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Form, substance and recharacterisation

Pey Woan LEE
Singapore Management University, pwlee@smu.edu.sg

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PEY-WOAN LEE*

I. INTRODUCTION

At common law, a court may 'recharacterise' a contract when it is satisfied that the transaction it embodies is substantially different from the label assigned to it by the parties. This process of recharacterisation is well-established in many legal spheres including those of employment, trusts, property, taxation and secured financing. Whether a transaction should be recharacterised is routinely said to depend on its 'substance'. Typically, this refrain is made to underscore the point that a court will not be bound by the label or form selected by the parties. However, precisely what constitutes 'substance' is less clear. Generally, a party seeking to recharacterise a transaction may do so on one of two grounds: first, that the transaction was a sham and hence unenforceable; or secondly, that on a true construction of the document, the transaction belongs to a category different from that identified by the parties. So expressed, these techniques engender the impression that recharacterisation – the location of 'substance' – is largely a matter of doctrinal analysis free from value judgment. But a closer inspection will reveal that the process is more textured and fine-grained.

This chapter examines the jurisprudence of recharacterisations in the areas of tenancy, employment, trusts and financing arrangements.[1] It argues that the characterisation of a transaction is always a question of law informed by policy considerations. Specifically, recharacterisations are concerned with *avoidances* so the central question is whether and to what extent parties are legally permitted to 'contract out' of a statutory regime or the legal incidents of a relationship. As such, the process of recharacterisation is neither reducible to the application of narrow legal doctrines nor merely an exercise in contractual interpretation. As will be observed, English courts generally incorporate policy considerations in this discourse but are accustomed to presenting them as ancillary (rather than primary) justifications in their reasoning. Only in legislative contexts such as those protecting tenants or employees where the policy underpinnings are unambiguous is a court likely to base a decision squarely on the pursuit of the legislative goal. In other cases, they are wont to retreat to the sanctuary of rules and doctrines. On the whole, therefore, the English judicial method in this context is more

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[1] Questions of characterisation are also common in tax disputes but that is an area better left to specialist treatment.

formal than substantive.[2] This predilection is not objectionable or detrimental where the relevant substantive concerns are balanced and embedded in the formal rules. But formal reasoning may descend into formalistic reasoning if the rules so harden as to eclipse important substantive concerns. This chapter contends that this risk subsists in recharacterisation cases. To minimise that risk, it is critical that judges articulate the interplay of values, policies and doctrines resulting in a particular characterisation. Similarly, courts should develop the broad techniques of recharacterisation (viz, shams and construction) more flexibly to make room for the evaluation of substantive reasons.

II. THE NATURE OF RECHARACTERISATION

Questions of characterisation arise in a wide variety of contexts. The characterisation of a particular issue in a dispute may, for example, determine which system of law is applicable to resolve that dispute.[3] The remedial consequence of a breach of obligation may depend on whether the obligation is 'fiduciary' in character.[4] Or a term of a contract may be unenforceable if it were properly characterised as a 'penalty'.[5] This chapter is concerned with characterisation in a narrower context, viz, situations where the characterisation of a transaction has been expressed in written form but which is challenged on the ground that the form is not reflective of its substance.

At the outset, it is necessary to clarify that the process of characterisation is distinguished from that of interpretation or construction.[6] The latter is concerned with ascertaining the meaning of words and language so as to determine their application to a set of facts whereas the former seeks to identify the legal category of a transaction in order to determine its legal effects. However, characterisation and interpretation are also intertwined in that characterisation is premised on an accurate understanding of the intended effects of the conduct constituting the transaction. In other words, a transaction can only be characterised if the conduct making up the transaction has first been construed. Where the transaction is effected by a written document, the construction of the document will, of course, precede categorisation.

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[2] PS Atiyah and RS Summers, *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions* (Oxford, Clarendon Press, 1987).

[3] *Macmillan v Bishopsgate (No 3)* [1996] 1 WLR 387.

[4] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

[5] *Cavendish Square Holding BV v Makdessi*; *ParkingEye Ltd v Beavis* [2015] UKSC 67, [2016] AC 1172.

[6] G McMeel, *The Construction of Contracts: Interpretation, Implication and Rectification*, 3rd edn (Oxford, Oxford University Press, 2017) para 1.20.

This inter-relation of construction and characterisation is summed up by Lord Millett in *Agnew v Commissioner of Inland Revenue*, a case concerned with the characterisation of charges, as a two-stage process:

> At the first stage it must construe the instrument of charge and seek to gather the intentions of the parties from the language they have used. But the object at this stage of the process is not to discover whether the parties intended to create a fixed or a floating charge. It is to ascertain the nature of the rights and obligations which the parties intended to grant each other in respect of the charged assets. Once these have been ascertained, the court can then embark on the second stage of the process, which is one of categorisation. This is a matter of law. It does not depend on the intention of the parties. If their intention, properly gathered from the language of the instrument, is to grant the company rights in respect of the charged assets which are inconsistent with the nature of a fixed charge, then the charge cannot be a fixed charge however they may have chosen to describe it.[7]

On this account, characterisation comprises: first, an interpretive stage to establish the intended rights and obligations as a matter of fact; and secondly, an analytical or evaluative stage where the court decides how those rights and obligations ought to be classified as a matter of law. Differentiating between these distinct stages is important as the evaluative nature of the second stage is often overlooked or concealed. In order to decide if an act or transaction falls within a particular legal category, the court is first required to distill the 'objective criterion' that defines that particular category.[8] That process of abstraction invariably requires an appraisal of the values pertinent to the issue in question. Writing extra-judicially, Chief Justice Allsop explains the process as 'one where a *value judgment* is made by reference to ascribed meaning, found facts, an expressed principle or rule and the relevantly organised values that are to be brought to bear for the task'.[9] Thus, a court that has to decide if a particular relationship is fiduciary in nature would first have to identify the values that define such relationships. That defining value – protecting those vulnerable to abuse by reason of reposing trust, confidence and power in another – is gleaned not by syllogistic reasoning or logical interpretation alone but also by an appreciation of the characteristics and policy underpinnings of accepted categories of fiduciaries (such as trustees, agents and directors).[10] An exercise in characterisation therefore encompasses but is more than, and distinct from, mere

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[7] *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28, [2001] 2 AC 710 [32] ('*Brumark*').

[8] *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148, 160 ('*Welsh Development*'). Eg, the criterion applicable to tenancy relationships is that of 'exclusive possession', the employer's 'control' in the case of employment relations, and the 'divestment of ownership' in the context of trusts.

[9] J Allsop, 'Characterisation: Its Place in Contractual Analysis and Related Enquiries' (2017) 91 *Australian Law Journal* 471, 471 (emphasis added).

[10] ibid 474.

interpretation.[11] The failure to keep the two processes apart may sometimes obscure the true justifications of a particular characterisation.

For *recharacterisation*, the evaluative function of the process bears an additional dimension as courts are essentially tasked to decide the legitimacy of attempts to avoid particular legal classifications and their attendant legal consequences. Or, to take an alternative perspective, it is a process that *delimits contractual or individual freedom*. For that reason, the process of recharacterisation inevitably involves the assessment of the social, moral or economic aims of a particular legal regime. Specifically, courts would have to weigh the value of self-determinacy against the interests protected by the legal regime that is being circumvented. That tension is not resolved by simply uncovering the factual meaning of parties' conduct (for example, interpretation) but requires the reasoned prioritisation of competing interests. Recharacterisation thus encapsulates a normative inquiry as to what legal consequences *ought* to be, and not merely what they are.

Seen in this light, recharacterisation functions as a judicial tool for policing illegitimate avoidances.[12] That explains why the exercise would often require departures from the usual rules of contractual or documentary construction. Where the contractual or written form is itself the means by which parties seek to circumvent a particular legal regime, the court must be able to look past that form to ascertain what the real transaction is in order to decide how *that* transaction should be characterised. It must have access to evidence extrinsic to the written contract or document, including the parties' subjective intention and subsequent conduct,[13] for

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[11] Allsop cites the classification of contractual terms as an instance of such conflation: ibid 478–80. In that context, the question whether a term is a condition, warranty or innominate term is said to depend on parties' intention as discerned from the contract taking into account the contract's 'nature, purpose and circumstances' (*Bunge Corporation New York v Tradax Export SA, Panama* [1981] 1 WLR 711, 717). But while the discovery of 'parties' intention' is customarily thought to be a matter of interpretation, courts would in fact have to evaluate the importance of the term and the seriousness of its breach to decide if it is a condition or an innominate term (see *Torvald Klaveness A/S v Arni Maritime Corp* [1994] 1 WLR 1465, 1476 where Lord Mustill observed that '[the] classification of an obligation as a condition or an "innominate" term is largely determined by its practical importance in the scheme of the contract'). The classification of terms, therefore, is necessarily 'framed by an understanding of the context (including commercial context) and imperatives of a given contract or type of contract. It is from that understanding that the relevant values are drawn' (ibid 481).

[12] See, in relation to shams, M Stewart, 'The Judicial Doctrine in Australia' in E Simpson and M Stewart (eds), *Sham Transactions* (Oxford, Oxford University Press, 2014) para 3.56. See also *Re Watson* (1890) 25 QBD 27, 33.

[13] *Hitch v Stone* [2001] EWCA Civ 63, [2001] STC 214 [65]–[66].

otherwise it would be 'led by the nose into the artificial task of defining the legal rights and obligations of the parties by reference to their proved documents and related conduct alone'.[14]

III. FORMAL AND SUBSTANTIVE REASONING

Understanding recharacterisation in this way makes clear that the courts' reference to 'substance' in this context is but a shorthand for the composite analysis that it undertakes. Such an analysis looks past the parties' labels to take into account the interpretation of the written document, the nature of the transaction or relationship that parties are purporting to create, the policy concerns residing in the relevant legal or legislative context and the extent to which it is permissible to 'contract out' of that legal or regulatory framework.[15] To the extent that such an approach requires the court to articulate the policy reasons for a particular characterisation, this emphasis on 'substance' may be seen as instances of substantive reasoning. According to Patrick Atiyah and Robert Summers, substantive reasoning is characterised by the use of 'moral, economic, political, institutional or other social consideration' to justify an outcome.[16] It is contrasted with formal reasoning, which bases a decision on legally authoritative precepts, such as legal rules, to exclude from consideration other countervailing substantive reasons.[17] However, the discussion below will suggest that English courts have not, in cases of recharacterisation, always equated 'substance' with substantive reasoning. Instead, they do often, in keeping with the general preference for formal reasoning, apply formal rules and doctrines to ascertain the 'substance' of a transaction. This is not in itself problematic because frequently, the rule and doctrine being applied is itself founded on adequate substantive reasoning. But formal reasoning may degenerate into formalistic reasoning, which is detrimental, when there is 'a failure to take substantive considerations into account *when they ought to be taken into account*'.[18] This may occur when formal reasoning so dominates as to conceal or suppress policy concerns germane to the issue at hand.

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[14] *Raftland Pty Ltd as Trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21, (2008) 238 CLR 516 [151].

[15] Without so expanding, the term 'substance' is a type of 'meaningless reference' as it does not, by itself, provide any specific basis for drawing a particular conclusion: J Stone, *Legal System and Lawyers' Reasoning* (London, Stevens & Sons Ltd, 1964) 241.

[16] Atiyah and Summers, above n 2, 1.

[17] ibid 2.

[18] ibid 29.

IV. RECHARACTERISATION TECHNIQUES

In *Welsh Development Agency v Export Finance Co Ltd*,[19] Staughton LJ identified two recharacterisation techniques. The first is to establish the written document as a 'sham' that does not represent the parties' true position. Absent evidence of sham, the second route is to characterise the transaction by interpreting the written document to ascertain the nature and effects of its terms. A key distinction between the two techniques is that the first 'external' route allows the court to look to extrinsic evidence to prove the existence of a *separate* agreement that is not reflected by the written contract, whilst the second 'internal' route considers principally the parties' agreement 'on the basis that the parties intended to be bound by its terms, *and nothing else*'.[20] The latter, in so far as it requires only proof of internal inconsistency, is commonly thought to be a matter of contractual interpretation.[21]

Although 'sham' reasoning has been employed in a wide range of contexts, its precise scope and rationale remain unsettled. Modern expositions invariably begin with Diplock LJ's dictum in *Snook v London and West Riding Investments Ltd*,[22] which confined 'shams' to situations where parties enter into a false transaction with the common intention to mislead a third party. So defined, the concept is of very limited application. Quite apart from the high threshold for proof of dishonest collusion, courts are unwilling to make findings of sham that have the effects of castigating parties as dishonest and undermining commercial certainty.[23] As a result, courts confronting blatant instances of avoidance have on occasion had to either extend the concept to include cases where only one party acted with the intention to mislead, or developed adjacent principles (such as 'pretences') to recharacterise the transaction in question. In other contexts, courts have adhered to a narrow concept of 'sham' but also applied the 'internal' route more robustly to police avoidances. On the whole, the judicial approach to 'shams' is mixed: it is

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[19] *Welsh Development* [1992] BCLC 148.

[20] *Welsh Development* [1992] BCLC 148, 187 (emphasis added).

[21] 'Once the documents are accepted as genuinely representing the transaction into which the parties have entered, its proper legal categorization is a matter of construction of the documents': *Orion Finance Ltd v Crown Financial Management Ltd* [1996] 2 BCLC 78, 84 (Millett LJ) ('*Orion*').

[22] *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786, 802 ('*Snook*'): '[sham] 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 intend to create. But one thing, I think, is clear in legal principle, morality and the authorities … that for acts or documents to be a "sham," with whatever legal consequences follow form 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' (footnotes omitted).

[23] *National Westminster Bank plc v Jones* [2001] EWCA Civ 1541, [2001] 1 BCLC 98 [59] ('*Westminster Bank*').

more flexible and substantive in contexts (such as tenancy and employment) where the strength of the legislative policy warrants a robust response, but more formal and restrictive in cases (such as those in trusts and financing) where legal certainty is prioritised above other concerns.

The 'internal' route of recharacterisation is employed when there is no apparent discordance between the form of the transaction and the parties' actual practice but the legal incidents of the transaction do not in fact correspond to those of the named category. Because its focus is on the terms of the document or contract, this technique may sometimes be construed as a mere interpretative exercise centred on the parties' contractual intention. As explained,[24] this is a reductive view of recharacterisation since the process is in fact interpretive *and* evaluative. Conceiving the process as one of construction or interpretation alone may also result in formalistic reasoning if it misleads the court to place excessive weight on the language chosen by parties (or, in the case of statutory interpretation, the literal meaning of a statute). Fortunately, English courts have (in the contexts considered below) generally avoided this pitfall by incorporating substantive reasoning into the 'construction' process. Nevertheless, the risk of formalistic reasoning subsists as formal reasoning remains dominant, such that substantive reasons are usually cited only as secondary reasons for a preferred characterisation.

V. TENANCY AGREEMENTS

In this context, English courts have employed recharacterisation techniques principally to counteract illegitimate avoidances of tenancy protection legislation. Typically, they are situations where landlords sought to disguise leases as licences to avoid statutory controls on rent or security of tenure. Although these devices have largely receded with the deregulation of the private rental market from the 1980s,[25] the cases decided in this context remain important examples of the situations in which recharacterisations are appropriate.

In the leading case of *Street v Mountford*,[26] the House of Lords characterised an agreement granting exclusive possession as a lease even though it was labelled as a licence. As the sole factual criterion for distinguishing between a lease and a licence is that of exclusive possession, the agreement is a lease once that criterion is satisfied; the parties could not alter that legal characterisation simply by giving it a different name. In the famous words of Lord Templeman, 'The manufacture of a five-pronged implement for manual digging results in a fork even if the

[24] See above, Section II.

[25] S Bright, H Glover and J Prassl, 'Tenancy Agreements' in E Simpson and M Stewart (eds), *Sham Transactions* (Oxford, Oxford University Press, 2013) paras 6.52–6.54.

[26] *Street v Mountford* [1985] AC 809 ('*Street*').

manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade'.[27]

Street was arguably a decision reached via the internal route as it was not alleged that the agreement involved a sham.[28] The fact of exclusive possession was conceded,[29] and the court's only task was to decide if that operative feature was consistent with the agreement's stated form. Nevertheless, Lord Templeman made clear that the court would have been equally 'astute to detect and frustrate sham devices and artificial transactions whose only object is to disguise the grant of a tenancy and to evade the Rent Acts'.[30] In practice, however, shams in the *Snook* sense are rare in this context as tenants would not usually have shared in the landlord's evasive intention. More commonly, the landlord would have sought to include in the agreement provisions denying exclusive possession, which the tenant accepted either without understanding or without belief that they would be enforced. In *Antoniades v Villiers*,[31] a landlord letting a single room to a couple sought to create a licence by including in the agreements a clause (Clause 16) that allowed him (or his nominee) to enter and share the room with the couple. The House of Lords held that Clause 16 was a 'pretence' rather than a genuine reservation of power to share occupation with the tenants.[32] A critical factor that led to this finding was the observation that the premises was too small for sharing between strangers.[33] Given that the couple were seeking a quasi-matrimonial home, there was 'an air of total unreality' in the terms seeking to negate the grant of exclusive possession.[34] The agreements in question therefore created a lease and the tenants were protected under the Rent Acts.

Antoniades was seen by some commentators to have extended 'shams' beyond that conceived in *Snook* because there was no finding in that case that the tenants had shared in the landlord's intention not to rely on Clause 16.[35] Instead, it was emphasised that tenants typically

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[27] *Street* [1985] AC 809, 819.

[28] Bright analysed *Street* as a 'labelling' case that fell within the ambit of the internal route: see S Bright, 'Avoiding Tenancy Legislation: Sham and Contracting Out Revisited' (2002) 61 *CLJ* 146, 159.

[29] *Street* [1985] AC 809, 823.

[30] ibid, 825.

[31] *Antoniades v Villiers* [1990] 1 AC 417 ('*Antoniades*').

[32] *Antoniades* [1990] 1 AC 417, 463.

[33] ibid.

[34] *Antoniades* [1990] 1 AC 417, 467.

[35] Bright also observed that 'Lord Templeman was seeking [in *Antoniades v Villiers*] to develop a flexible doctrine, free from the constraints of the *Snook* definition of sham, that would apply whenever an agreement has been artificially structured so as to be tantamount to contracting out of the Rent Acts'. See S Bright, 'Beyond Sham and into Pretence' (1991) 11 *OJLS* 136, 139–40. See further B MacFarlane and E Simpson, 'Tackling

had no real choice in the inclusion of such clauses because '[a] person seeking residential accommodation may sign a document couched in any language in order to obtain shelter'.[36] Moreover, the pretence that was operative in *Antoniades* also differed from *Snook* shams in that it related only to a particular term of the contract rather than the validity of the agreement as a whole.

Subsequent courts that found the *Snook* constraints obstructive welcomed the flexibility inherent in the broader notion of 'pretence'. In *Bankway Properties Ltd v Pensfold-Dunsford*, Arden LJ explained *Antoniades* as an application of the doctrine of pretence, a 'variant' of the *Snook* sham.[37] This doctrine, according to Arden LJ, applies where the court has to resolve an issue by discovering 'the substance and reality of the transaction entered into by the parties'.[38] For that purpose, it may look at all relevant circumstances, including subsequent conduct, but proof of a common intention to deceive is not needed.[39] Applying the doctrine to the facts, Arden LJ struck down as a pretence a rent review clause that purported to increase the rent to more than five-fold after two years.[40] It was not a genuine provision for fixing rent but a mere 'device' to enable the landlord to repossess the leased premises otherwise than in accordance with the statutory scheme of the Housing Act 1988 (UK).[41]

The decisions in *Antoniades* and *Bankway* are clear instances of substantive reasoning, motivated by the desire to give effect to relevant legislative policies. In *Antoniades*, Lord

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Avoidance' in J Getzler (ed), *Rationalizing Property, Equity and Trusts: Essays in Honour of Edward Burn* (London, LexisNexis, 2003) 152.

[36] *Antoniades* [1990] 1 AC 417, 458.

[37] *Bankway Properties Ltd v Pensfold-Dunsford* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [43] ('*Bankway*'). The distinction between 'pretence' and 'sham' was accepted by the Court of Appeal in the earlier cases of *Aslan v Murphy (Nos 1 and 2)* and *Duke v Wynne* [1990] 1 WLR 766, 770–71.

[38] *Bankway* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [43].

[39] ibid, [44].

[40] Pill LJ, however, analysed the issue using the 'internal' route. He found that the terms of the lease evinced a clear intention to create an assured tenancy and thereby to grant long-term security. The rent review clause, which has the effect of precipitating early termination, was 'inconsistent with and repugnant' to that main purpose and ought therefore be ignored: *Bankway* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [66]–[70]. For a criticism of this reasoning, see Bright, above n 2828, 166.

[41] *Bankway* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [55]. Her Ladyship based this conclusion on three findings: the absence of any evidence that the parties had even negotiated the rent-review clause; that the increased rent well exceeded the market rate and was clearly beyond the means of the defendants or other persons likely to rent in the same location; and that the landlord had taken no action to demand the higher rent when it could have done so: see *Bankway* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [53], [54], [60].

Templeman prefaced his discussion with the declaration that 'Parties to an agreement cannot contract out of the Rent Acts; if they were able to do so the Acts would be a dead letter because in a state of housing shortage a person seeking residential accommodation may agree to anything to obtain shelter'.[42] This ready acceptance of an implicit prohibition against 'contracting out' underscores the primacy of the legislative objective – the protection of a vulnerable class. It affirmed, as did Arden LJ in *Bankway*,[43] that the disparate bargaining powers (then) inherent in landlord and tenant relationships warranted closer scrutiny of, and interference with, contractual arrangements. The broad latitude within which landlords could draft and dictate contractual terms necessitated that courts be equipped with an equally responsive tool to detect more subtle and indirect ways of circumventing statutory protection for tenants. A narrow sham doctrine in the *Snook* sense did not adequately meet this purpose.

Those who are uncomfortable with the uncertainty that resides in such an approach have, unsurprisingly, agitated over the difficulty of justifying these 'anomalous' cases in doctrinal terms.[44] On one view, they may be seen as manifestations of the general principle that courts may disregard terms conceived for purely avoidance motives, viz, where they were incorporated into the contract for no purpose other than to avoid a particular mandatory regulatory regime.[45] But this explanation is unsatisfactory as it is well established that an avoidance motive is not, by itself, a sufficient reason for striking down a contract or a term.[46] An alternative explanation is that pretence is simply a wider concept of sham in that a contract or an obligation could be regarded as 'not genuine' if there was no intention to enforce or rely on it.[47] Yet this, too, is flawed since contracting parties may always legitimately form an intention of non-enforcement for reasons of benevolence rather than deception or

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[42] *Antoniades* [1990] 1 AC 417, 458. His Lordship also cited (463) *Street* as authority for reasserting the principle that parties cannot contract out of the Rents Act.

[43] *Bankway* [2001] EWCA Civ 528, [2001] 1 WLR 1369 [45], citing Lord Simon in *Johnson v Moreton* [1980] AC 37, 66–67.

[44] Bright, Glover and Prassl, above n 25, 110.

[45] *Antoniades* [1990] 1 AC 417, 462, 463. Bright thus explicated the case as having laid down the rule that 'if a non-exclusive occupation clause is inserted as a pretence and is not intended to be relied upon, that this is an attempt to contract out of the Rent Acts and so cannot be allowed'. See Bright, above n 35, 141.

[46] Thus, Megarry J observed in *Miles v Bull* [1969] 1 QB 258, 264 that 'a transaction is no sham merely because it is carried out with a particular purpose or object. If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it'. See also McFarlane and Simpson, above n 35, 158.

[47] Bright, above n 28, 157, citing Neuberger J in *National Westminster Bank plc v Jones* [2001] EWCA Civ 1541, [2001] 1 BCLC 98 [45].

contrivance.[48] Once the requirement for common intention (to deceive) is abandoned, it is also unclear what threshold conduct would justify the finding of a 'non-genuine' term.[49]

These concerns reflect the anxiety that is commonly experienced when substantive reasons are prioritised over formal ones. The flexibility that enables courts to respond to varying avoidance tactics inevitably undermines predictability. To some degree, such instability may be mitigated if courts react consistently to a recurrent fact pattern so that a formal rule is eventually recognised to govern that situation, but even so, the rigid application of such a rule regardless of context could lead to questionable outcomes. In *Swan v Uecker*,[50] the Supreme Court of Victoria held that a tenant had 'sublet' the rented premises when he offered it for short-term occupation through Airbnb. Under Victorian residential tenancy law, subletting without the landlord's consent is a ground upon which the landlord may evict the tenants. Notwithstanding that the Airbnb agreement was labelled as a licence, Croft J found it constituted a lease because its terms granted exclusive possession to Airbnb guests. This was a surprising outcome as it runs counter to the common perception that such short-term home-sharing arrangements are no more than mere licences. At its heart, the case is concerned with a tenant's security of tenure, whether eviction rights should be restrictively construed, and the extent to which a tenant's right to quiet enjoyment extended to a right to participate in the sharing economy.[51] By adopting a formalistic approach that focused narrowly on the test of 'exclusive possession', the Court effectively sidestepped these substantive concerns and arrived at an inadequately-considered outcome. The surprising outcome highlights the centrality of policy considerations even in cases where the issue hinges on an apparently stable rule (such as the 'exclusive possession' test).

VI. EMPLOYMENT AGREEMENTS

Like tenants, employees constitute a vulnerable group that is statutorily protected against exploitation and unfair treatment. A person who qualifies as an 'employee' will therefore enjoy particular protections such as the right to redundancy payments and the right not to be unfairly dismissed,[52] while a 'worker' is entitled (inter alia) to minimum wage and protections for working overtime.[53] In practice, employers who wish to avoid these additional burdens may,

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[48] McFarlane and Simpson, above n 35, 160–61.

[49] Bright, Glover and Prassl, above n 25, 114.

[50] *Swan v Uecker* [2016] VSC 313, (2016) 50 VR 74.

[51] See the criticisms of B Swannie, 'Trouble in Paradise: Are Home Sharing Arrangements "Subletting" under Residential Tenancies Legislation' (2016) 25 *Australian Property Law Journal* 183.

[52] Employment Rights Act 1996 (UK), ss 135, 94.

[53] National Minimum Wage Act 1998 (UK); Working Time Regulations 1998 (SI 1988/1833) (UK).

in a contract of appointment, explicitly exclude the indicia of employment so as to ensure that the relationship falls outside the ambit of the relevant statutory protections. Where, however, there is evidence that such attempts are a matter only of form and bear no relation to reality, the question would arise as to whether the agreement is in truth one of employment.

Traditionally, courts have been reluctant to look behind the parties' written contracts in the employment context.[54] Close adherence to contractual orthodoxy meant that parol evidence is generally inadmissible in construing the contract of appointment. Hence, a contract that explicitly excludes salient features of employment (such as control or the obligation to provide personal service) would be given effect to even if there were evidence that the term was not enforced.[55] Moreover, the *Snook* doctrine is not usually of assistance in this context since the contracts are typically drafted by the employer and signed by the putative employee on a 'take-it-or-leave-it' basis so the latter can hardly be said to have been complicit in the employer's 'deception'.

More recently, however, a new approach emphasising substance over form has evolved in recognition of the power imbalance inherent in employment relations. In *Consistent Group Ltd v Mrs Kalwak*,[56] Elias J upheld a tribunal decision that a group of Polish workers who had contracted with an employment agency ostensibly as 'sub-contractors' were in fact employees. Although the contract contained various explicit denials of employment relations (by, for example, providing for the right to refuse work and to provide substitute service), these provisions were shams as they did not reflect reality. Explaining why it was crucial to look behind written contracts to discern the parties' true agreement, Elias J astutely observed:

> The concern to which tribunals must be alive is that armies of lawyers will simply place substitution clauses, or clauses denying any obligation to accept or provide for work in the employment contracts, as a matter of form, even where such terms do not begin to reflect the real relationship.[57]

These observations point to the real risk of employers depriving workers and employees of their statutory protection simply by creating a documentary fiction of self-employment.

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[54] See ACL Davies, 'Employment Law' in E Simpson and M Stewart (eds), *Sham Transactions* (Oxford, Oxford University Press, 2013) paras 10.25–10.30.

[55] See, eg, *Express & Echo Publications Ltd v Tanton* [1999] ICR 693, 697, where a finding of an employment relationship by the Employment Appeal Tribunal was overturned because the Tribunal judge placed too much weight on 'what actually happened' rather than what the legal obligations were.

[56] *Consistent Group Ltd v Mrs Kalwak* EAT/0535/2006 ('*Consistent*').

[57] *Consistent* EAT/0535/2006 [57].

Elias J's decision was reversed on appeal,[58] but his reasoning was subsequently endorsed in *Firthglow Ltd v Szilagyi*.[59] In this case, the English Court of Appeal held that a claimant who had contracted as a 'partnership' was in fact employed by the defendant. Under the arrangement, the claimant (Szilagyi) was required to form a partnership with another, and the partnership in turn contracted to supply services to the defendant, Protectacoat. The service agreement provided, inter alia, that Protectacoat was under no obligation to provide the partnership with work. The undisputed purpose of these arrangements was to ensure that Szilagyi would not become an employee of Protectacoat. Eventually, a dispute arose and the arrangements were terminated.

Szilagyi brought proceedings in the Employment Tribunal for unfair dismissal. A preliminary issue that arose was whether the Tribunal had jurisdiction to hear the case, which turned on whether Szilagyi was an employee of the company. The Court of Appeal affirmed the Tribunal's decision that an employment relationship existed because both the partnership and service agreements were shams. Smith LJ, who delivered the principal judgment, was emphatic that 'the test for a sham must be sensitive to the context'.[60] Her Ladyship accepted that a broader test (than *Snook*) is justified in the employment context where contractual terms are not usually negotiated but dictated by the employer.[61] So, rather than insist on a common intention to deceive a third party,[62] the right approach is simply to consider whether the written contract represents the parties' true intentions. What that means is that 'If the evidence establishes that the true relation was, and was intended to be, different from what is described in the document, then it is that relationship and not the document or the document alone which defines the contract'.[63] Applying these principles to the facts, the Court was satisfied that an employment relationship existed between the parties. No true partnership existed between Szilagyi and his assistants since they did not operate a common business for profit.[64] The parties' actual conduct further confirmed that Protectacoat had significant control over Szilagyi,[65] and that mutuality of obligations was implicit in their agreement.[66]

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[58] *Consistent Group Ltd v Mrs Kalwak* [2008] EWCA Civ 430, [2008] IRLR 505.

[59] *Firthglow Ltd (trading as Protectacoat) v Szilagyi* [2009] EWCA Civ 98, [2009] ICR 835 [54] ('*Firthglow*').

[60] *Firthglow* [2009] EWCA Civ 98, [2009] ICR 835 [42].

[61] ibid, [52].

[62] ibid [53].

[63] ibid [56].

[64] ibid [63].

[65] ibid [59].

[66] ibid [67].

Together, the approach of Elias J in *Consistent* and that of Smith LJ in *Firthglow* marked a trend towards greater worker-protection that has since been vindicated by the Supreme Court in *Autoclenz Ltd v Belcher*.[67] *Autoclenz* concerned a claim by a group of valeters that they were 'workers' entitled to minimum wage under relevant wage protection regulations.[68] The valeters were engaged by the respondent company (Autoclenz) to provide car cleaning services. Although the contracts described the valeters as self-employed independent contractors and contained the usual rights to substitute and refuse work, the UK Supreme Court held that the claimants were workers for the purposes of the National Minimum Wage Regulations 1999 (UK). Delivering the sole judgment of the Court, Lord Clarke unhesitatingly adopted the wider notion of 'sham' advocated by Elias J in *Consistent*.[69] In his view, the *Snook* definition was 'too narrow',[70] and not the only route by which the courts may disregard a term of the written contract.[71] That employment relations are distinguished by unequal bargaining power justifies greater skepticism in assessing the genuineness of the written terms. Lord Clarke summed up this 'purposive approach' as follows:

> [T]he relative bargaining power of the parties must be taken into account in deciding whether the terms of any written agreement in truth represent what was agreed and the true agreement will often have to be gleaned from all the circumstances of the case, of which the written agreement is only a part.[72]

Autoclenz now stands as high authority for the proposition that a court may recharacterise a contract on the basis of sham analysis even if the conditions of *Snook* are not satisfied. It is a clear instance of substantive reasoning at work, where the Court readily departed from standard contractual doctrines (by admitting evidence of the parties' subsequent conduct and disregarding the signature rule[73]) in order to give effect to legislative policy. Alan Bogg has sought to rationalise such departure as a special *contractual* doctrine that is 'attuned to the distinctiveness of the personal employment contract'.[74] On that view, the identification of 'true agreement' in *Autoclenz* could be explained as a type of contextual interpretation based on an expanded view of the principles set out in *Investors Compensation Scheme v West Bromwich Building Society*.[75] That would involve 'a more aggressive form of contextualism in the context

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[67] Davies, above n 54, para 10.31; *Autoclenz Ltd v Belcher* [2011] UKSC 41, [2011] 4 All ER 745 ('*Autoclenz*').

[68] Viz, National Minimum Wage Regulations 1999 (UK) and Working Time Regulations 1998 (UK).

[69] *Autoclenz* [2011] UKSC 41, [2011] 4 All ER 745 [29].

[70] ibid [28].

[71] ibid [23].

[72] ibid [35].

[73] *L'Estrange v F Graucob Ltd* [1934] 2 KB 394.

[74] A Bogg, 'Sham Self-Employment in the Supreme Court' (2012) 41 *Industrial Law Journal* 328, 331.

[75] ibid 336–39; *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896. cf the argument of Bright, Glover and Prassl in the tenancy context that the *ICS* principles cannot explain the pretence

of personal employment contracts',[76] that allows courts recourse to evidence of 'how the parties conducted themselves in practice and what their expectations of each other were'.[77] By this means, Bogg sought to bring *Autoclenz* back within the fold of doctrinal (and formal) analysis but its effect is to elide the distinct processes of interpretation and characterisation with the risk of reducing the test of characterisation to one of parties' intention and suppressing the proper analysis of substantive, policy considerations.

Rather than force-fitting the decision within the strictures of contractual doctrines, *Autoclenz* is better defended on substantive grounds. The Court was not there concerned with the construction of contract per se but with the broader issue of avoidance.[78] The issue at hand was not simply what the terms of the contract meant, but whether the employer could legitimately devise a 'fake' self-employment to evade its statutory obligations. That inquiry necessarily requires the court to discern the parties' true agreement in order to establish if an evasive scheme exists in the first place, and (if it does) then to determine if the scheme is permissible having regard to the legislative policies. The latter is inevitably a normative inquiry which the court must undertake within the confines of legislative objectives.

VII. TRUSTS

Given the widespread use of the trust as an asset-protection mechanism, it is unsurprising that attempts are occasionally made to invalidate trust settlements as 'shams' devised to shield assets from creditors, former spouses and tax authorities. Increasingly, these settlements are structured as discretionary trusts, so that the settlor could be said to have no proprietary interest in the trust assets even if he is named as a potential beneficiary. In this context, as in others, the courts have employed the *Snook* definition of sham. A trust document is a sham if it is not intended to have the legal effects that it purports to create. A classic instance is *Abdel Rahman v Chase Bank (CI) Trust Company Limited*,[79] where the Royal Court of Jersey was prepared to

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'doctrine' as they are only applicable when ambiguity subsists in the contractual terms: see Bright, Glover and Prassl, above n 25, para 6.36.

[76] Bogg, above n 74, 339.

[77] *Autoclenz* [2011] UKSC 41, [2011] 4 All ER 745 [30], citing Smith LJ in *Autoclenz Ltd v Belcher* [2008] EWCA Civ 1172, [2010] IRLR 70 [53].

[78] As Davies cogently observes, courts are justified in taking a more astute approach in tackling 'fake' self-employment arrangements as they are, in substance, attempts to contract out mandatory employment regulations: Davies, above n 54, para 10.43.

[79] *Abdel Rahman v Chase Bank (CI) Trust Company Limited* [1991] JLR 103 ('*Abdel Rahman*').

invalidate a trust settlement that reserved significant powers to the settlor,[80] because the settlor had 'exercised dominion and control over the trustee in the management and administration of the settlement … [and] treated the assets comprised in the trust fund as his own and the trustee as though it were his mere agent and nominee'.[81] The settlement was a sham 'in the sense that it was made to appear to be a genuine gift when it was not'.[82]

Unlike tenancy and employment agreements, trusts may be constituted unilaterally but that has not persuaded courts to adopt a wider concept of sham than that defined in *Snook*. Despite some dicta to the contrary,[83] the prevailing view appears to be that a trust that is prima facie validly constituted can only be struck down as a sham upon proof that the settlor and trustee(s) shared a *common* intention to mislead another,[84] although a reckless indifference as to the genuineness of the transaction could count as requisite intention.[85] Conaglen has defended the strict application of *Snook* in this context.[86] He argues that *Snook* shams are manifestations of a doctrine distinct from that of construction, which 'permits the court to step outside the normal process of construction, and to consider evidence of the subjective intention of the parties which show that the arrangements that they put in place were a façade or disguise'.[87] On this

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[80] The settlement was stated to be discretionary but provided, inter alia, that the settlor may without the consent of the trustee appoint up to one-third of the trust fund and its income over a 12-month period; that the trustee could at its absolute discretion pay or apply the whole or part of the capital of the trust fund to the settlor or for his benefit and in so doing *shall* have regard exclusively to the settlor's interests; that the powers to invest, to change the law of the settlement, to delegate and to change trustees were all to be exercised either with the sanction of the settlor or in accordance with his instruction: see *Abdel Rahman* [1991] JLR 103, 140–46.

[81] *Abdel Rahman* [1991] JLR 103, 147.

[82] ibid.

[83] See, eg, *Midland Bank plc v Wyatt* [1997] 1 BCLC 242, 245; *Minwalla v Minwalla* [2004] EWHC 2823 (Fam), [2005] 1 FLR 771 [53]–[55]; *Carmen v Yates* [2004] EWHC 3448 (Ch), [2005] BPIR 476 [218]; *Ali v Bashir* [2014] EWHC 3853 (Ch) [26].

[84] See *Shalson v Russo* [2003] EWHC 1637, [2005] 2 WLR 1213 [190]; *A v A* [2007] EWHC 99 (Fam), [2007] 2 FLR 467 [38]–[40]; *JSC Mezhdunarodniy Promyshlenniy Bank v Sergei Viktorovich Pugachev* [2017] EWHC 2426 [150] ('*Pugachev*'). cf *Painter v Hutchison* [2007] EWHC 758 [114]–[115] where Lewison J confined the requirement for common intention to cases of bilateral trusts.

[85] *In re Esteem Settlement* [2003] JLR 188 [58]; *A v A* [2007] EWHC 99 (Fam) [52]; *Pugachev* [2017] EWHC 2426 [150], [435].

[86] M Conaglen, 'Sham Trusts' [2008] 67 *CLJ* 176; M Conaglen, 'Trusts and Intention' in E Simpson and M Stewart (eds), *Sham Transactions* (Oxford, Oxford University Press, 2013).

[87] Conaglen, 'Trusts and Intention', above n 86, 125.

view, it is the intention to deceive that lies at the heart of sham reasoning.[88] For that reason, courts are justified to depart from the objective approach to construction and look, instead, to the parties' subjective state of mind.

This explanation has influenced the jurisprudence on sham trusts in New Zealand,[89] and one can see the obvious force of the suggestion that shams have much to do with deliberate attempts to present a misleading front. Nevertheless, it does not logically or necessarily follow that shams as defined in *Snook* bears the status of a 'doctrine' that is of universal application.[90] As we have just seen in the context of tenancy and especially that of employment, courts have been prepared to adopt broader notions of 'sham' where the context justifies doing so. While it is true that *Snook* shams would often be the most flagrant examples of illegitimate avoidances, it is not obvious that the *Snook* criteria are the only criteria relevant for detecting shams in all contexts. Nor is it always the case that an agreement or a term would be disregarded only because it does not reflect reality.[91] Ultimately, the question whether a transaction should be set aside as a sham is assessed not only by legal doctrines but also by the intensity of the substantive policy reasons relevant to the context.

For trusts, the key policy consideration that has shaped judicial preference for a restrictive conception of shams is the need to preserve commercial certainty. As Robertson J acknowledged in *Official Assignee v Wilson*: 'A court will only look behind a transaction's ostensible validity if there is good reason to do so, and "good reason" is a high threshold, since a premium is placed on commercial certainty'.[92] This 'premium' on commercial certainty is especially needed to protect two specific groups – the trustee and the beneficiaries – who would

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[88] Conaglen, 'Sham Trusts', above n 86, 186–87.

[89] *Official Assignee v Wilson* [2008] NZCA 122, [2008] 3 NZLR 45 ('*Wilson*').

[90] MacFarlane and Simpson, above n 35, 139.

[91] See the interesting Canadian case *1524994 Ontario Ltd v Canada* [2007] FCJ No 234 [20] where the Ontario Federal Court of Appeal held that an arrangement contrived to circumvent the strict rules regulating insurable audiological services must be regarded as representing the true economic reality for taxation purposes even though the arrangement was in fact a contractual fiction intended to misrepresent a legal relationship. The principle, Décary JA explained, is that 'Where a taxpayer has created a fiction and has lived by it, his fiction has become its real economic world, for better and for worse, plus GST'.

[92] *Wilson* [2008] NZCA 122, [2008] 3 NZLR 45 [52].

in all likelihood act in reliance on the trust. A formal, doctrinal approach to sham reasoning would protect honest trustees from liability,[93] as well as the beneficiaries' security of receipt.[94]

But whilst important, commercial certainty does not exhaust the policy considerations relevant to trusts law. An obvious countervailing concern is the need to deter abuses of trust structures, which in recent years has sparked the judicial recognition of 'illusory trusts'. In *Clayton v Clayton*,[95] the Supreme Court of New Zealand accepted (obiter) that a trust that is honestly intended by the settlor (and hence not a sham) may still fail as an 'illusory trust',[96] either because the settlor had reserved so much power to himself that he could not be said to have divested sufficient control to constitute a trust, or the breadth of the powers vested in the settlor calls into question the irreducible core of the trustee's duties set out in *Armitage v Nurse*.[97] The question whether a trust fails on this ground is a matter of construction of the trust deed. So, unlike a sham, an 'illusory' trust is 'not about deception, but self-contradiction that is apparent on the face of the trust deed'.[98] In *JSC Mezhdunarodniy Promyshlenniy Bank v*

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[93] This concern was, eg, implicit in *A v A* [2007] EWHC 99 (Fam) [79], [86] where Munby J emphasised that 'there is not a shred of evidence to justify a finding of "sham" against "four professional men"'. See also A See, 'Revisiting Sham Trusts: Common Intention, Estoppel and Illegality' [2018] *Conveyancer & Property Lawyer* 31, 36.

[94] As evidenced, eg, by Rimer J's reasoning for insisting on 'common intention' in S*halson v Russo* [2003] EWHC 1637, [2005] 2 WLR 1213 [190]: 'One might as well say that an apparently outright gift made by a donor can subsequently be held to be a sham on the basis of some unspoken intention by the donor not to part with the property in it. But if the donee accepted the gift on the footing that it was a genuine gift, the donor's undeclared intentions cannot turn an ostensibly valid disposition of his property into no disposition at all. To set that sort of case up the donee must also be shown to be a party to the alleged sham.'

[95] *Clayton v Clayton* [2016] NZSC 29, [2016] 1 NZLR 551 [123] ('*Clayton*').

[96] Though the Court rejected the 'illusory' label since it has no value except to describe a trust that has failed: see *Clayton* [2016] NZSC 29, [2016] 1 NZLR 551 [123], [129]. See also *Pugachev* [2017] EWHC 2426 [169]. This chapter will, however, continue to use the term as a convenient shorthand for a trust that fails by reason of the excessively wide powers reserved by the settlor.

[97] *Armitage v Nurse* [1998] Ch 241. See *Clayton* [2016] NZSC 29, [2016] 1 NZLR 551 [124]. The case concerned a dispute over the division of matrimonial property. A large part of Mr Clayton's property was settled under various trusts and Mrs Clayton sought to argue that these assets were 'relationship property' to which she was entitled under the Property (Relationships) Act 1976 (NZ). The Supreme Court disposed of the issue on the ground that the trust assets fell within the definition of 'relationship property' by reason of the general power of appointment vested in Mr Clayton. As such, it did not have to determine the true rationale of 'illusory trusts': see *Clayton* [2016] NZSC 29, [2016] 1 NZLR 551 [127].

[98] L Ho, '"Breaking Bad"—Settlors' Reserved Powers' in R Nolan, K Low and HW Tang (eds), *Trusts and Modern Wealth Management* (Cambridge, Cambridge University Press, 2018) 45.

Sergei Viktorovich Pugachev,[99] Birss J in the English High Court adopted this reasoning to invalidate several discretionary trusts. The significant features of this case were that the settlor was not only a named beneficiary under the discretionary trusts but also their protector. In his capacity as protector, he could exercise extensive powers,[100] selfishly for his own benefit, the effect of which was to 'allow him to retain complete control over the assets he had settled in the trusts'.[101] Consequently, the trust deeds did not have the effect of divesting the settlor of the beneficial ownership of the trust assets.

Pugachev is controversial as its correctness has been doubted.[102] Specifically, it has been criticised for suggesting that a trust may fail by reason of extensive settlor control even if the trustee remains accountable to the beneficiaries,[103] and continues to exercise real discretion in the administration of the trust.[104] Such an approach conflates the distinct concepts of power and property,[105] and threatens to unsettle even trusts that reserve wide powers to settlors for legitimate reasons.[106] But even if one accepts these criticisms as cogent, it does not necessarily follow that the case was wrongly decided. Rather, these doctrinal lapses point to the substantive reasons that underpin the decision. So, despite Birss J's attempt to couch his reasoning in formal (doctrinal) terms (by invoking the authority of *Clayton* and stressing the objective, interpretive nature of the inquiry),[107] his Lordship's interpretation of the trust deeds was ultimately coloured by the perception that the settlor had established the trusts principally to

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[99] *Pugachev* [2017] EWHC 2426.

[100] The protector had the power to veto all major decisions regarding investment, distribution of income or capital and variation of the deed, had the right to appoint new beneficiaries, to appoint a successor in the event that he is barred by a (legal) disability from acting, and was free to remove a trustee who did not act in accordance with his wishes: see *Pugachev* [2017] EWHC 2426 [236]–[244].

[101] *Pugachev* [2017] EWHC 2426 [245].

[102] See J Davies, 'New Developments in Settlor Reserved Powers' [2018] *Conveyancer and Property Lawyer* 175; J Brightwell and L Richardson, '*Mezhprom v Pugachev*: Bold New Approach or Illusory Development?' (2018) 24 *Trusts & Trustees* 398.

[103] cf *Re AQ Revocable Trust* [2010] Bda LR 26.

[104] And so is not a mere agent or nominee.

[105] *Re Armstrong* (1886) 17 QBD 521, 531.

[106] G Hogan, 'Case Note: *Mezhprom Bank v Pugachev* [2017] EWHC 2426 (Ch)' (2018) 24 *Trusts & Trustees* 212, 214–15.

[107] *Pugachev* [2017] EWHC 2426 [166]–[168].

ring-fence his assets against creditors.[108] This context featured prominently in his Lordship's analysis of the settlor-protector's powers. In deciding that the settlor-protector's powers were personal (evidencing control) rather than fiduciary (negating control) in nature, Birss J was categorical that a court should not lend its assistance to an 'unscrupulous person',[109] who tried to conceal his beneficial ownership of property by using a trust deed to vest unfettered powers on himself as protector so as to defeat the claims of creditors.[110]

To sum up, the current English approach to recharacterisation in the area of trusts is marked by a discernibly formal approach to the sham 'doctrine', while a more intricate interplay of form and substance is observable in the nascent development of illusory trusts. A court confronting an alleged illusory trust will typically utilise formal reasoning as the starting point to keep faith with precedents and promote legal certainty but is willing to employ substantive reasoning to bridge the gap when it perceives existing rules to be deficient in deterring the abuse of trust structures as an avoidance device. Overall, however, judicial preference for formal reasoning would mean that substantive reasons are accorded only a subsidiary role in rationalising particular outcomes. In *Pugachev*, Birss J's attempt to present the outcome as an application of an exercise in 'construction' premised on strong judicial authority,[111] did not ultimately conceal the judge's concern for protecting creditors, but it is conceivable that the leaning in favour of formal reasoning may occasionally undermine a decision by obscuring pertinent policy considerations.

VIII. FINANCING ARRANGEMENTS

Attempts to recharacterise financing agreements are typically made to secure priorities in the event of the debtor's insolvency. Although it is clear that such transactions may be set aside upon proof of *Snook* shams,[112] the 'internal' route or 'construction' method is more commonly employed as parties entering into financing agreements *do* usually intend to perform the terms agreed.[113] In so far as this approach is understood as a process of objective interpretation aimed

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[108] There was evidence that the settlor had engaged the services of a consultancy firm specifically to defend his assets against Russian creditors and that the settlor's powers as protector were designed to be judgment proof: see *Pugachev* [2017] EWHC 2426 [23], [275].

[109] *Pugachev* [2017] EWHC 2426 [182].

[110] ibid [187].

[111] And such reasoning is therefore formal in appearance: see M Bennett, 'Trusts law—Form over Substance or Substance over form?' (Obligations IX Conference, Melbourne, July 2018).

[112] See, eg, *Re Watson* (1890) 25 QBD 27.

[113] D Neuberger, 'Company Charges' in E Simpson and M Stewart (eds), *Sham Transactions* (Oxford, Oxford University Press, 2013) para 9.04.

at discovering the 'intention of the parties', it is formal in appearance. In general, however, this approach has not (but with notable exception)[114] resulted in formalistic reasoning as English courts are often cognizant of the policy factors at play.

The leading cases of *Brumark* and *In re Spectrum Plus Ltd*, on the characterisation of company charges usefully illustrate this policy-informed process.[115] Both cases attest to the important principle that the categorisation of a charge is a question of law not dictated by parties' contractual labels. In *Brumark*, the Privy Council held that a purported 'fixed' charge over uncollected book debts was a floating charge as the chargor was at liberty to use the proceeds of the debts. The decision confirmed that contracting parties are *not* free to make whatever agreements they like.[116] *Brumark* was followed a few years later by *Spectrum Plus*. Adopting Lord Millett's exposition of legal categorisation,[117] the House of Lords held that a mislabelled 'fixed' charge over book debts was in substance a floating charge as the chargor could freely draw on the proceeds of the receivables. The parties' declared intention or label may be relevant but is not conclusive.[118] While the reasoning in both cases proceeded largely on a formal basis by identifying the chargee's control as the defining feature of a fixed charge, the Courts clearly also took into account policy factors militating against an exclusively contractual approach. In *Spectrum Plus*, Lord Scott highlighted the need to keep in mind the legislative imperative to preserve preference creditors' priority over the floating chargee in the event of insolvency as the common law develops the concept of 'floating charge'.[119] Likewise, Lord Walker observed, after noting the parallel with the lease/licence distinction drawn in *Street*, that there is 'public interest' in 'ensuring that preferential creditors obtain the measure of protection which Parliament intended them to have'.[120]

Transactions involving title financing are another fertile ground that breeds problems of characterisation. Hire purchase, sale and leasebacks and retention of titles are common examples of such transactions. Unlike cases on charges, the judicial approach to this category of transactions has sometimes been criticised for placing too much weight on parties' express intention (and hence formalistic). *Welsh Development* is a case in point. There, the English Court of Appeal had to decide if a complex receivables financing arrangement that was

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[114] See *PST Energy 7 Shipping LLC v OW Bunker Malta Ltd* [2016] UKSC 23, [2016] AC 1034, discussed below, text accompanying nn 129–37.

[115] *Brumark* [2001] UKPC 28, [2001] 2 AC 710; *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680 ('*Spectrum Plus*').

[116] Overruling *In re New Bullas Trading* [1994] 1 BCLC 485.

[117] *Spectrum Plus* [2005] UKHL 41, [2005] 2 AC 680 [141].

[118] ibid [80], [119], [141].

[119] ibid [98].

[120] ibid [141].

structured as a sale should be recharacterised as a secured loan. The Court upheld the parties' characterisation. In its reasoning, the Court reiterated the need to look at the 'substance' of the agreement but went on to locate 'substance' largely in the 'language' of the agreement.[121] Indeed, the deference to form seemed complete when Dillon LJ approvingly cited Lord Wilberforce in *Lloyd's & Scottish Ltd v Cyril Lord Carpet Sales Ltd* to the effect that '[it] would be a strange doctrine of "looking for the substance" or "looking through the documents" which would produce a contractual intention so clearly negated by the documents and by oral evidence'.[122] 'Substance' is therefore equated with parties' intention,[123] so their choice of legal category would (save in the rare case of a sham) generally prevail.[124]

Prioritising form over substance is not, however, formalistic or objectionable if there are good substantive reasons so to do. In this context, the main reason for respecting the selected form is the recognition that parties should generally be free to finance their trades through sales.[125] That this was a highly germane consideration in *Welsh Development* is evident in Dillon LJ's observation that:

> The crux of this point, as I see it, is that the parties were entitled to choose the way in which Parrot would raise finance. There was nothing illegal about it. It could be raised either by borrowing or by the sale of assets, whether goods or book debts.[126]

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[121] *Welsh Development* [1992] BCLC 148, 161–62.

[122] *Welsh Development* [1992] BCLC 148, 168; *Lloyd's & Scottish Ltd v Cyril Lord Carpet Sales Ltd* [1992] BCLC 609, 615.

[123] See A Berg, 'Recharacterisation after Enron' [2003] *Journal of Business Law* 205, 218.

[124] Or, as Millett LJ summed up in *Orion* [1996] 2 BCLC 78, 85: 'The legal classification of a transaction is not, therefore, approached by the court in vacuo. The question is not what the transaction is but whether it is in truth what it purports to be. Unless the documents taken as a whole compel a different conclusion, the transaction which they embody should be categorised in conformity with the intention which the parties have expressed in them.'

[125] See also F Oditah, 'Financing Trade Credit: *Welsh Development Agency v Exfinco*' [1992] *Journal of Business Law* 541, 541–43. The commercial reasons that may justify a sale structure would include the trader's borrowing limits, its gearing ratio, whether consents are required for creating further debt or security, restrictions by way of cross-default or negative pledge provisions in existing debt instruments, whether off-balance results are desired and whether registration would damage the trader's credit.

[126] *Welsh Development* [1992] BCLC 148, 168.

As such, a genuine finance sale would not usually be recharacterised as a loan simply because it has the economic effects of a loan.[127] Courts would only countenance recharacterisation if there are sound policy reasons to justify the reallocation of contractual risks.[128]

From this cursory account, it will appear that the judicial technique employed in this context is a prima facie formal one: the characterisation of a transaction is determined by construing the document to determine if its intended effects are consistent with the features of a particular legal category. In practice, however, courts do take into account policy factors that may favour one construction over another though such considerations are usually presented as subsidiary or supplemental justifications for outcomes derived by the process of objective construction. Often, this 'blended' approach would allow courts to adequately weigh and mediate divergent policy interests. Yet, the (often unconscious) subordination of substantive reasons implicit in such an approach may, on occasion, so stifle or obscure relevant social or economic goals as to render a decision insensible in its context.

A poignant example is found in the perplexing decision of *PST Energy 7 Shipping LLC v OW Bunker Malta Ltd*.[129] In this case, the owners of the *Res Cogitans* had contracted to purchase bunkers from the OWB group ('OWB') subject to a retention of title ('ROT') clause. OWB, in turn, obtained the bunker from other suppliers who physically delivered the bunkers to the vessel. When OWB became insolvent, the owners (fearing it might be liable twice over to both OWB and the physical suppliers) sought declarations that it was not liable to pay OWB the price of the bunkers. It argued that since the transaction was a sale subject to the Sale of Goods Act 1979 (UK) ('SOGA'), OWB could only maintain an action for price under section 49 SOGA if the property in the bunkers had first vested in the owners. On the facts, this condition was not satisfied since the property in the bunkers had been consumed without property having first passed to the owners under the ROT clause.[130] To avoid the awkward result argued by the owners (that they do not have to pay for the consumed bunkers), the UK Supreme Court recharacterised the supply contract as a sui generis licence to consume bunkers

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[127] As Lord Devlin said *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] AC 209, 216–17: 'If in form [the transaction] is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money.'

[128] In *Welsh Development*, a relevant counter policy argument arose from the concern that sale structures with recourse could, as a form of off-balance sheet financing, render the trader's financial statements misleading and unreliable. Ralph LJ considered this argument but ultimately decided that the redress of any such concern lies in the province of the legislature rather than the judiciary: see *Welsh Development* [1992] BCLC 148, 178–79.

[129] *PST Energy 7 Shipping LLC v OW Bunker Malta Ltd* [2016] UKSC 23, [2016] AC 1034 ('*The Res Cogitans*').

[130] A line of reasoning previously affirmed in *FG Wilson (Engineering) Ltd v John Holt & Co (Liverpool) Ltd* [2013] EWCA Civ 779, [2014] 1 WLR 2365.

for the propulsion of vessels.[131] That meant, significantly, that the transaction was *not* a contract for the sale of goods to which the SOGA applied. However, while this preserved the seller's rights to sue for price on the sui generis contract, the decision is astounding in overturning the widely-held assumption that the SOGA governed sales of goods subject to ROT clauses. Given that ROT clauses are widely adopted on the (implicit if not express) understanding that the buyer could use, consume or sell the goods before payment is due, to exclude such contracts from the ambit of the SOGA is virtually to deprive the Act of all practical relevance.[132] Outside the SOGA framework, it is also uncertain how this new category of sui generis contracts would be interpreted.[133] Ironically, therefore, *The Res Cogitans* has, in vindicating the seller's rights, also greatly destabilised the law on contracts subject to ROT clauses. In large part, this unfortunate outcome is the result of an excessively formal analysis. 'Title fundamentalism',[134] combined with a narrow view of 'contractual interpretation', have the unwitting effect of excluding from the court's view the policies that underpin the historical development of ROT clauses. As a ubiquitous feature of modern trade, ROT clauses serve a useful function in facilitating credit financing by securing the seller's interests in the event of the buyer's insolvency. On that view, such clauses are a mechanism that reorders proprietary interests in the limited context of insolvency but were not intended to alter the nature of the underlying transaction as a sale, nor to prevent the seller from suing for price when the buyer is solvent.[135] Sales on credit that envisage the consumption of goods before property passes and payment is due have become widespread precisely because they strike a fair balance between the buyer's need for credit and the seller's need for security.[136] Against this backdrop, the recharacterisation in *The Res Cogitans* is puzzling: it is difficult to see why credit sales on ROT terms should be excluded from the SOGA when they do not offend the policies of the

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[131] The Court reasoned that since the contract specifically contemplated that the bunkers could be consumed before payment was due without any property passing in the bunkers consumed, the contract did not meet the definition of a 'sale' under s 2(1) of the SOGA, viz, a contract by which a seller *transfers or agrees to transfer the property in the goods* to the buyer for a money consideration: see *The Res Cogitans* [2016] UKSC 23, [2016] AC 1034 [26]–[28].

[132] L Gullifer, '"Sales" on Retention of Title Terms: Is the English Law Analysis Broken?' (2017) 133 *LQR* 244, 259; KFK Low and KCF Loi, 'Bunkers in Wonderland: A Tale of How the Growth of Romalpa Clauses Shrank the English Law of Sales' [2018] *Journal of Business Law* 229, 247–48.

[133] Discussed in M Bridge, 'The UK Supreme Court Decision in *the Res Cogitans* and the Cardinal Role of Property in Sales Law' [2017] *Singapore Journal of Legal Studies* 345. See also Gullifer, above n 132, 256–60; Low and Loi, above n 132132, 249–52.

[134] See, eg, 'the high degree of importance attaching to property matters in the law of sale': see Bridge, above n 133, 348.

[135] Gullifer, above n 132, 252–53.

[136] ibid 246–50.

Act. Had the Court given more explicit consideration to the legitimate economic functions of the ROT clause, it might well have adopted alternative analyses that recognise a sale as a sale.[137]

IX. CONCLUSION

At the heart of recharacterisation lies the question of self-determination: to what extent are parties free to prescribe the legal consequences of their acts by adopting particular forms and terms? The foregoing analysis demonstrates that English courts have largely addressed that question through a composite process of interpretation and evaluation. Construing the constitutive contract or document sets the stage for determining its legal effects, but its legal character is ultimately determined by weighing competing values and social goals. But while English courts recognise the composite nature of the analysis, they have customarily placed greater weight on formal rather than substantive reasons with the result that the latter are usually considered more obliquely or incidentally. This chapter has argued that there is a need for more explicit articulation of policy influences in recharacterisation cases. That is not to abandon settled rules and doctrines, but it does mean that courts should intentionally and scrupulously examine the policy underpinnings of a particular legal category to decide if the parties' characterisation should prevail. The honest and open consideration of such factors is particularly important for developing new rules and doctrines (such as 'illusory trusts') or where recharacterisation threatens (as did *The Res Cogitans*) to unsettle a longstanding and widely adopted practice. Even in contexts where the rules of characterisation appear settled by reference to a particular concept or test (such as 'exclusive possession'), the concept or test would still have to be applied with acute sensitivity to the underlying social objectives. Finally, if recharacterisation is essentially a judicial response to improper avoidances, then the judicial weaponry would have to be flexible and responsive to context, so that a one-size-fits-all approach – such as a universal 'doctrine' of sham – that applies across diverse contexts would generally be inappropriate.

[137] Eg, by implying the term that property in the goods passed to the buyer immediately before consumption: see Gullifer, above n 132, 260–61; Low and Loi, above n 132, 252–53.