhue - Alternative analysis

728. He was questioned on his alternative analysis:

(1) He agreed that in general a bank, a landlord and a licensor do not bring in the net present value of a secured loan, rent or licence fees (even if they are fixed and secured) in the first period because that would accelerate a receipt/profits and that would follow even more strongly where the relevant activity involves more than granting a licence and that is the essence of Note G. It was put to him that to bring in the full sums in the first period would give an entirely distorted view of the profits of the entity. He said that Note G "requires you to bring in a right to consideration once you have completed all your obligations". It was put to him that he was changing his mind given his acceptance of counsel's general propositions. He said that the shortfall guarantee is just that and, if one has to take the DA at face value, then "Gala has done all it needs to do to earn that guaranteed minimum payment…Gala has done all it needs to do in order to earn its right to that consideration. So that would have to be recognised".

(2) He was asked, in effect, why he takes a different view here than that he takes in the case of a licensor. He said (a) Gala has done all it needs to do in order to earn its right to that consideration and so that would have to be recognised. So as far as he can tell, Gala did everything it needed to do to earn that income. So it did not bring it forward. It recognised it at the time it earned the right to it, and (b) this minimum guaranteed payment is effectively a sale:

> "It is a debtor. The fact it might be paid in 7 years' time does not affect when it is accounted for. It is when that debt is earned…that's what one does with revenue recognition…a licensor is granting a licence that covers a period of time. Gala doesn't have to do anything else."

(3) When questioned as to why he took different views as regards (a) the case of a licensor who does nothing more than grant a licence and enjoy the fruits of that licence over time, and (b) Gala's position as regards the shortfall guarantee, as a right to payment over time, which guarantees/underwrites a right to income under the waterfall, he said that:

> "the difference is that here there is a right to income at the date the agreements are signed. It is a guaranteed minimum payment."

(4) When pressed, he said he was giving a very consistent answer. The seller has completed all his obligations and has therefore earned the right to consideration and that counsel gave him:

> "hypothetical examples without terms, conditions, whatever. What I am talking about are the terms of this agreement…Because the right to earn that aspect of the income is earned on the signing of the agreement".

(5) When it was put to him that this is no different to a licensor who licences something for a period of years for a fixed amount with security who he seemed to agree should bring in the receipts over the life of the licence, he said (a) it would depend on the terms of the licence such as whether it is exclusive or non-exclusive, and (b) that could make a difference as the essence of an asset is the right to use rights and to exclude others from using them:

> "It's because it is a fixed guaranteed minimum amount. We use guarantee in the terms of the contract there rather than income guarantee…It's a fixed amount that will come whatever happens".

(6) His overall conclusion whereby he excluded everything is based on who, as far as he can tell, controls the accounts. When it was put to him that, on his disaggregated approach, he sets-off the expenditure and the guaranteed minimum against each other, he said he did not do that and:

> "I would record the guaranteed minimum as income and a debtor…Income and debtors will always be the same amount, but if you are disaggregating things then it would represent income. The fact that it happens to exactly match the expenditure is partly why I don't feel the accounts show a true and fair view."

729. In re-examination on this point, he said:

> "you recognise revenue when you have performed your services. I could not see any further obligations on Gala to perform any services, and therefore given that the guaranteed minimum payment was always going to come in, if one looked at just the [DA] in isolation, one had to recognise it…Mr Vallat started talking about SSAP 9 and long-term contracts…the corollary of that and Mr Steadman's evidence also said about matching income and expenses. So if one looked at the [DA] as a long-term contract, then all the costs associated with that would become a work in progress. The net effect would be the same, but I still believe that all the contractual obligations had been completed and therefore….if one was looking at that agreement on its own, they would be recognised, but if for some reason there were further performance obligations, then the P&A expenditure was part of the cost of earning that guaranteed minimum payment and therefore should be matched largely to when that income arises."

730. In cross-examination, he said that (1) the set of accounting policies put to Ernst & Young were not adopted in the financial statements and he did not think they agreed to the policies which were adopted so their opinion is not relevant, (2) in his view the accounts are wrong and, therefore, Moores Rowland's unqualified opinion is incorrect due to a fundamental disagreement as to the commercial effects of the contracts, (3) in his rewriting of the accounts he has removed the loans, the drawings, the relevant Minimum Sums, the cost of sales and reclassified the asset fundamentally because of the different view he takes of the overall commercial effects of the arrangement. He agreed that (a) in his view this does not involve setting off in para 29 terms but collapsing multi-party arrangements although he would say removing rather than collapsing, and (b) as a high level summary the real debate between him and Mr Steadman is (i) what is the overall commercial substance of the arrangement and, (ii) how much should one focus on Gala as a distinct entity in reflecting that commercial substance. In re-examination he said he did not net anything off but excluded both sides of an equal and opposite transaction that have no commercial effect.

Conclusion

731. We consider that both experts were generally trying to assist the tribunal, but we have some difficulties with some aspects of the evidence of each of them. The main difficulties we find with Mr Steadman's overall approach are that:

(1) When describing the effect of FRS5 in general terms, in many of his comments, Mr Steadman appeared to adopt a restricted view of the effect of the provisions in FRS5 dealing with "a group of transactions". For the reasons already given, we can see no basis for such a view in the wording of FRS5 (see [642]).

(2) When applying FRS5, in practice, overall he adopted a somewhat rigid and blinkered view which is out of kilter with the "substance" based approach it requires. He appeared to have based his analysis on the premise that each individual element of the Gala arrangements is to be accounted for separately according to its legal form with little consideration of whether it is part of "a group of transactions" or of the broader context in which that individual element took place. We note, for example, that (a) he made no mention of the LC and Deposit in his first report, (b) he only took account of "the wider implications" at the end of his first report, separately from his main analysis and, in doing so, considered only whether limited parts of the overall arrangements should be viewed as "a group of transactions", and (c) he appears not to have considered the substance of a number of elements of the arrangements and to have taken some statements made by Gala at face value without full analysis. For example, (i) he seemed simply to accept that Gala had an activity of the acquisition and exploitation of distribution rights as stated in its accounts without analysis of the position under the documents, (ii) he was insistent that Gala received an inflow of economic benefit under the waterfall, as a result of receipts under the fourth provision, notwithstanding that the relevant sums were to be paid direct to the licensors in repayment of Sony's "Cost of Production", and (iii) he placed reliance on the HL letters despite their obvious limitations.

(3) When questioned at the hearing, (a) he appeared reluctant at times to accept propositions which are evidently correct, such as that whether Gala could expect an inflow of economic benefits from Gross Receipts under the waterfall depends on the terms of the waterfall, and that the right to the Minimum Sums arose from past transactions and events, and (b) he referred to general examples or propositions without relating them back to the specific circumstances of these appeals, such as when he was questioned on the relevance of the security arrangements and why he did not consider that Gala should account for the shortfall guarantee.

(4) The combination of the above factors means that the basis for some aspects of Mr Steadman's evidence are not at all clear. In particular, as set out below, he was not able to explain adequately the reason for his view that Gala was correct under GAAP not to account for the shortfall guarantee.

732. In our view, Mr Donhue's overall approach of assessing (1) whether all or part of the arrangements constitute "a group of transactions", and (2) whether and to what extent any such "group of transactions", viewed as a whole according to its overall commercial effect, gives rise to new or, changes in existing, assets or liabilities of Gala is permitted and, indeed, required by FRS5. However, our main difficulty with Mr Donhue's evidence is that, when applying this approach in practice, he based his analysis on a premise which does not reflect the commercial effects of certain aspects of Gala's transactions. His opinion that Gala's accounts should not show Gala as having

incurred an expense of £102 million on the approved Gala Expenses is based on the premise that (1) the SG loans of £102 million had no commercial effect on Gala or its members due to the "pre-ordained" or "circular" flow of funds under the loan repayment arrangements so that (a) Gala's SG loan should not be recognised in Gala's accounts, and (b) members' capital should be reduced by a sum equal to the members' SG loans; he views the SG loans as though they were made to SPR, and (2) it follows that the sum spent on approved Gala Expenses was paid by SPR for its own benefit: (a) SPR provided Barclays with the Deposit of a sum equal to the principal of the SG loans/Initial Expenditure, and (b) the Initial Expenditure in the expenditure account was under SPR's control and disbursed on Gala Expenses on its films.

733. However, this involves ignoring the legal and commercial consequences of the loan repayment arrangements:

(1) The members and Gala took out the SG loans, as full recourse borrowings, and the members contributed their borrowings to Gala as capital subject to the terms of the MA (see section 3 of Part A).

(2) As set out in section 10 of Part B and in our conclusions in Parts C and D, in our view, in using £102 million of the total funds Gala received to put the Initial Expenditure into the expenditure account, as a matter of commercial and economic substance, Gala incurred a cost. Pursuant to the terms of the DA, Gala discharged an obligation to SPR to pay that sum into the expenditure account and bore an economic burden, albeit that (a) the sum was not incurred by Gala on, or for the purposes of, approved Gala Expenses but for the purpose of funding SPR's provision of the Deposit in order to create a "self-funded" loss with a view to the members obtaining the tax benefit, and (b) there is a question, therefore, about whether and how a cost of that nature should have been reflected in Gala's accounts.

(3) The security arrangements were just that. They gave Gala and the members a high degree of security and comfort that they would receive sums sufficient to repay the SG loans in full under the LC as funded by the Deposit. However, the members and Gala were liable under their respective SG loans should the security arrangements fail albeit that that was a relatively remote risk. Their liability in this respect was not affected by the fact that, under the security arrangements, (a) the sums due under the LC were to be funded by SPR's Deposit, which was itself to be funded, in effect, by the Initial Expenditure, and (b) the relevant amounts were to be paid direct to SG, who agreed to utilise them in payment of sums due under the SG loans.

(4) In our view, the legal and commercial effect of these arrangements is not affected by the fact that Sony could be viewed as having "substantial" control of the expenditure account, as the term control is used in FRS5. Even if Gala is viewed as ceasing to control the monies used to fund the Initial Expenditure as soon as they were put into that account (in the sense that it did not have the ability to obtain the future economic benefits relating to the funds in the account and to restrict the access of others to those benefits), we cannot see that it follows that (a) Gala incurred no cost in the first place, in putting the Initial Expenditure into the expenditure account, and (b) SPR can be viewed, in effect, as the party in direct receipt of the SG loans. Whilst, on that basis, Gala could be viewed as having incurred a cost immediately when it put the funds in the account, we cannot see that it could be viewed as not having incurred any cost at all, as though (i) Gala had never received funds under its SG loans and from the members, as regards the portion of their contributions funded by their SG loans, (ii) Gala had never made those funds available to a third party, SPR, and (iii) Gala and the

members had no liability under the SG loans – on the basis, in effect, that SPR was the borrower.

734. It seems to us that (1) assessing whether a complex set of arrangements, such as these, constitute in whole or part "a group of transactions" on the basis that they achieve or are designed to achieve an overall commercial effect, is not an exact science, and (2) for understandable, rational and reasonable reasons, accounting experts may form different views on where the line is to be drawn as to whether, and to what extent, particular elements of a set of arrangements constitute such a group. However, we consider that it is highly unlikely that the approach required by FRS5 authorises such a comprehensive re-drawing of the transactions as Mr Donhue proposes, when that re-drawing involves ignoring substantive commercial and economic effects of some of the elements involved, which are expressed and reflected in their legal form. Given this difficulty with the basis underpinning Mr Donhue's main analysis, we cannot accept that analysis as establishing that Gala's accounts do not comply with GAAP.

735. It seems to us, however, that there is a problem with Gala's accounting treatment of the transactions in that, as Mr Donhue identified in his alternative analysis, Gala has not accounted for the shortfall guarantee as required by Note G. To recap:

(1) Note G requires "the seller to recognise revenue under an exchange transaction with a customer when it obtains the right to consideration in exchange for its performance".

HMRC pointed out in their submissions on the accounting position that (a) there is no definition of exchange transaction but FRS12 defines a "Non-exchange transaction" as: "A transaction whereby an entity receives value from another entity without directly giving approximate equal value in exchange or gives value to another entity without directly receiving approximately equal value in exchange", and (b) whilst FRS12 was not applicable in 2003/04 there is no suggestion that the meaning of that concept is different now than it was then. Therefore, on its plain meaning "exchange transaction" is a broad concept which encompasses transactions where an entity receives value from a transaction and gives approximate equal value.

(2) "Performance" is defined for this purpose as the performance of "the seller's contractual obligations to a customer through the supply of goods and services" and a "right to consideration" as a "seller's right to the amount received or receivable in exchange for its performance…"

736. Mr Donhue's view is that Note G4 requires Gala to account for the present value of the expected cash flows, because the only conditions required for Gala to obtain the right to secure the Minimum Amount was to take out the SG loans and deposit certain sums in the expenditure account, those conditions were apparently satisfied by 5 April 2004, and there were no further performance obligations on Gala's part. He said under cross-examination that this is correct because, Gala had "done all it needs to do to earn that guaranteed minimum payment…in order to earn its right to that consideration" and "the right to earn that aspect of the income is earned on the signing of the agreement".

737. We consider that Mr Donhue's alternative analysis reflects the substance of these transactions. In our view, Gala was a party to an "exchange transaction" whether a broad or narrow view is taken of what that constitutes:

(1) Essentially, Sony granted Gala the Rights in respect of the transaction films in return for Gala (a) paying the Sony licensors licence fees under the LAs, and (b) sub-licensing the Rights to another Sony entity, SPR, on the terms of the DA. Under the DA, in effect, in return for Gala agreeing to provide the Initial Expenditure for SPR to use to meet approved Gala Expenses by 5 April 2004,

SPR agreed to (a) pay Gala (i) a sum equal to the Initial Expenditure/principal of the SG loans, as a fixed minimum amount, due at the end of the term of the DA or on an early termination of the DA and, (ii) fixed sums due annually, which were calculated specifically to cover the interest due on the SG loans, and to ensure that, if the DA were in place for the full term of around 8 years, Gala would realise a small profit if it did not receive any Gross Receipts, (b) procure the issue of the LC to guarantee the payment of those sums as funded by the Deposit (as, in effect, funded by the Initial Expenditure). We refer to our comments in section 10 of Part B as regards the purpose and effect of this part of the arrangements.

(2) On closing of the transactions (a) Gala "performed" its relevant contractual obligations to SPR under the DA, by providing the Initial Expenditure to SPR, and (b) in exchange for that, simultaneously received the benefit of the LC (as duly procured by SPR on it providing the Deposit to Barclays) and became entitled to consideration in the form of the Minimum Sums. As set out in full in section 10 of Part B and in our conclusions in Part C, Gala's right to receive, and the amount of, the Minimum Sums, was not tied to, or dependent in any way upon Gala's asserted exploitation of the Rights, whether by their sub-licensing to SPR or otherwise, and/or on SPR's commercial exploitation of the sub-licensed rights and/or the success of the transaction films.

738. We consider that (1) as Mr Donhue said, it is reasonable to recognise the "present value of the cash inflows expected to be received" under the shortfall guarantee as a sum equal to the principal of the SG loans of around £102 million, and (2) it is relevant to the measurement of the revenue to be recognised that the risk that Gala would not receive this sum was remote given that the shortfall guarantee was guaranteed, in effect, by Barclays under the LC as funded by the Deposit.

739. Mr Steadman suggested that it supports his contrary analysis that, so he said, Gala could not have known what sum to account for in respect of the shortfall guarantee because the Minimum Amount could have turned out to be a sum less than the Initial Expenditure/principal of the SG loans if the transaction films were so successful that Gala received a share of Gross Receipts under the waterfall; under the terms of the DA, any such sums were to be deducted from the Minimum Amount. In our view, (a) that scenario is so remote that it is to be disregarded; for all the reasons set out in section 11 of Part B and in our conclusions in Part C, there was no reasonable prospect of Gala receiving any such sums, and (b) in any event, if that scenario is to be taken into account, we cannot see that it materially affects the overall analysis. The fact remains that the shortfall guarantee ensured that, even if Gala received no Gross Receipts, a specified *minimum* amount would be received by no later than a long stop date of the end of the term of the DA. If Gala received Gross Receipts at an earlier stage, in substance, that would simply accelerate its receipt of all or part of the specified *minimum* sum to that earlier time.

740. Otherwise, the precise basis for Mr Steadman's reasons for disputing that this is the correct analysis is not clear to us. He said that this is not an exchange transaction within Note G and that Note G does not apply to multi-year contracts such as the DA. He seemed to accept at times that, on closing of the transactions, Gala had done all it needed to do in order to be entitled to the Minimum Sums but then said "there is time" and, in general terms, that "royalties" are "earned" over the period of the royalty contract and so accounted for on the "accruals" basis. He did not reference any specific accounting standard he was relying on if he was not relying on Note G and expressly said he was not relying on SSAP 9 which relates to long-term contracts. He accepted that there is no definition of "earned" for accounting purposes but noted that the Principles talk about matching of revenue and receipts associated with the passage of

time, and the concept of matching over a period is at the heart of accounting. We take him there to be speaking of the "accruals" basis. Gala's legal team pointed out that the accruals basis is covered in the Principles (at 5.6 and 5.26 onwards) and there is nothing in the accounting materials before the tribunal that expressly covers the interaction between Note G and the accruals basis although they seemed to suggest that Mr Steadman had explained the interaction satisfactorily.

741. We cannot see that anything Mr Steadman or Gala put forward detracts from the analysis set out above. It is plain that Note G applies to all exchange transactions including long-term, multi-year contracts and that SSAP 9 simply provides more detailed guidance on long-term contracts. As noted, Mr Steadman was clear that he did not rely on SSAP 9. On the normal meaning of the terms Mr Steadman used, a person may be said to have "earned" income, such as a royalty, when the person has done or provided whatever he needs to do in order to be entitled to receive that sum or when whatever other criteria or conditions for the entitlement to receive the sums, as agreed between the relevant parties, have been met. In this case, for the reasons already given, there simply were no such on-going performance criteria (whether as regards the continued sub-licensing of the Rights to SPR or otherwise) upon which Gala's entitlement to, and/or the quantum of, the Minimum Amount (and the other Minimum Sums) depended; the only relevant condition was satisfied in full on closing of the transactions and the Minimum Amount/an equal sum was due on any early termination of the arrangements.

742. We do not accept Mr Vallat's criticism that Mr Donhue accepted certain general propositions but not that the same principle applies in this case, without giving a reasoned basis for this view other than to say Gala had done all it needed to do to earn its income on day 1 (which Gala contends is wrong). When questioned in general terms, Mr Donhue was clear that the precise position depends on particular terms of the arrangements and, for the reasons given, we consider that his view of the effect of these arrangements is correct. We cannot see that there is, as Gala seemed to suggest, the potential for some mismatch between the accruals concept and the revenue recognition criteria within Note G given that the accruals concept is a foundational principle of GAAP.

Conclusion and rights of appeal

743. For all the reasons set out above, the appeal is dismissed and the questions asked in the referral are answered as set out in Part E.

744. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber)

Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

HARRIET MORGAN
TRIBUNAL JUDGE

RELEASE DATE: 4 August 2023