SHAM TRANSACTIONS

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by

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Recent cases have included **Rossendale BC v Hurstwood Properties (A) Ltd [2019] EWCA Civ 364** (business rates; piercing the corporate veil); **Schettini v Silvestri [2019] EWCA Civ 349** (jurisdiction to entertain an appeal against an undertaking); **Sackville UK Property Select II (GP) No.1 Ltd v Robertson Taylor Insurance Brokers Ltd [2018] L&TR 22**; (service of break notice by equitable assignee); **NRAM v Evans [2018] 1 WLR 639** (rectification of the land register);

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I: INTRODUCTION

"The word *Sham* is a true Cant of the Newmarket Breed, It is contracted out of *ashamed*. The native Signification is a Town Lady of Diversion, in Country Maid's Cloathes, who to make good her Disguise, pretends to be so *sham'd*!"

Roger North (d.1734)

What is a 'Sham'?

1. Precise formulations of the legal doctrine of 'sham' differ. However, in modern times, they tend to coalesce around the well-known statement of Diplock LJ in **Snook v West Riding Investments Ltd [1967] 2 QB 766**, at 802C-E:

> "… I apprehend that if [the legal concept of 'sham'] has any meaning in law, it means acts done or documents executed by the parties to the sham which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create. But one thing, I think is clear, in legal principle, morality and authorities … for acts or documents to be a 'sham,' with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating."

2. However, the concept of 'sham' does not comprise a single category of case, but covers a variety of scenarios in which it is said that the parties' written agreement does not reveal everything about what they have agreed. As it was put by Smith LJ in **Firthglow Ltd v Szilagyi [2009] EWCA 98**, at [42]: "The test for a sham must be sensitive to context." That said, in practice, three scenarios are commonly encountered:

    2.1 **The first scenario**: where the party or parties to an arrangement intend to give the false impression to a third party that the arrangement has legal effect, whereas it does not.

    2.2 **The second scenario**: where the language of an arrangement superficially indicates one kind of legal relationship between the parties,

whereas when properly analysed in light of the surrounding circumstances the arrangement falls into another.

3. I will consider each scenario in turn.

II: THE FIRST SCENARIO
WHERE THE PARTY OR PARTIES TO THE ARRANGEMENT INTEND TO GIVE A FALSE IMPRESSION THAT THE ARRANGEMENT HAS LEGAL EFFECT

The Juridical Nature of the Sham

4. The essence of this type of sham transaction was neatly encapsulated by Neuberger J in **National Westminster Bank Plc v Jones [2001] 1 BCLC 98**,[1] at [45]:

> "… the whole point of a sham provision or agreement is that the parties intend to give the impression that they are agreeing that which is stated in the provision or agreement, while in fact they have no intention of honouring with their respective obligations, or enjoying their respective rights, under the provision or agreement."

5. For these purposes, the test of intention is subjective. In the case of a multilateral transaction, the intention must be common to all of the parties: **Stone v Hitch [2001] EWCA Civ 63**, at [66] and [69].[2]

6. Importantly, an allegation of sham in this sense "carries with it a degree of dishonesty" (see **National Westminster Bank**, at [46], per Neuberger J). This is because a sham involves an "element of pretence" where parties do one thing and say another (per Sir Thomas Bingham MR in **Belvedere Court Management Ltd v Frogmore Developments Ltd [1997] QB 858**, at 876).

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[1] Later subject to an appeal, albeit in relation to issues arising under Section 423 of the Insolvency Act 1986: **[2001] EWCA Civ 1541**.

[2] As to what is required to establish the common intention, see e.g. **Midland Bank Plc v Wyatt [1996] BPIR 288**, at 699, per Mr David Young Q.C.: "… 'a sham transaction will still remain a sham transaction even if one of the parties to it merely went along with the 'shammer' not either knowing or caring about what he or she was signing. Such a person would still be a party to the sham …"

7. The forensic consequence of this was made explicit in the **National Westminster Bank** case, at [59], where Neuberger J said:

> "… Because a finding of sham carries with it a finding of dishonesty, because innocent third parties may often rely upon the genuineness of a provision or an agreement, and because the court places great weight on the existence and provisions of a formally signed document, there is a strong and natural presumption against holding a provision or a document a sham. …"

8. It follows that, in order to prove the existence of a sham, cogent evidence will be required: see the familiar observations of Lord Nicholls in **Re H (Minors) (Sexual Abuse: Standard of Proof) [1996] AC 563**, at 586E-587A.

9. Although sham transactions usually involve two or more persons there is, in principle, no difficulty in having a sham unilateral transaction See e.g. **Painter v Hutchison [2007] EWHC 758 (Ch)** (concerning a unilateral declaration of trust).

Artificial Transactions

10. It has been made clear at the highest level of authority that a contractual transaction is not rendered a sham merely because it is entered into for an artificial or an uncommercial purpose. As Arden LJ said in **Stone v Hitch**, at [67]:

> "... A distinction is to be drawn between the situation where the parties make an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship."[3]

[3] See also **ND v SD [2017] EWHC 1507 (Fam)**, at [240], per Roberts J: "… it is important to distinguish between motive as distinct from intention … [Even] an artificial transaction which is put in place for the purpose of asset protection will not necessarily be cast aside as a sham and of no legal effect if all the parties to the transaction genuinely intended the agreements incorporated in the documents in which they appear to take effect …"

11. The distinction between artificial and sham transactions is well-illustrated by the following authorities.

12. In **Wentworth Securities Ltd v Jones [1980] AC 74**, Mr and Mrs Jones were the tenants of a property in Potters Bar. They sought to exercise their rights under the Leasehold Reform Act 1967 and acquire the freehold of the property. By a leaseholder's notice under the Act, dated 5 October 1967, but not served until 8 October, notice was given to Wentworth Securities Co Ltd of their desire to acquire the freehold. It was common ground that, had the matter rested there, the sum payable for the freehold would have been £300. However, on 6 October 1967, between the date of the notice and the date of its service, the freeholder (Wentworth) interposed between the freehold and the tenant's lease a concurrent lease to Wrotham Park Estate Co for a term of 300 years from 25 December 1970, subject to and with the benefit of the lease to the tenants. The effect of this was to increase the premium payable for the freehold from £300 to £4,000. The transaction between Wentworth and Wrotham was admittedly a device to discourage the tenants from acquiring the freehold by exercising their rights under the 1967 Act. Nonetheless, this did not defeat the entitlement to a higher premium.

13. As Lord Diplock said at, 106F-107B:

> "… This somewhat odd, possibly unique and certainly ingenious transaction was not a sham: it was a reality … In my opinion, it was clearly the policy of the legislature under the Act of 1967 that the tenant should obtain the freehold of his home at the ordinary market price and not at a price which had been inflated by a transaction such as the present. I have no doubt that if it had ever occurred to the legislature that a transaction such as the present might have been devised and put into operation, clear words would have been introduced into the Act, which would preclude such a transaction from affecting the market price, which the tenant would have to pay for the freehold of his home. As it is, no such words appear in the Act: and accordingly it contains a gap. It is well settled, however, that the courts have no power to fill in any gap in an Act, even if satisfied, that had the legislature ben aware of the gap, it would have filled it in …"

14. **Hilton v Plustitle Ltd [1989] 1 WLR 149** concerned a transaction designed to avoid the effect of the Rent Act 1977 by relying on a particular statutory

exemption, viz. if a dwelling house is let to a limited company, the company cannot become a statutory tenant under the terms of Section 2 thereof. The facts of the case were as follows: Mr Hilton advertised a flat for rent at 45 Priory Road, London, NW6. He made it clear that any letting would have to be a company let. Miss Rose wished to take the flat. Therefore, she purchased a company off the shelf called Plustitle Ltd and became its sole shareholder and director. On 1 September 1986, the company entered into a written agreement with Mr Hilton to take the flat for an initial term of six months at a rent of £345 per month. The agreement gave the company the right to nominate the occupiers of the property, who would pay no rent. When it came to renewing the tenancy, there was a dispute about the amount of rent to be paid. Mr Hilton then sought possession. Miss Rose refused to leave, contending that the letting to the company was a sham. This argument was rejected at trial and on appeal, where Croom-Johnson LJ said as follows, at 152D-153G:

> "… The mere fact that the purpose of the legal arrangement was to prevent the creation of a statutory tenancy is by itself not enough. In **Aldrington Garages Ltd v Fielder (1978) 37 P&CR 461**, 468, Geoffrey Lane LJ said:
>
> > 'There is no reason why, if it is possible and properly done, agreements should not be entered into which do not fall within the Rent Acts, and the mere fact that those agreements may result in enhanced profits for the owners does not necessarily mean that the agreements should be construed as tenancies rather than licences.'
>
> Roskill LJ said, at p.473:
>
> > 'persons are entitled to arrange their affairs to their best advantage so long as the law allows it. That has long been the position in tax cases, and equally long been the position in Landlord and Tenant and Rent Act cases.'
>
> … In the present case the judge found as a fact that it was the intention of both parties, with all knowledge of what was involved, that the flat should be let to the company and not to Miss Rose personally. This finding has not been challenged. Directing himself in accordance with the law as stated by Diplock LJ in the **Snook** case, he held that this transaction was not a sham. We do not find it possible to fault this reasoning …"

15. In the **Belvedere** case**,** the freeholder of a block of flats in the Hampstead Garden Suburb entered into an apparently artificial transaction with a company it effectively owned as part of an elaborate scheme the purpose of which was significantly to reduce the benefit of the rights which the tenants of the flats would otherwise have had under the provisions of the Landlord and Tenant Act 1987. In proceedings brought in the County Court, the tenants sought declaratory relief that the transaction was a sham intended to deprive the tenants of their rights under the 1987 Act. At trial the judge dismissed this argument. On appeal, Sir Thomas Bingham MR agreed. He said, at 876D-F:

> "… I share the judge' view that these arrangements were not a sham ... The parties were not doing one thing and saying another. I would accept the judge's views that the Atherton leases were an artificial device intended to circumvent a result the Act would otherwise have brought about ... Many transactions between group companies may be artificial. That does not entitle the court in ordinary circumstances to treat such transactions as null …"

16. To a similar effect, in the **National Westminster Bank** case (see above), Neuberger J said, at [30] (in relation to a transaction designed to take advantage of Section 99(13A) of the Law of Property Act 1925):

> "… In the absence of a specific statutory provision to that effect, it appears to me that, as a matter of principle, it is not open to a party to challenge a transaction simply on the basis that it was entered into solely to obtain an advantage as a result of a statutory provision … The fact that the purpose for which a transaction has been entered into can be characterised as artificial in no way invalidates the transaction … [An] artificial transaction is not the same as a sham transaction …"

17. For present purposes, the facts of **National Westminster Bank** are illuminating. In that case, Mr and Mrs Jones granted a tenancy of a farm to a company of which they were the directors and beneficial owners. It was admitted that the formation of the company and the grant of the tenancy were artificial, in that they occurred "solely because the defendants wished to do their best to protect the farming business, and their home, from being taken from them and sold over their heads by the Bank" (judgment, at [36]). During evidence, it became apparent that, when the tenancy was granted, Mr Jones "did not know the level

of rent and instalments" and had no idea "when the rent or the instalments fell due" (judgment, at [49]). Moreover, after the tenancy was granted, the company made "no attempt whatever … to pay any part of the rent" and no thought was given by either Mr and Mrs Jones "in their capacity as landlords … to enforce their rights [e.g. to forfeit the lease]" (judgment, at [54]). Nonetheless, it was not shown that the agreement was a sham. As Neuberger J said, at [68]:

> "… Both principle and the authorities indicate that the court is slow to find that an agreement is a sham, and that, before the court can reach such a conclusion, it must be satisfied that the purported agreement is no more than a piece of paper which the parties have signed with no intention of its having any effect, save that of deceiving a third party and/or the court into believing that the purported agreement is genuine. Taking all the evidence together, I think that the Bank has plainly fallen short of discharging the onus, which it undoubtedly has, of establishing that [the agreement] was a sham …"

Sham in Part Only?

18. As a matter of law, can an instrument be a sham in part but genuine as to the remainder? This was a question which arose in **Stone v Hitch**.

19. **Stone v Hitch** was a second appeal, arising out of a decision of the Special Commissioners (a tax tribunal). The case concerned two complicated agreements. The first agreement was made between three parties, namely, H, C and M. This contained an agreement to grant a 999-year lease of a piece of land ("**the Green Land**") to C in terms of an annexed draft lease, in return for (inter alia) an annual rent calculated by reference to the agricultural value of the land. The second agreement ("**the 1984 Deed**") contained two distinct parts. Under the first part (Clause 1), H created a 999-year lease over another piece of land ("**the Red Land**") in favour of X, in consideration of the payment of £1m. Under the second part (Clause 2), H created a 999-year lease over the Green Land in favour of C (i.e. giving effect to the first agreement). Clause 1(4)(e) of the 1984 Deed expressly provided that X should not be affected by Clause 2. There was no question as to the genuineness of the first part of the 1984 Deed (i.e. the lease granted to X).

20. At trial, it was found that the first agreement was a sham. This was upheld by the Court of Appeal. A follow-on question was whether the 1984 Deed (which gave effect to the first agreement) could ever be held to be a sham. Answering this question in the affirmative, Arden LJ said as follows:

> "[85] I have already noted that it is an established requirement of a sham transaction that the parties should have the common intention that it should not take effect according to its tenor and in addition that a false impression should be given to third parties. But this point raises one of the issues of law that has arisen in this case: common to whom? Mr Price submits that the intention must be common to all the parties to a document save in very exceptional circumstances, which he does not define and which he submits it is not appropriate to define since they were not applicable in this case. Thus, on his submission, all the parties had to have a common intention, and hence the 1984 Deed was incapable on the facts as found by the Special Commissioners of being a sham. He refers to this as the 'all or nothing' principle. Mr Vallance submits that this is not a necessary requirement of a sham, and does not apply where (as here) the document implemented more than one transaction. In principle I accept Mr Vallance's submission. In **Snook's** case Diplock LJ was concerned with the situation where the document implemented a single transaction, and his words must be read in the context of the case before him. In any event, the effect of Mr Price's submission is that the court will be precluded from finding that a document is a sham because it includes an additional provision which is intended to be effective. This might deprive the doctrine of sham of any operation in a situation which is logically indistinguishable from the situation where the doctrine of sham already applies. In my judgment, the law does not require that in every situation every party to the act or document should be a party to the sham. I accordingly reject Mr Price's submission save that I accept that the case where a document is properly held to be only in part a sham will be the exception rather than the rule, and will occur only where the document reflects a transaction divisible into separate parts. For the purposes of this case, it is sufficient that the court can identify two transactions in the document, one in favour of [X] and one in favour of [C]. The first of these two transactions involves a new party. It may be that it is not necessary that there should be a new party but since that point does not arise I need not express a final opinion on it."

21. Thus, where a document reflects a transaction divisible into separate parts, it is possible for one part to be a sham (in the sense described above), whilst the other part is valid and of legal effect.

Once a Sham, Always a Sham? If Genuine, Always Genuine?

22. If a transaction is a sham at the point of creation, can it become genuine at a later point in time? Equally, if a transaction is genuine at the point of creation, can it later become a sham?

23. These points were considered in **A v A [2007] 2 FLR 467**. In that case the allegation of sham was levelled by a wife against two discretionary trusts which held shares in a family business which she and the husband had run throughout a twenty year marriage. The settlors were the husband's father (who had originally established the business) and his brother. The trustees had changed through the life of the trusts but were based offshore in Jersey at the time of the litigation which concerned the wife's entitlement to ancillary (financial) relief arising on divorce. The wife alleged that the trusts were shams and that the husband should be treated as holding a significantly enlarged share of the business.

24. Munby J had to consider the question whether a trust which was not at its point of creation a sham could subsequently become a sham because of the changed intentions of settlor, trustee or both. On this, Munby J said as follows:

> "[42] … Once a trust has been properly constituted, typically by the vesting of the trust property in the trustee(s) and by the execution of the trust deed setting out the trusts upon which the trust property is to be held by the trustee(s), the property cannot lose its character as trust property save in accordance with the terms of the trust itself, for example, by being paid to or applied for the benefit of a beneficiary in accordance with the terms of the trust deed. Any other application of the trust property is simply and necessarily a breach of trust: nothing less and nothing more.
>
> [43] A trustee who has bona fide accepted office as such cannot divest himself of his fiduciary obligations by his own improper acts. If therefore, a trustee who has entered into his responsibilities, and without having any intention of being party to a sham, subsequently purports, perhaps in

agreement with the settlor, to treat the trust as a sham, the effect is not to create a sham where previously there was a valid trust. The only effect, even if the agreement is actually carried into execution, is to expose the trustee to a claim for breach of trust and, it may well be, to expose the settlor to a claim for knowing assistance in that breach of trust. Nor can it make any difference, where the trust has already been properly constituted, that a trustee may have entered into office — may indeed have been appointed as a trustee in place of an honest trustee — for the very purpose and with the intention of treating the trust for the future as a sham. If, having been appointed trustee, he has the trust property under his control, he cannot be heard to dispute either the fact that it is trust property or the existence of his own fiduciary duty."

25. So, it appears as though a disposition cannot subsequently become a sham, if it was genuine at the point of creation. However, the converse is not necessarily true. As Munby J went on to say, at [49]:

> "[49] … Whatever the settlor or anyone else may have intended, and whatever may have happened since it was first created, a trust will not be a sham - in my judgment cannot as a matter of law be a sham - if either:
> (i) The original trustee(s), or
> (ii) The current trustee(s),
> were not, because they lacked the relevant knowledge and intention, party to the sham at the time of their appointment. In the first case, the trust will never have been a sham. In the second case, the trust, even it was previously a sham, will have become a genuine — a valid and enforceable — trust as from the date of appointment of the current trustee(s) …"

Who Can Assert the Existence of a Sham?

26. There is no difficulty in an innocent third party asserting that a document is a sham as between the parties thereto.

27. However, what about the party or parties to the transaction itself? What if (say) an individual purports to execute a declaration of trust in favour of another person in order to conceal assets from HMRC (**Painter v Hutchison**, above)? Or, what if an individual purports to transfer a property to another in order to give a pressing creditor the false impression that he has no (or only limited) assets (**Hussain v Salam [2012] EWHC 1760 (Ch)**)? Can that individual later turn

around and contend, as against the purported beneficiary or the purported transferee, that the transaction in question is a sham?

28. These questions require consideration of what is sometimes called the 'illegality principle.'

29. The classic statement of the principle as it has traditionally been understood remains that of Lord Mansfield CJ in **Holman v Johnson (1775) 1 Cowp 341**, at 343:

> "The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff, by accident if I may so say. The principle of public policy is this; ex dolo malo non oritur actio. No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise ex turpi causa, or the transgression of a positive law of this country, there the court says he has no right to be assisted."

30. Over the past three years, the 'illegality principle' has been considered by the Supreme Court on no fewer than four occasions: see **Allen v Hounga [2014] 1 WLR 2889**, **Les Laboratoires Servier v Apotex Inc [2015] AC 430**, **Bilta (UK) Ltd v Nazir [2016] AC 1**, and most recently **Patel v Mirza [2016] 3 WLR 399**.

31. A detailed exploration of the nature and scope of the illegality principle is outside of the remit of this seminar. For present purposes, it is perhaps sufficient to observe that, even at Supreme Court level, there is sharp disagreement as to whether the principle ought to operate via (i) a 'rule-based' approach (exemplified by e.g. **Tinsley v Milligan [1994] 1 AC 340**) or (ii) a 'range of factors' approach based upon the equities of each individual case. Judicial disagreement on the topic has left the law in "disarray" (**Patel v Mirza**, at [164], per Lord Neuberger).

32. **Patel v Mirza** was heard by a panel of nine. In that case, Mr Patel had given Mr Mirza £620,000 pursuant to an agreement that the money would be used to bet on the price of Royal Bank of Scotland shares on the basis of inside information that Mr Patel thought he was going to receive. That agreement amounted to a conspiracy to commit an offence of insider dealing contrary to section 52 of the Criminal Justice Act 1993. Mr Patel did not receive that information and the bets were never placed. When he sued Mr Mirza for the return of the money, Mr Mirza contended that it was contrary to public policy for the courts to lend their aid to Mr Patel whose claim was reliant on illegality. In analysing the defence of illegality, Lord Toulson SCJ said as follows:

> "[109] The courts must obviously abide by the terms of any statute, but I conclude that it is right for a court which is considering the application of the common law doctrine of illegality to have regard to the policy factors involved and to the nature and circumstances of the illegal conduct in determining whether the public interest in preserving the integrity of the justice system should result in denial of the relief claimed. I put it in that way rather than whether the contract should be regarded as tainted by illegality, because the question is whether the relief claimed should be granted."

33. Thus, Lord Toulson JSC proposed an approach to the illegality principle based upon a 'range of factors.' He said:

> "[120] The essential rationale of the illegality doctrine is that it would be contrary to the public interest to enforce a claim if to do so would be harmful to the integrity of the legal system (or, possibly, certain aspects of public morality, the boundaries of which have never been made entirely clear and which do not arise for consideration in this case). In assessing whether the public interest would be harmed in that way, it is necessary (a) to consider the underlying purpose of the prohibition which has been transgressed and whether that purpose will be enhanced by denial of the claim, (b) to consider any other relevant public policy on which the denial of the claim may have an impact and (c) to consider whether denial of the claim would be a proportionate response to the illegality, bearing in mind that punishment is a matter for the criminal courts. Within that framework, various factors may be relevant, but it would be a mistake to suggest that the court is free to decide a case in an undisciplined way. The public interest is best served by a principled and transparent assessment of the considerations identified, rather by

than the application of a formal approach capable of producing results which may appear arbitrary, unjust or disproportionate."

34. Baroness Hale DPSC, Lord Kerr, Lord Wilson and Lord Hodge JJSC agreed with the approach of Lord Toulson JSC (Lord Kerr giving a short concurring judgment). Lord Neuberger PSC also endorsed this approach. He said:

> "[174] the approach suggested by Lord Toulson JSC … provides as reliable and helpful guidance as it is possible to give in this difficult field. When faced with a claim based on a contract which involves illegal activity (whether or not the illegal activity has been wholly, partly or not at all undertaken), the court should, when deciding how to take into account the impact of the illegality on the claim, bear in mind the need for integrity and consistency in the justice system, and in particular (a) the policy behind the illegality, (b) any other public policy issues, and (c) the need for proportionality.
>
> [175] I must admit that I was initially not attracted by this approach because it seemed close to giving a discretion to judges when it comes to deciding how to deal with a claim based on a contract with an illegal element. However, on further reflection, it appears to me that … the structured approach proposed by Lord Toulson JSC is not akin in practice to a discretion, and, in any event, it is the best guidance that can sensibly be offered at the moment …"

35. The minority of the Supreme Court comprised Lord Mance, Lord Clarke and Lord Sumption JJSC. They preferred a 'rule-based' approach, affording certainty to this area of the law. Rejecting the alternative 'range of factors' approach, Lord Mance said:

> "[206] What is apparent is that this approach, would introduce not only a new era but entirely novel dimensions into any issue of illegality. Courts would be required to make a value judgment, by reference to a widely spread mélange of ingredients, about the overall "merits" or strengths, in a highly unspecific non-legal sense, of the respective claims of the public interest and of each of the parties."

36. To a similar effect, Lord Clarke said:

> "[219] The striking feature of that approach [i.e. the approach taken by Lord Toulson] is as I see it that it puts the question, not whether the contract should be regarded as tainted by illegality but whether the relief claimed should be granted. That seems to me to be essentially a

> question of discretion, or at least a consideration of all the relevant factors in order to decide where the balance should be struck. As I see it, there is no support in any of the authorities for that approach and it is directly contrary to many of the cases referred to by Lord Sumption and Lord Mance JJSC … It would be close to reviving the public conscience test."

37. The third dissenting judgment was given by Lord Sumption JSC. At [262], he considered that the approach of Lord Toulson JSC was "unprincipled." He concluded:

> "[265] For these reasons, I regret that I cannot agree with the conclusion of Lord Toulson JSC (para 109) that that the application of the illegality principle should depend on 'the policy factors involved and … the nature and circumstances of the illegal conduct, in determining whether the public interest in preserving the integrity of the justice system should result in the denial of the relief claimed.' In my opinion, this is far too vague and potentially far too wide to serve as the basis on which a person may be denied his legal rights. It converts a legal principle into an exercise of judicial discretion, in the process exhibiting all the vices of 'complexity, uncertainty, arbitrariness and lack of transparency' which Lord Toulson JSC attributes to the present law. I would not deny that in the past the law of illegality has been a mess. The proper response of this court is not to leave the problem to case by case evaluation by the lower courts by reference to a potentially unlimited range of factors, but to address the problem by supplying a framework of principle which accommodates legitimate concerns about the present law. We would be doing no service to the coherent development of the law if we simply substituted a new mess for the old one."

38. However, since six of the nine Justices of the Supreme Court have approved of the 'range of factors' approach enunciated by Lord Toulson JSC, this may now be taken to be the law (at least until the matter is revisited again at the highest level of authority). This approach has since been adopted in e.g. **Standard Chartered Bank (Hong Kong) Ltd v Independent Power Tanzania Ltd [2016] EWHC 2908 (Comm)** and **Singularis Holdings Ltd v Daiwa Capital Markets Europe Ltd [2018] 1 WLR 2777**.

39. It follows that, in any case where a claimant, who was party to a sham transaction, wishes to assert the existence of the sham, it will be necessary to consider whether it would be contrary to the public interest in maintaining the

integrity of the legal system to enforce his claim. In making such an assessment, the Court will have to weigh up the three factors identified by Lord Toulson JSC, including the question of proportionality. The author is not aware of any authority in which the 'range of factors' approach endorsed by Lord Toulson JSC has been applied in the context of a case involving sham transactions.

Innocent Third Parties

40. A final question to consider: what is the position where the interests of an innocent party (**X**), who contends that an agreement between **A** and **B** is a sham, conflict with the interests of another innocent party (**Y**), who contends that the agreement is genuine? Whose interest should prevail? This is a point on which there is no authority. It was left open by Neuberger J in the **National Westminster Bank** case, at [60]. So, watch this space!

III: THE SECOND SCENARIO
WHERE THE LANGUAGE OF AN ARRANGEMENT SUPERFICIALLY INDICATES ONE KIND OF LEGAL RELATIONSHIP BETWEEN THE PARTIES

Introduction

41. No-one could argue with Lord Templeman that "the manufacture of a five-pronged implement for manual digging results in a fork even if the manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade" (**Street v Mountford [1985] AC 809**, at 819). Following this beguilingly simple assertion, however, one quickly encounters a number of cases that have led to considerable uncertainty as to when an agreement might properly be classified as one thing, when it is labelled as another.

42. This uncertainty comes about because, whereas parties are free to enter into what contracts they please (subject to questions of illegality and public policy), they are not competent to determine the nature of the relationship created by the terms of the contract into which they have freely entered: see e.g. **Weiner v Harris [1910] 1 KB 224**, at 290, per Cozens-Hardy MR:

> "… Two parties enter into a transaction and say 'It is hereby declared there is no partnership between us.' The Court pays no regard to that. The Court looks at the transaction and says 'Is this, in point of law, really a partnership? It is not in the least conclusive that the parties have used a term or language intended to indicate that the transaction is not that which in law it is.' …"

43. The meaning of the contract (in the sense of determining what is the substance of the obligations into which the parties have entered) is a question of interpretation; that is of ascertaining the meaning that would be understood by a reasonable reader with the background knowledge of the parties. However, the legal effect of the contract is to be determined as a matter of law; not as a matter of interpretation.

Some Examples

44. The scenario described above has frequently arisen in the landlord and tenant context. There are numerous examples. For present purposes, two might suffice.

45. The first example is the leading decision of **Street v Mountford**. There, Mr Street had granted to Mrs Mountford the right to occupy rooms for a weekly rent, subject to termination by written notice. The terms were set out in a written agreement, which was called a 'licence.' It was conceded that Mrs Mountford had exclusive possession. The House of Lords held that the agreement was a tenancy. The parties were free to attach their own label to the agreement. In the words of Lord Templeman, at 826-827:

> "By the agreement Mrs. Mountford was granted the right to occupy residential accommodation. The landlord did not provide any services or attendance. It was plain that Mrs. Mountford was not a lodger ... But in addition to the hallmark of exclusive occupation of residential accommodation there were the hallmarks of weekly payments for a periodical term. Unless these three hallmarks are decisive, it really becomes impossible to distinguish a contractual tenancy from a contractual licence save by reference to the professed intention of the parties or by the judge awarding marks for drafting ...
>
> My Lords, the only intention which is relevant is the intention demonstrated by the agreement to grant exclusive possession for a term at a rent. Sometimes it may be difficult to discover whether, on the true construction of an agreement, exclusive possession is conferred. Sometimes it may appear from the surrounding circumstances that there was no intention to create legal relationships. Sometimes it may appear from the surrounding circumstances that the right to exclusive possession is referable to a legal relationship other than a tenancy. Legal relationships to which the grant of exclusive possession might be referable and which would or might negative the grant of an estate or interest in the land include occupancy under a contract for the sale of the land, occupancy pursuant to a contract of employment or occupancy referable to the holding of an office. But where as in the present case the only circumstances are that residential accommodation is offered and accepted with exclusive possession for a term at a rent, the result is a tenancy."

46. The second example is **Antoniades v Villiers [1990] 1 AC 417**. There, the landlord, by separate but identical agreements entered into contemporaneously,

granted a young man and his girlfriend, whom the landlord knew would be living as husband and wife, the right to occupy in his property the top flat comprising a bedroom, a sitting room with a bed-settee and fold-up bed table, a kitchen and a bathroom. The agreements were expressed to be licences and stated, inter alia, that the Rent Acts did not apply, that 'the licensor is not willing to grant . . . exclusive possession' and that the use of the rooms was 'in common with the licensor and such other licensees or invitees as [he] may permit from time to time to use the said rooms.' The landlord later served on the occupants a notice to quit. The House of Lords held that the purported right of the landlord to introduce further occupiers into the flat was a pretence to avoid the provisions of the Rent Acts whereas in reality there had been an intention to confer on the occupants exclusive possession of the flat for a term in consideration of periodical payments. Accordingly, a tenancy had been created. At 454, Lord Bridge said:

> "Here the artificiality was in the pretence that two contemporaneous and identical agreements entered into by a man and a woman who were going to live together in a one-bedroom flat and share a double bed created rights and obligations which were several rather than joint. As to the nature of those rights and obligations, the provisions of the joint agreement purporting to retain the right in the respondent to share the occupation of the flat with the young couple himself or to introduce an indefinite number of third parties to do so could be seen, in all the relevant circumstances, to be repugnant to the true purpose of the agreement. No one could have supposed that those provisions were ever intended to be acted on. They were introduced into the agreement for no other purpose than as an attempt to disguise the true character of the agreement which it was hoped would deceive the court and prevent the appellants enjoying the protection of the Rent Acts. As your Lordships all agree, the attempt fails."

47. To a similar effect, at 463, Lord Templeman said:

> "... The owner's real intention was to rely on the language of the agreement to escape the Rent Acts. The owner allowed the occupiers to enjoy jointly exclusive occupation and accepted rent. A tenancy was created. **Street v Mountford** reasserted three principles. First, parties to an agreement cannot contract out of the Rent Acts. Secondly, in the absence of special circumstances, not here relevant, the enjoyment of exclusive occupation for a term in consideration of periodic payments creates a tenancy. Thirdly, where the language of licence contradicts the

reality of lease, the facts must prevail. The facts must prevail over the language in order that the parties may not contract out of the Rent Acts. In the present case clause 16 was a pretence.

The fact that clause 16 was a pretence appears from its terms and from the negotiations. Clause 16 in terms conferred on Mr Antoniades and other persons the right to share the bedroom occupied by Mr. Villiers and Miss Bridger. Clause 16 conferred power on Mr Antoniades to convert the sitting-room occupied by Mr Villiers and Miss Bridger into a bedroom which could be jointly occupied by Mr Villiers, Miss Bridger, Mr Antoniades and any person or persons nominated by Mr Antoniades. The facilities in the flat were not suitable for sharing between strangers. The flat, situated in an attic with a sloping roof, was too small for sharing between strangers. If clause 16 had been genuine there would have been some discussion between Mr Antoniades, Mr Villiers and Miss Bridger as to how clause 16 might be operated in practice and in whose favour it was likely to be operated. The addendum imposed on Mr Villiers and Miss Bridger sought to add plausibility to the pretence of sharing by forfeiting the right of Mr Villiers and Miss Bridger to continue to occupy the flat if their double-bedded romance blossomed into wedding bells ..."

48. Other cases involving similar sorts of considerations include **Crancour Ltd v Da Silvaesa (1986) 18 HLR 265**, **Mikeover Ltd v Brady [1989] 3 All ER 618**, **Aslan v Murphy [1990] 1 WLR 766**, **Bankway Properties Ltd v Pensfold-Dunsford [2001] EWCA Civ 528** and London **College of Business Ltd v Tareem [2018] EWHC 437 (Ch)**.

A Search for Principle?

49. In **Aslan v Murphy**, at 770-771, Lord Donaldson MR said:

"Prima facie, the parties must be taken to mean what they say, but given the pressures on both parties to pretend, albeit for different reasons, the courts would be acting unrealistically if they did not keep a weather eye open for pretences, taking due account of how the parties have acted in performance of their apparent bargain. This identification and exposure of such pretences does not necessarily lead to the conclusion that their agreement is a sham, but only to the conclusion that the terms of the true bargain are not wholly the same as those of the bargain appearing on the face of the agreement."

50. However, is there any guiding principle as to when the Court might (to adopt the language of Lord Donaldson) 'identify and expose' the sort of pretence here

described? When, and in what circumstances, might the Court ignore the written terms of a document in favour of the 'true' agreement between the parties?

51. Here, useful reference may be made to **Autoclenz Ltd v Belcher [2011] ICR 1157**. Autoclenz provided car-cleaning services to motor retailers and auctioneers. It was involved in a dispute with 20 individual valeters who provided car-cleaning services. Those individuals claimed that they were "workers" within the meaning of certain Regulations; and that, as workers, they were entitled to be paid the national minimum wage / to receive statutory paid leave. The resolution of this issue depended on whether or not they had entered into a "contract of employment" (a classic description of which is to be found in the judgment of MacKenna J in **Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance [1968] 2 QB 497**, at 515C). The contract between Autoclenz and each individual was found in two documents, both of which gave the impression that the relationship was intended to be one of contractor / sub-contractor. The first document, not signed by the individual, included the following:

> "For the purpose of providing car valeting services to its client's garages, Autoclenz wishes to engage the services of car valeters FROM TIME TO TIME on a sub-contract basis. We understand that YOU ARE AN EXPERIENCED CAR VALETER and might be prepared to offer your services to Autoclenz. If so would you please complete and return to us the form of agreement set out below, which is intended to confirm that any contractual relationship between Autoclenz and yourself is one of client and independent contractor and not one of employer/employee and to protect Autoclenz against any claim on Autoclenz for income tax and/or national insurance contributions in respect of payments made to yourself. For the avoidance of doubt, as an independent contractor, you are entitled to engage one or more individuals to carry out the valeting on your behalf, provided that such an individual is compliant with Autoclenz's requirements of sub-contractors as set out in this agreement …"

52. The document concluded:

> "If you wish to provide services to Autoclenz would you please sign and return to Autoclenz the form agreement attached. YOU WILL NOT BE OBLIGED TO PROVIDE YOUR SERVICES ON ANY PARTICULAR OCCASION NOR, IN ENTERING INTO SUCH AGREEMENT, DOES

AUTOCLENZ UNDERTAKE ANY OBLIGATION TO ENGAGE YOUR SERVICES ON ANY PARTICULAR OCCASION."

53. The second document, which was signed, described the individual as a sub-contractor throughout. It was expressly agreed that it was the intention of the parties that the sub-contractor was not and should not become an employee of Autoclenz.

54. Notwithstanding the written terms of the documents, the Supreme Court unanimously held that the individuals were workers who had entered into a contract of employment. The only judgment was given by Lord Clarke. At [29], he said that the question in "every case" was "the true agreement between the parties." He went on, at [31], to endorse the following observations of Smith LJ in the Court of Appeal:

> "… where there is a dispute as to the genuineness of a written term in a contract, the focus of the enquiry must be to discover the actual legal obligations of the parties. To carry out that exercise, the tribunal will have to examine all the relevant evidence. That will, of course, include the written term itself, read in the context of the whole agreement. It will also include evidence of how the parties conducted themselves in practice and what their expectations of each other were. Evidence of how the parties conducted themselves in practice may be so persuasive that the tribunal can draw an inference that that practice reflects the true obligations of the parties."

55. However, in focusing on the 'true' intentions of the parties, one has to be careful not to concentrate too much on what were the private intentions. In this regard, at [32], Lord Clarke agreed with the following remarks of Aikens LJ in the Court of Appeal:

> "What the parties privately intended or expected (either before or after the contract was agreed) *may* be evidence of what, objectively discerned, was actually agreed between the parties: see Lord Hoffmann's speech in the **Chartbrook** case **[2009] AC 1101**, paras 64–65. But ultimately what matters is only what was agreed, either as set out in the written terms or, if it is alleged those terms are not accurate, what is proved to be their actual agreement at the time the contract was concluded. I accept, of course,

that the agreement may not be express; it may be implied. But the court or tribunal's task is still to ascertain what was agreed."

56. It is fair to point out that employment cases are decided is very different to an ordinary commercial contract dispute. Indeed, at [34], Lord Clarke expressly recognised that the circumstances in which contracts relating to work or services are concluded are often very different from those in which commercial contracts between parties of equal bargaining power are agreed. Frequently, organisations which are offering work or requiring services to be provided by individuals are in a position to dictate the written terms which the other party has to accept. In practice, in the employment context, it may be more common for a court or tribunal to have to investigate allegations that the written contract does not represent the actual terms agreed and the court or tribunal must be realistic and worldly wise when it does so.

57. Nonetheless, as a matter of principle, there is no reason why the approach in **Autoclenz** ought not to be applied in any other context. Indeed, in **Secret Hotels2 Ltd v HMRC [2014] UKSC 16**, at [32], Lord Neuberger said:

> "… When interpreting an agreement, the court must have regard to the words used, to the provisions of the agreement as whole, to the surrounding circumstances in so far as they were known to both parties, and to commercial common sense. When deciding on the categorisation of a relationship governed by a written agreement, the label or labels which the parties have used to describe their relationship cannot be conclusive, and may often be of little weight …"

58. Thus, when the Court is asked to determine the "true agreement" between the parties, it needs to look at "all the circumstances of the case, of which the written agreement is only a part" (Lord Clarke, at [35]). This is what might be described as a 'purposive approach' to the problem.[4] In carrying out this exercise, the court will "identify the rights and obligations of the parties as a matter of construction of the written agreement; but it will then go on to consider whether those obligations

[4] More recently, **see Pimlico Plumbers Ltd v Smith [2017] ICR 657**, at [144], where Underhill LJ said that "tribunals will look narrowly at lawyer-drafted documentation which does not appear to correspond to the reality of the relationship." See further **Uber BV v Aslam [2018] EWCA Civ 2748** (currently on appeal to the Supreme Court).

fall within the relevant legal description" (per Lewison J in **A1 Lofts Ltd v Revenue and Customs Commissioners [2010] STC 214**, at [40]).

59. Notwithstanding all of the foregoing, the label which the parties give to the relationship into which they have entered may be of some relevance in seeking objectively to ascertain their presumed intention. Indeed, the label may also be of considerable importance in borderline cases in deciding whether a contract answers some legal description. In **Massey v Crown Life Insurance Co [1978] 1 WLR 676**, at 679, Lord Denning M.R. said:

> "… if the true relationship of the parties is that of master and servant under a contract of service, the parties cannot alter the truth of that relationship by putting a different label upon it. … On the other hand, if the parties' relationship is ambiguous and is capable of being one or the other, then the parties can remove that ambiguity, by the very agreement itself which they make with one another. The agreement itself then becomes the best material from which to gather the true legal relationship between them."[5]

60. For this reason, where an agreement has been negotiated between parties of equal bargaining power, with the benefit of legal advice, the court will often be reluctant to disregard the parties' express statements as to the nature of the relationship created: see **Clear Channel UK Ltd v Manchester City Council [2006] 1 EGLR 27**, at [29], per Jonathan Parker LJ. According to **Megarry & Wade, The Law of Real Property (8th ed)**, at paragraph 17-025: "As a consequence, it is becoming increasingly clear that, in the business context, the courts are less likely to adopt an interventionist approach, and that it may therefore be more difficult for an occupier of commercial property to establish that a tenancy has been granted where the terms of the agreement indicate that the parties did not intend the conferment of anything more than a licence".

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[5] See also **Stringfellow Restaurants Ltd v Quashi [2012] EWCA Civ 1735**, at [52], per Elias LJ ("… it is legitimate for a court to have regard to the way in which the parties have chosen to categorise the relationship, and in a case where the position is uncertain, it can be decisive …"); and **MJP Media Services Ltd v HMRC [2012] EWCA Civ 1558**, at [77], per Lewison LJ ("… where there is real difficulty in characterising a transaction, the label that parties attach to it can be of value in resolving the difficulty …").