



SHAMS: WHEN IS A TRANSACTION NOT A TRANSACTION?

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Introduction

1. It is not uncommon for individuals and companies embarking on speculative business ventures to take steps to protect their assets against the risk of failure. In some cases, they will merely seek to create the illusion that ownership has been parted with in order to persuade creditors that such assets are not capable of being enforced against. In others, they will ensure that the assets are actually transferred to a third party. In any given case, this may raise issues relating to the doctrine of “sham” transactions and/or the application of s 423 of the Insolvency Act 1986 (“IA”).
2. In this paper, and the case study which it supports, we will consider the relevant legal principles at play and their interaction with one another.

“Sham” Transactions

What is a Sham?

3. The classic (and oft cited) definition of a sham transaction is found in the speech of Diplock LJ in *Snook v London and West Riding Investments Ltd*¹:

“As regards the contention of the plaintiff that the transactions between himself, Auto Finance and the defendants were a “sham,” it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it 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 intend to create.**”

The Necessary Intention

4. Diplock LJ went on to say:

“But one thing, I think, is clear in legal principle, morality and the authorities (see *Yorkshire Railway Wagon Co v Maclure and Stoneleigh Finance Ltd. v Phillips*), that 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. No unexpressed intentions of a “shammer” affect the rights of a party whom he deceived.** There is an express finding in this case that the defendants were not parties to the alleged “sham.” So this contention fails.”

5. This principle was considered in *Midland Bank Plc v Wyatt*², a classic “rainy day agreement” case. The defendant had decided to set up his own textile company. In order to protect his family from long-term commercial risk, and acting on advice from his solicitor, the defendant and his wife signed a declaration of trust purporting to transfer the defendant’s beneficial interest in the family home to the wife and their two daughters. Once executed, the declaration of trust was placed in the safe and not acted upon in any way whatsoever; nothing changed in the defendant’s behaviour or attitude with regard to his dealings involving the property. In relation to the claimant’s contention that the declaration of trust was a sham transaction, D E M Young QC (sitting as a deputy High Court Judge) held:

“I do not believe Mr Wyatt had any intention when he executed the trust deed of endowing his children with his interest in Honer House, which at the time was his only real asset. I consider the

¹ [1967] 2 QB 786 (at 802C-F)

² [1996] BPIR 288



trust deed was executed by him, not to be acted upon but to be put in the safe for a rainy day - as Mr Wyatt states in his affidavit, as a safeguard to protect his family from long-term commercial risk should he set up his own company. As such I consider the declaration of trust was not what it purported to be but a pretence or, as it is sometimes referred to, a 'sham'. The fact that Mr Wyatt executed the deed with the benefit of legal advice from Mr Ellis does not in my view affect the status of the transaction. It follows that even if the deed was entered into without any dishonest or fraudulent motive but was entered into on the basis of mistaken advice, in my judgment such a transaction will still be void and therefore an unenforceable transaction if it was not intended to be acted upon but was entered into for some different or ulterior motive. Accordingly, I find that the declaration of trust sought to be relied upon by Mr Wyatt is void and unenforceable."

6. In reaching such conclusion, the learned Judge gave the following useful guidance as to the relevant test:
 - 6.1 The burden was on the claimant to establish that a transaction was a sham as such an allegation directly impugned the motives of the transferor or creator of the transaction;
 - 6.2 Although the claim that the transaction was a sham was a serious allegation, it was not necessary to establish a fraudulent motive to prove that the transaction was a sham or pretence transaction;
 - 6.3 In their proper context, Diplock LJ's observations in *Snook* state no more than where a 'sham' transaction affects the rights of a third party the 'shammer' cannot rely on the sham transaction unless the third party is also a party to the sham. The 'shammer' is otherwise estopped by his conduct from so relying on the sham transaction;
 - 6.4 Accordingly, it is not necessary in every case that all the parties to the sham must have a common interest; 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;
 - 6.5 In determining the nature of the transaction in question, the subsequent history of the defendant's dealings with the property is relevant; the court's consideration is not confined to conduct at the time of making the agreement or immediately thereafter. In other words, the court is entitled to look at the way the property has been dealt with after the purported transfer.
7. The question of the necessary intention of the parties was explored further in *Painter v Hutchison and Another*³ where Lewison J approved the following analysis:
 - 7.1 In the case of a settlement executed by both settlor and trustee, there can be no sham if the trustee accepts the assets on the basis of the trusts of the settlement, even if the settlor has an unspoken intention that the assets are in fact to be treated as his own. There will only be a sham if the trustee shares that intention;
 - 7.2 Similarly, an apparently outright gift made by a donor cannot be held to be a sham on the basis of some unspoken intention by the donor not to part with the property in it if the donee accepted it on the footing that it was a genuine gift— to set that sort of case up, the donee must also be a party to the alleged sham;
 - 7.3 But in the case of a unilateral declaration of trust where the intended beneficiary is not a party to the trust deed and has not accepted the gift, it is the intention of the settlor alone that is decisive.

³ [2007] EWHC 758 (Ch), particularly at [115].



Standard of Proof

8. The authorities are clear that the court must be very careful before it accepts an argument of sham. As Neuberger J said in *National Westminster Bank plc v Jones*⁴:

“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”.

9. Merely because an agreement is artificial and produces a result that the court does not like or merely because the agreement was executed for the purpose of improving a person’s position unmeritoriously against another person, does not of itself entitle the Court to say that the agreement is a sham. A sham is a pretence; it involves a finding that the real agreement between the parties is something other than that which appears on the face of the documents. Sham is not the same as fraud (eg the forgery of a transfer document) but it will often involve an element of dishonesty.
10. The point is well illustrated in *Vooght v Hoath*⁵. The bankrupt was evicted from his former property and subsequently his half brother contended that the bankrupt had granted him a tenancy on 5 December 1987 of the whole of the property and that there was an arrangement between them whereby the bankrupt was allowed thereafter to remain in occupation. The trustee contended that the lease was not entered into in 1987 but was a document manufactured by the bankrupt and his half brother at some point long after that date with a view to enabling the bankrupt to salvage something from the wreckage of his bankruptcy (“the fraud argument”). Alternatively, if it had been entered into on 5 December 1987 it was not a genuine agreement, but a sham to which the court should give no legal effect (“the sham argument”).
11. The district judge rejected the fraud argument on the basis that the standard of proof for fraud is a high one and fraud had not been proved, but he accepted the sham argument.
12. On appeal, Neuberger J considered the district judge should have upheld the fraud argument and found, upon the evidence, that the agreement was not entered into in 1987, but was entered into much later and had been back dated to try to protect the Bankrupt’s occupancy. The Judge considered that the district judge’s finding of sham in this case did involve dishonesty:

“like most findings of sham, it involved finding that [the bankrupt] and [his half brother] had entered into the agreement with the intention of using it to deceive others into thinking it was a genuine document. I find it a little difficult to see why the district judge should, on the one hand, have been prepared to find that the evidence enabled him to clear the hurdle of sham, but nevertheless to refuse the hurdle of fraud. I can see that it may be said that the fraud involved a somewhat greater degree of dishonesty than the sham, but I do not think it would have involved a very much greater amount of dishonesty than the sham finding which the district judge was rightly prepared to make”.⁶
13. Virtually all of the evidence was entirely consistent with the document not being genuine and inconsistent with it being genuine. If it were nonetheless held that fraud had not been established in those circumstances, it would place an intolerable burden on the party alleging that the document was subsequently manufactured and back dated, since the Court would not find that a document with a specific date was in fact executed afterwards unless it could be established through the evidence of one of the parties to the document or a witness.

Examples

⁴ [2000] BPIR 1092 at [59]

⁵ [2002] BPIR 1047

⁶ At page 1051



14. There are a number of common factual scenarios which may give rise to a plea that the transaction is a sham:
- 14.1 The transfer of property (eg the family home or shares in a business) by the debtor to a relative, an associate or into a trust eg *Wyatt* (above) which was never acted upon but was kept in hand for a rainy day;
 - 14.2 The creation of a lease over the debtor's property in favour of a third party associate with the purpose of depressing the value of the freehold (see eg *Ashe v Mumford*⁷) or otherwise to improve the bankrupt's position upon bankruptcy enabling the bankrupt to continue to occupy (see eg *Vooght v Hoath*, above) ;
 - 14.3 Similarly, the creation of a charge over the debtor's property, again with the purpose of making that property appear to be less valuable . For example in *Vickers v Jackson*⁸ the court held no money was owing to Mr Jackson under a purported charge which had been executed to deceive Mr Vicker's creditors, and entries in the Land Register relating to the charge were ordered to be removed. By contrast, in *Earp v Kurd*⁹, a very recent decision of Nicholas Strauss QC (sitting as a deputy judge) , it was held that a charge over the bankrupt's property was not a sham, even though the object of the exercise was to ensure that the bankrupt had no beneficial interest in the property during his sojourn in prison, because it was intended to operate as a charge and there was no intention of deceiving the court or any third party (it being executed before the bankrupt entered into any financial difficulty). The charge recorded an advance of £75,000 when in fact only £30,000 had been paid, but there was no reason why a charge could not be made on the basis that the facts were as stated and agreed by the parties and therefore the bankrupt (and his trustee) would be bound by what was in the charge even where he knew that what was there stated did not correspond to the amount actually advanced).
 - 14.4 Where the relevant transfer document is executed later in time, supposedly to "perfect" a prior transaction (eg in *Mawr v Bland*¹⁰ the bankrupt, after the bankruptcy, executed a stock transfer to an associate and attempted to backdate the transfer. The judge considered that this conduct justified the continuation of the suspension of his discharge from bankruptcy, having disbelieved the bankrupt's assertion that he had agreed to give his associate the shares in exchange for a £24,000 loan to pay his legal fees such that his associate had the beneficial interest in hte shares before the bankruptcy and the transfer of the legal title afterwards was merely perfecting that transaction).

Shams and illegality

15. It is worth noting that a transferor who wishes to assert his/her title in property cannot assert the relevant transfer was a sham where in order to do so he/she has to rely on his/her own illegal act (see the decision of the House of Lords in *Tinsley v Milligan*¹¹).
16. In *Tribe v Tribe*¹² Millet LJ (with whom Otton LJ agreed) described the position thus:

"In my opinion the following propositions represent the present state of the law.

(1) Title to property passes both at law and in equity even if the transfer is made for an illegal purpose. The fact that title has passed to the transferee does not preclude the transferor from bringing an action for restitution.

⁷ [2001] BPIR 1

⁸ [2011] EWCA Civ 725

⁹ [2013] BPIR 965, particularly at [135] – [137]

¹⁰ Decision of Rose J on 12 June 2013, unreported.

¹¹ [1994] 1 AC 340

¹² [1996] Ch 107 at page 134



(2) The transferor's action will fail if it would be illegal for him to retain any interest in the property.

(3) Subject to (2) the transferor can recover the property if he can do so without relying on the illegal purpose. This will normally be the case where the property was transferred without consideration in circumstances where the transferor can rely on an express declaration of trust or a resulting trust in his favour.

(4) It will almost invariably be so where the illegal purpose has not been carried out. It may be otherwise where the illegal purpose has been carried out and the transferee can rely on the transferor's conduct as inconsistent with his retention of a beneficial interest.

(5) The transferor can lead evidence of the illegal purpose whenever it is necessary for him to do so provided that he has withdrawn from the transaction before the illegal purpose has been wholly or partly carried into effect. It will be necessary for him to do so (i) if he brings an action at law or (ii) if he brings proceedings in equity and needs to rebut the presumption of advancement.

(6) The only way in which a man can protect his property from his creditors is by divesting himself of all beneficial interest in it. Evidence that he transferred the property in order to protect it from his creditors, therefore, does nothing by itself to rebut the presumption of advancement; it reinforces it. To rebut the presumption it is necessary to show that he intended to retain a beneficial interest and conceal it from his creditors.

(7) The court should not conclude that this was his intention without compelling circumstantial evidence to this effect. The identity of the transferee and the circumstances in which the transfer was made would be highly relevant. It is unlikely that the court would reach such a conclusion where the transfer was made in the absence of an imminent and perceived threat from known creditors."

17. In *Vickers v Jackson* (above), despite the fact that the judge had concluded that the charge was a sham designed to mislead Mr Vickers' creditors and that in fact there was no underlying debt secured by it, Mr Jackson (the charge-holder) sought to argue that no relief should be granted to Mr Vickers (in the form of an order entitling him to have the entries relating to the charge removed from the register) because to do so would enable him to take advantage of his own illegality. He lost on this point but was given permission to appeal.
18. On appeal, Lloyd LJ proceeded on the assumption that the intention to mislead and deceive involved illegality sufficient to bring into play the relevant principles. He considered that, subject to the question of whether Mr Vickers was disqualified from taking the point by his own illegality, Mr Vickers had been entitled to put in issue whether any sum at all is due from him to Mr Jackson which was to be secured by the charge.
19. As to the question of illegality, Lloyd LJ held that where A sued B on a contract which was apparently lawful, it was open to B to show that the contract was a sham intended to deceive or defraud some third party and B is not prevented from putting forward such a case because it involves him asserting his own as well as the other parties' criminal conduct. Here, while Mr Vickers had brought the proceedings, Mr Jackson, by way of his counterclaim for enforcement of the charge, was in substance the party seeking to rely on and enforce the transaction and seeking the court's assistance for that purpose: Mr Jackson could not prove Mr Vickers owed him money without alleging the agreement under which it fell due which the court had to refuse to give effect to because it was illegal. Therefore the appeal was dismissed.

Relief



20. A sham transaction has been described as a nullity and as having no legal effect. Thus in *Re Ramratten*¹³ Mann J held that, whatever arguments could be made about the proper relief under s 339 (transaction at an undervalue) on the basis of conduct issues, where the court below had found that the transfer by a bankrupt into his wife's name was a sham (her signature and that of the witnesses having been forged) the registrar was not entitled to exercise his discretion to grant no relief. Having concluded the transfer was a sham, the only relief the registrar could have properly granted was a declaration that, in so far as the wife held the legal estate pursuant to the transfer, then she must (because it was a sham) have held the property on trust originally for the bankrupt and, after the bankruptcy, for his trustee. The Transfer had no real dispositive effect and, since it was a transaction without effect the court ought to grant a declaration to that effect and to give proprietary effect to it. Even if the circumstances, and in particular the delays, justified a discretionary withholding of relief under s 339 of the Act, that the same factors would not apply to the claim based on sham.

21. However, the analysis of a sham agreement as a nullity and therefore incapable of having legal effect has been challenged in other cases. *In Re Yates (A Bankrupt)*¹⁴, Charles J considered that it was established in *National Westminster Bank v Jones* (above) that :

“a conclusion that a document, agreement or provision is a sham or pretence does not make it void, or of no effect, for all purposes. Rather if there is a sham or pretence:

(i) the parties will not be able to rely on it as representing the true position as to the rights and obligations they have created and that court can ignore it in determining what those rights are, and

(ii) as against an innocent third party it cannot lie in the mouths of the pretenders to assert to the disadvantage of that innocent third party that the transaction is a sham, or pretence, and thus of no effect.

22. In *Jones*, Neuberger J had said¹⁵:

“However, I would suggest that the possible prejudice of innocent third parties who have relied on the document or the provision should not stand in the way of the court concluding that the document is a sham as between the parties thereto and as against a party who claims to be prejudiced thereby (and particularly the party against whom the sham is directed, if I can put it that way). If a tenancy agreement is a sham, and an innocent third party accepts it as security for a loan to the tenant, then it seems to me that the third party is entitled to treat the tenancy in existence as against the landlord and as against the tenant: it can scarcely lie in the mouth of either of them to contend that the tenancy agreement does not exist as against the mortgage in such circumstances. However, difficulties could arise where the interest of one innocent party, who contends that the agreement is a sham, clash with the interests of another innocent party, who contends that it is genuine. That is a problem which will have to be considered if and when it arises”.

23. This passage was cited with approval by Charles J in *Re Yates*¹⁶:

“ The point made by Neuberger J that such a conflict would have to be dealt with when it arose is an indication that when a sham or pretence is established the court has some flexibility as to what the rights and interests of the persons who have entered into it, and those who are affected by it, are.”

Relationship with s 423 of the Insolvency Act 1986

¹³ [2010] BPIR 1210

¹⁴ [2005] BPIR 476

¹⁵ At [60]

¹⁶ At [220]



24. In *Wyatt*, the learned Judge (after finding that the declaration of trust was a sham) went on to hold that, as he had already found that Mr Wyatt had no intention of disposing of his interest to benefit his children, it must follow that the real purpose of entering into the declaration of trust was to screen or protect them from 'unknown risks' of his proposed new business venture. The judge was therefore also satisfied that the declaration of trust was entered into for the purpose of putting his interest in the property out of the reach of any future creditors who might wish to make a claim against it, and therefore it constituted a transaction defrauding creditors pursuant to s 423 of the Insolvency Act 1986.
25. *Wyatt* was considered by Charles J in *Re Yates (A Bankrupt) (above)*. He took the view that if it can be said that the relevant transaction is a sham, it is void and of no effect and therefore there was no "transaction" to set aside under s 423. On that basis the two routes (sham and s 423) are strictly alternatives. Charles J considered that it was natural that the question of whether there was any conflict between the two routes to the same result was not considered in *Wyatt* because in that case the route taken would have made no difference to the outcome – Mr Wyatt retained the beneficial interest in the property whether the transaction was liable to be set aside as a transaction defrauding creditors or a sham. However, the matter is more complicated where the impugned conduct is a series of transactions involving both the transferor and various third parties, since the remedy in such a case may not be the same depending on whether the plea is of sham or under s 423.
26. Charles J went on to consider the pros and cons of bringing a claim of sham and bringing a claim under s 423. He considered that a claim pursuant to s 423 was the easier claim in the circumstances of the case, since (1) it did not necessitate establishing the relevant documents did not reflect the underlying agreements and intentions of the parties and (2) it gives the court a wide discretion as to relief, whereas if the claim is based upon a sham the court has to grapple with what the effect of the true arrangements are in law and equity by reference to the principles that would govern litigation between the participants in the sham as to their respective interests. This involves ascertaining their agreement and intentions and may be complicated by (i) the point that the purpose of, or motive for, the pretence or sham is to defraud creditors (and is thus tainted by illegality) and (ii) questions relating to the presumption of advancement and resulting, constructive and implied trusts. Charles J was therefore of the view that, unless there is some reason why the statutory claim is not available (because, for example, of limitation, or because the purpose behind the sham is not covered by the statutory claim) the better course was to rely on s 423 (see, in particular, [174]).

Transactions Defrauding Creditors

27. Sections 423 IA has been described as a "general statutory anti-avoidance measure"¹⁷ the object of which is to remedy the avoidance of debts¹⁸. This is by no means a new provision; provisions of this nature can be traced back at least as far as 1376¹⁹.
28. Although this provision is now located in the Insolvency Act²⁰, it is not exclusively an insolvency provision but can operate both outside insolvency proceedings and where there are no insolvency proceedings²¹. This is because an application for an order under s 423 IA may be made by a victim of the transaction, although the leave of the court will be needed to pursue such application in a case where the debtor is formally insolvent²². In such case, the application is governed by CPR Part 7 and not the Insolvency Rules.

¹⁷ *AC v DC (Financial Remedy: Effect of s.37 Avoidance Orders)* [2012] EWHC 2032 (Fam); [2013] 2 F.L.R. 1483 at [16] per Mostyn J

¹⁸ *Chohan v Saggar* [1994] 1 B.C.L.C. 706

¹⁹ Fraudulent Assurances Act 1376 (50 Edw III, c 6).

²⁰ Replacing s 172 of the Law of Property Act 1925, which provided that every conveyance of property made with intent to defraud creditors was voidable at the instance of any person thereby prejudiced.

²¹ *Re Banco Nacional de Cuba* [2001] 1 W.L.R. 2039

²² s 424(1) IA



29. In this paper, we will limit our scope to considering applications by insolvency office holders. It is somewhat unclear whether the Insolvency Rules apply to such application.²³ It has been suggested, as with victims' applications, that an office holder's application should also be commenced by way of claim form²⁴. However, the authors do not share this view and consider that such application can be issued within the existing insolvency proceedings by way of application notice in Form 7.1A.
30. In order to succeed in an application pursuant to s 423 IA, it is necessary to demonstrate that the debtor entered into a transaction at an undervalue²⁵ for the purpose of putting assets beyond the reach of a person who is making, or may at some time make, a claim against him²⁶, or of otherwise prejudicing the interests of such a person in relation to the claim which he is making or may make²⁷.
31. Where these requirements are satisfied, the court may make such order as it thinks fit for restoring the position to what it would have been if the transaction had not been entered into, and protecting the interests of persons who are victims of the transaction²⁸.

Transaction at an Undervalue

32. By s 423(1) IA, a person enters into a transaction at an undervalue with another person if:
- (a) he makes a gift to the other person or he otherwise enters into a transaction with the other on terms that provide for him to receive no consideration;
 - (b) he enters into a transaction with the other in consideration of marriage or the formation of a civil partnership; or
 - (c) he enters into a transaction with the other for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by himself.
33. This definition of a transaction at an undervalue mirrors that found in s 238(4) and 339(3) IA, which, unlike s 423 IA, do not require the court to have regard to the transferor's mental state. Accordingly, it will only be necessary for an office holder to pursue a claim pursuant to s 423 IA where: (i) the transaction did not take place at a relevant time within the meaning of s 240(1)(a) (within 2 years of the onset of insolvency) or s 341(1)(a) (within 5 years of the presentation of the bankruptcy petition on which the debtor was adjudged bankrupt); or (ii) the debtor was not insolvent at the time of the transaction and did not become insolvent in consequence thereof.
34. Section 423(1)(c) requires a comparison to be made between the value obtained by the company for the transaction and the value of consideration provided by the company. Both values must be measurable in money or money's worth and both must be considered from the company's point of view²⁹.
35. As Lord Scott noted in *Phillips v Brewin Dolphin Bell Lawrie*³⁰, the issue is not to identify the 'transaction' for the purposes of s 423(1) IA but to identify the consideration received by the company.

²³ *TSB Bank plc v Katz* [1997] BPIR 147 and see Schaw Miller and Bailey: Personal Insolvency Law and Practice (4th ed) at 21.27

²⁴ See Parry, Transaction Avoidance in Insolvencies (2nd ed) at 10.101).

²⁵ s 423(1) IA

²⁶ s 423(3)(a) IA

²⁷ s 423(3)(b) IA

²⁸ s 423(2) IA

²⁹ *Re M C Bacon Ltd* [1990] BCC 78; *Menzies v National Bank of Kuwait SAK* [1994] 2 BCLC 306

³⁰ [2001] UKHL 2, [2001] 1 WLR 143, HL



36. Accordingly, in some cases a particular course of dealing between two parties may be structured in a complex manner, involving two or more linked agreements that are 'indissolubly bound up as part of the same overall transaction'³¹.
37. The following cases provide a useful illustration of the court's approach to valuation of consideration:
- 37.1 In *Agricultural Mortgage Corporation plc v Woodward*³², an insolvent farmer granted an agricultural tenancy of his mortgaged farm to his wife at full market rent. As a result, the mortgagee could not sell the farm with vacant possession. In consequence, the value of the mortgagee's security was substantially reduced. The Court of Appeal held that the 'transaction' for the purposes of s 423(1)(c) was wider than the tenancy agreement and that the benefits conferred on the wife (which included security of tenure on the family home, protection from creditors and the ability to negotiate a large surrender value in future dealings with the mortgagee) were significantly greater than the value of the consideration provided by her;
- 37.2 In *National Westminster Bank plc v Jones*³³, insolvent farmers granted an agricultural tenancy of their mortgaged farm to a company incorporated by them for that purpose in order to prevent the mortgagee from selling the farm with vacant possession. In light of the decision in *Woodward*, the tenancy agreement provided that the company was required to pay not only the full market rent but also the base rent (i.e. payments in consideration for the benefit of obtaining the surrender and/or ransom values). As a matter of valuation, the court held that the transaction was still an undervalue. It also rejected the farmers' argument that there was no transaction at an undervalue because any diminution in the value of their freehold interest in the farm was matched by a corresponding gain in their capacity as shareholders in the company;
- 37.3 In *Delaney v Chen*³⁴, judgment debtors sold the freehold of their home (which was valued in the region of £275,000) to a third party for £210,000 and took a leaseback for a fixed rent of £500 per calendar month. The transaction was entered into to prevent their creditors from obtaining a charging order over the property. The court held that there was no transaction at an undervalue. The consideration provided by the debtors was either the value of the freehold subject to the lease (approximately £115,000 or a combination of £210,000 and the value of the lease (approximately £80,000).

The Purpose

38. For the purposes of s 423(3) IA, it is the actual subjective purpose of the Company that is at issue³⁵. However, the court is not restricted to findings based on direct evidence of the Company's purpose in entering the transaction. Inferences may be drawn from the facts and dates and circumstances of the case³⁶.
39. Thus, in *Moon v Franklin*³⁷ Mervyn Davies J rejected the debtor's assertion that he transferred the sale proceeds of his accountancy business and his beneficial interest in the matrimonial home in recognition of the assistance which she had given him over the years in building up his business. Given that the transfer was effected at a time at which the debtor was faced with legal proceedings for professional negligence, his insurance cover was doubtful and the transfer left him with no other means, it was inferred that the debtor's actual subjective purpose was to place assets beyond the reach of his creditors.

³¹ *Delaney v Chen and Another* [2010] EWCA Civ 1455 [2011] BPIR 39

³² [1994] BCC 688, CA

³³ [2001] EWCA Civ 1541 [2002] BPIR 361

³⁴ [2010] EWCA Civ 1455 [2011] BPIR 39

³⁵ *Royscot Spa Leasing Limited v Lovett* [1995] BCC 502; *Random House UK Ltd v Allason* [2008] EWHC 2854 (Ch)

³⁶ cf *Moon v Franklin* [1996] BPIR 196; *Barnett v Semenyuk* [2008] EWHC 2939 (Ch), [2008] BPIR 1427

³⁷ [1996] BPIR 196



40. It is not necessary that either of the purposes listed in s 423 was the debtor's sole purpose, provided it was a substantial purpose³⁸. In *Commissioners of Inland Revenue v Hashmi*³⁹, Arden LJ gave the following "homely example" to illustrate the distinction between a "real substantial purpose" and a "by-product" of the transaction under consideration:

"Suppose that I need to post a letter and also need to take the dog for a walk, and combine both operations in the same outing. I approach this example on the footing that neither objective counts as trivial. It will be clear that I have two purposes in leaving the house. It is a meaningless inquiry to ask whether I regard one of those objects as superior to the other or regard them as of equal potency. By contrast, if I go out to post a letter and the dog gets out of the house, slips under the gate and runs after me, it could certainly not be said that I had two objects in that I was not intending to take the dog for a walk at the time. Likewise, if I go to take the dog for a walk, and going past the postbox find an unposted letter in my pocket and take the opportunity of posting a letter at the same time, it will not be correct to say that I had two objects in that walk. I had only the one object, that of walking with the dog, and the posting of the letter was but a consequence of it. On the other hand, if I decide to take the dog for a walk but take the view that I will use the opportunity to post the letter at the same time, it can be said that I had two objects in that outing even if I would not have posted the letter until another day but for the need to take the dog for a walk.

41. This is usefully demonstrated by the following cases:

- 41.1 In *Royscot Spa Leasing Limited v Lovett*⁴⁰, the debtor transferred a house to his wife and stepson immediately before summary judgment was granted against him in respect of a personal guarantee liability. The evidence indicated that the debtor's purpose in making the transfer was not to place assets beyond the reach of creditors but to enable the wife and stepson to obtain further finance by way of a mortgage on the house. The mortgagee would not have made any further advances to the debtor;
- 41.2 In *Papanicola v Fagan*⁴¹, the debtor had a substantial alcohol problem which gave rise to associated mental health difficulties. His wife became concerned to protect her family and children against anything foolish that he may have done and gave him an ultimatum: she would divorce him unless he transferred his interest in the property to her. The court held that the transfer was not a transaction at an undervalue because the wife had given valuable consideration by her forbearance from petitioning for divorce and prosecuting her valid claim for a property adjustment order. Moreover, whilst the wife's purpose was to protect the matrimonial home against any liabilities and debts that might result from the debtor's alcoholism and gambling, the debtor's subjective purpose was to save his marriage;
- 41.3 In *Rubin v Dweck*⁴², the debtor transferred all his interest in the family home to his wife as a result of an ultimatum. The wife was concerned that the debtor might use the family home as security for business loans. However, the court accepted that the debtor's purpose was to save his marriage;
- 41.4 In *Williams v Taylor*⁴³, the debtor transferred his solely owned property to his wife and himself, to hold on trust for themselves as tenants in common in equal shares. Three weeks later, the parties executed a declaration of trust which recorded that the transfer was to reflect the wife's interest in the property, and she was stated as having paid £120,000 after the marriage to pay for building work to extend and improve the property and as having lent £120,000 to the family company, guaranteed by the debtor, which

³⁸ *Commissioners of Inland Revenue v Hashmi* [2002] EWCA Civ 981, [2002] BPIR 974; *4Eng Ltd v Harper* [2009] EWHC 2633(Ch)

³⁹ [2002] BPIR 974 at [24]

⁴⁰ [1995] BCC 502

⁴¹ [2008] EWHC 3348 (Ch); [2009] BPIR 320

⁴² [2012] BPIR 854

⁴³ [2012] EWCA Civ 1443; [2013] BPIR 133



was still outstanding. The court accepted that no part of the debtor's purpose in entering into the transfer and the deed of trust was to escape his liabilities.

42. Although s 423 IA is headed "transactions defrauding creditors", the defendant's motive for entering into the transaction need not be dishonest. Accordingly, the fact that the defendant acted on the basis of professional advice does not *per se* absolve him from liability⁴⁴.

Appropriate Order

43. The court has a broad discretion as to the most appropriate order to make where the requirements of s 423 IA are satisfied. Section 425 IA provides a non-exhaustive list of orders which the court may make. In *Re Thoars (No 2)*⁴⁵, Jonathan Parker LJ considered the proper approach to be taken by the court in relation to the comparative list in s 342 IA:

"In considering what is the appropriate remedy on the facts of any particular case the court should not start from any *a priori* position. Each case will turn on its particular facts, and the task of the court in every case is to fashion the most appropriate remedy with a view to restoring, so far as it is practicable and just to do so, the position as it 'would have been if [the debtor] had not entered into the transaction'. In some cases that remedy may take the form of reversing the transaction; in others it may not. In some cases it may take the form of an order for monetary compensation; in others it may not."

44. The discretion is wide enough to enable the court, if justice so requires, to make no order against the other party to the transaction (*Re Paramount Airways* [1993] Ch 223). However, the court will only decline to make an order in exceptional circumstances (*Stonham v Ramratten* [2010] BPIR 1210, particularly at paragraph 40).
45. In determining the most appropriate order to make, there is no express requirement that the court have regard to the recipient's mental state. Nevertheless, in *4Eng Ltd v Harper*⁴⁶, Sales J provided the following guidance as to the court's approach
- 45.1 Where the requirements of s 423 IA are satisfied, the usual interests of a transferee in the security of his receipts is overridden in favour of the transferor's creditors so as to make the transaction reversible for the benefit of those creditors;
- 45.2 Whilst the statute does not specify any particular mental state or action on the part of the transferee as an ingredient of the trigger conditions for liability, that does not mean that such matters are irrelevant for defining the extent of the liability to be imposed, or the order to be made, at the next stage in the analysis, when the court considers the question of remedy under s 423(2) and s 425 IA;
- 45.3 Although the trigger conditions set out the basic balance to be struck between the interests of the creditors and of a transferee as established by Parliament, the making of an order under s 423(2) and s 425 IA necessarily requires some further balancing of those interests to be determined by the court [13];
- 45.4 Accordingly, the nature of any order and the extent of the relief granted by the court under s 423(2) and s 425 IA should take into account the mental state of the transferee and the degree of their involvement in the fraudulent scheme of the transferor to put assets out of the reach of his creditors;
- 45.5 By analogy with claims based on unjust enrichment, where a transferee has received a gift of money in good faith, without knowing that the transferor acted with a relevant purpose in making the gift and has changed his position on the basis of the receipt in a way that would make it unfair to repay the money it would not be appropriate for the court

⁴⁴ *Arbuthnot Leasing International Ltd v Havelet Leasing Ltd (No 2)* [1990] BCC 636

⁴⁵ [2004] EWCA Civ 800; [2005] 1 BCLC 331

⁴⁶ [2009] EWHC 2633, [2010] BPIR 1



to make an order under s 425(1)(d) IA requiring the transferee to pay back a sum equivalent to the amount he has received; a defence of good faith change of position applies;

- 45.6 In choosing what relief is appropriate in a given case, a great deal will depend upon the particular facts. Whilst helpful analogies may be drawn with other areas of the law to guide the court in reaching its conclusion, it would be wrong to be unduly prescriptive in trying to lay down hard and fast rules for the application of s 423 IA.
46. Sales J subsequently followed his own decision in *The trustee in Bankruptcy of Gordon Robin Claridge v Gordon Robin Claridge and Gay Claridge*⁴⁷ where he held that the spouse of the bankrupt had received her husband's share of a loan made to them jointly in good faith, and believing herself entitled to spend it, spent it on home improvements. Since she remained liable to repay the outstanding loan advance and there was no evidence that the improvements had increased the value of house, the Judge considered that the benefit she received from the transaction was limited and it would not be just to make a money order (see particularly paragraphs 48 and 49). In neither case did Sales J have cited to him or consider *Ramrattan*.
47. However, as the editors of *Muir Hunter on Personal Insolvency* note⁴⁸, both of these decisions have been the subject of criticism. In *4Eng v Harper: Restitution and Insolvency*⁴⁹, Simon Davenport QC suggests that the availability of a change of position defence to an application pursuant to s 423 IA would be contrary to the overwhelming purpose of Part XVI IA, namely the claw back of funds for the general body of creditors and to maintain proper priority between them. Professor Sir Roy Goode has also trenchantly criticised these decisions⁵⁰, and his criticisms can be summarised as follows:
- 47.1 The transaction avoidance provisions are concerned not with the resolution of claims between private parties but with the protection of creditors in a winding up, and they have the specific policy of protecting the value of the company (or individuals)'s assets. By contrast, the principles of unjust enrichment deal with striking a fair balance between two parties: the party who has mistakenly paid away his property or money and the party who has innocently received and used it. The application of those principles in the insolvency context could have the effect of giving the transferee an unfair advantage over the body of creditors (which is inimical to the underlying policy of pari passu distribution). Change of position per se should not be identified as a defence since it does nothing to mitigate the loss suffered by the creditors.
- 47.2 Where legislation contains detailed remedial provisions, it is not open to the court to invoke common law rules either to confine the discretion given to the court by the statutory provisions or to bypass restrictions on remedial relief imposed by those provisions. The protection given to a transferee in good faith for value without notice by section 342(2)(a) does not apply to a transferee from the debtor himself, which clearly demonstrates that the overriding concern is to ensure that asset value is not lost in the run up to bankruptcy, even if this causes hardship to a wholly innocent counterparty. Specific provision is made for defence under section 342(2) for those other than the transferee who receive the property or a benefit in good faith and for value without notice of the petition, but Parliament deliberately chose to afford no protection to a transferee who is a bona fide purchaser for value without notice against a claim by the trustee. In those circumstances, it is hard to see how the statute can be said to leave it open to the Court to consider the mental state of the transferee when it comes to granting relief, and to refuse to grant relief to any person who has changed his position. Goode therefore concludes Acts of reliance by the creditor on the validity of the transaction should be regarded as res inter alios acta and irrelevant to claims under section 339 IA 1986.

⁴⁷ [2011] EWHC 2047 (a case decided under section 339 IA 1986)

⁴⁸ 3-2940

⁴⁹ (2011) 24 *Insolvency Intelligence* 91

⁵⁰ See his 4th edition of *Principles of Corporate Insolvency Law* (2011) at paragraph 13-150



47.3 The court's discretion in fashioning the remedy is to ensure the remedy is tailored to the purpose of "restoring the position to what it would have been if the company had not entered into that transaction", rather than to allow the Court to take account of hardship to the transferee.

Nature and Extent of Change of Position Defence

48. The defence of change of position was first recognised by the House of Lords in *Lipkin Gorman v Karpnale Ltd*⁵¹, in which Lord Goff succinctly stated the broad principle:

"The defence is available to a person whose position has so changed that it would be inequitable in all the circumstances to require him to make restitution, or alternatively restitution in full. I wish to stress however that the mere fact that the defendant has spent the money, in whole or in part, does not of itself render it inequitable that he should be called upon to repay, because the expenditure might in any event have been incurred by him in the ordinary course of things."

49. Accordingly, it is necessary for a defendant seeking to successfully invoke the defence of change of position to demonstrate that he incurred "extraordinary expenditure"⁵². The test is whether he entered a transaction that he would not have entered but for his enrichment⁵³.

50. In *Scottish Equitable v Derby*, the Court of Appeal held that the payment of existing debts does not generally constitute a change of position, because it does not reduce the defendant's overall wealth, the detrimental effect of the payment being offset by the beneficial effect of his release from liability to the creditor, although exceptionally it might be if there were a "long-term loan on advantageous terms".

⁵¹ [1992] 2 AC 548

⁵² *Dextra Bank & Trust Co Ltd v Bank of Jamaica* [2001] UKPC 50; [2002] 1 All ER (Comm) 193

⁵³ *Scottish Equitable plc v Derby* [2001] 3 All ER 818



Limitation

51. In *Law Society v Southall*⁵⁴, it was assumed that no limitation period applied to application under s 423 IA. However, it has subsequently been held that such application is a claim on a specialty and thus subject to a limitation period of 12 years⁵⁵. Moreover, it has been suggested that if the facts of the case and the nature of the relief sought by the claimant show that the claim is in essence an action to recover a sum of money, a limitation period of 6 years will apply⁵⁶.
52. In *Hill v Spread Trustee Co Ltd*, a majority of the Court of Appeal held that time starts to run from the date of the debtor's insolvency and not the date of the impugned transaction.

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January 2014**

⁵⁴ [2002] BPIR 336

⁵⁵ *Hill v Spread Trustee Co Ltd* [2006] EWCA Civ 542, [2007] 1 WLR 2404; *Random House UK Ltd v Allason* [2008] EWHC 2854 (Ch)

⁵⁶ cf *Re Yates* [2004] EWHC 3448 (Ch); [2005] BPIR 476.

