Sham transaction – a comparative approach

Article 108(1) of Korean Civil Code provides as follows:

> Declaration of intention falsely made in collusion with the other party shall be null and void.

While the statute might appear to employ a language which has a clear moral tone ('falsely' and 'collusion'), commentators have considerably toned down the moral flavour of the clause. The 'falsehood' here has been explained merely as a 'lack of correspondence' between the objective meaning of the expression and the subjective intention of the party. The word 'collusion' has been explained in a manner which further minimises the moral impact of the word. 'Collusion' is explained rather broadly as an 'agreement' or 'mutual awareness' as to the lack of correspondence between the expression and the intention. Interpreted in such a 'neutral' manner, Article 108(1) becomes almost indistinguishable from the second half of Article 107(1), which provides as follows:

> Declaration of intention which does not reflect the party's true intention shall nevertheless be effective if it was knowingly made by the party. If, however, the other party knew or should have known that the expression did not reflect the party's true intention, it shall be null and void.

Unlike Article 108(1), Article 107(1) uses a language which does not necessarily carry an unequivocally negative moral judgment. We do at times say things which do not accurately reflect what we truly mean. And it is not necessarily a bad thing to do so. In particular, the second half of Article 107(1) is broad enough to cover expressions which are not meant to be taken seriously. Suppose a teacher makes a somewhat jocular remark during his lecture that a brand-new Ferrari would be offered to any student who correctly answers his question. If one can rightly assume that the teacher obviously did not mean it, the latter half of Article 107(1) could be invoked to argue that the teacher's statement may not be given legal effect.[1] It is one thing to make a remark without really meaning it. It is quite another to make a false remark. And it is yet another matter to be engaged in fabricating a false transaction in collusion with the other party. However, scholarly endeavour to neutralise the moral edges of Article 108(1) makes it difficult to distinguish between these.

Unfortunately, the 'amoral' and scholarly interpretation of Article 108(1) has been adopted by the Court as well. I shall offer a brief discussion of cases where banks or other lending bodies chose to use non-genuine borrowers in an attempt to evade lending restrictions. A number of statutes require lending bodies to stipulate for

1 However, one should not recklessly indulge in jokes. See Keith A. Rowley, 'You asked for it, you got it... toy Yoda: Practical jokes, prizes and contract law', 3 *Nevada Law Journal* 526.

themselves and enforce lending limits for certain types of borrowers. Agricultural Cooperatives, Fishery Cooperatives, Credit Cooperatives, Mutual Credit Associations and Housing Cooperatives are all operating under such lending restrictions. The purpose of these statutory requirements is to ensure financial soundness of these lenders by diversifying the risk of unrecoverable credit. However, there are many cases where the lender's employee and the borrower who already reached the borrowing limit conspire to evade the restriction. A third person is used: he signs the loan agreement and the money passes through him to the 'true' borrower. If the latter's business thrives and the loan is fully repaid, all is well. All too often, however, things turn out bad and the lender sues the person who signed the loan agreement.

This comes as an unpleasant surprise for the defendant because when he was persuaded to sign, he was told, often by the lender's employee, that he would not be asked to repay. It was all a sham, a pretense, an 'administrative paperwork', he was told. He did not mean to borrow, he did not mean to repay. He did not get the money. But he signed the documents. Now he is asked to repay.

The Court's analysis is very logical and very confusing. In some cases, the defendant did not have to pay. In others, he had to pay. Where the defendant succeeded, the Court seemed to invoke Article 108(1) and treated the loan agreement as null and void. Where the defendant failed, the Court's reasoning vacillated between 107(1) and 108(1). Let us first have a look at the Court's logic to bail out the defendant.

In the Supreme Court case 2001DA11765, a branch manager ('A') of the plaintiff (Dairy Cooperative) apparently suggested to the borrower ('B') who already reach the borrowing limit that further credit could be given if a different person should sign the loan agreement. The defendant was thus recruited by B for this purpose. The plaintiff cooperative purportedly prepared credit assessment and evaluation forms regarding the defendant, which turned out to be substantially inaccurate and perfunctory. When the loan was approved, the fund went straight to B and the defendant was not even notified. This was repeatedly done: more than 20 different signatories were involved in this loan scam and the defendant was one of them. In appreciation of the loans, B offered to the branch manager a sizable amount of rebate (1.5% – 5% of the loan, on each occasion). The case report does not reveal whether the defendant received any payment from B in return for his signature to the loan agreement. The Court did, however, note that the defendant and B are unrelated.

The Court's reasoning seems to be straightforward and transparent. The Court found that the defendant did not have the 'true' intention to become the borrower. The plaintiff Cooperative, through its branch manager, had the knowledge of the lack of correspondence between the expression (the loan agreement) and the defendant's 'true' intention. The contract of loan, therefore, shall be null and void as it was falsely made in collusion with the other party. It was a mere façade unsupported by the

party's true intention.[2]

So much for the logic. Now, the confusion. Even a casual survey of other cases where the decision went the other way, would immediately demonstrate that the so-called 'true' intention is a far more complicated business. In a case which is not very different from the one we just discussed, the Supreme Court held that the defendant who signed the loan agreement did have the 'true' intention to be bound by the agreement (98DA17909). He may have had an intention, an idea, a wish, a plan, a notion, an understanding that the fund would be spent not by him but by someone else. He may have hoped, wanted, intended that he would not have to repay out of his own pocket. But that was irrelevant. Those were his economic or business decisions or plans relating to the use of the fund. As far as his 'legal' obligations are concerned, he was aware that he would be held responsible for the loan agreement which he voluntarily signed. That was true enough an intention which perfectly corresponds with the expression he produced (the signed document).

The fact that the branch manager of the plaintiff (lender) took the initiative to suggest this subterfuge did not pose any difficulty for the Court. The branch manager merely suggested possible economic uses of the fund the defendant was to receive under the loan agreement. In some of these cases, the Court's conclusion was based on an analysis of Article 107(1).[3] In others, it was based on Article 108(1).[4] In either line of cases, the Court's reasoning started from a finding that the loan agreement reflects the 'true' intention of the party. So it did not really matter whether the other party knew what was going on. There was nothing to form a collusion about.

In these two lines of cases, the Court's analysis was logical enough. It even has a 'scientific' appearance. The Court's analysis is presented with an air of inevitability as it takes the course of first establishing the 'true' intention and then comparing it with the objective meaning of the expression. In such an analysis, the 'falsehood' mentioned in Article 108(1) becomes a boolean concept, rather than an ethical concept. There is no room for imprecise 'moral' discourse in these tight, terse and logical analyses.

In my view, however, the quest for the 'true' intention is unfortunate and misleading. There are an infinite number of layers to what goes on in our mind. It is an arbitrary exercise to say that one of them is 'true' and the rest is irrelevant. To make an attempt to distinguish the 'intention' from the rest of what goes on in our mind, such as wish, hope, desire, understanding, awareness, knowledge, etc. is equally arbitrary and even temerarious. Only those who fail to understand the subtlety of our mental operations would attempt to find a workable legal distinction between them.

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2 The same reasoning was used in 96DA18076, 98DA48989, 2000DA65864 and 2001DA7445.

3 96DA18182, 97DA8403.

4 98DA17909, 2003DA7357, 2004DU2332.

But the legacy of Pandectist legal science (*Rechtswissenschaft*) looms large in Korean Civil Code. It still dominates the conceptual landscape of Korean commentators and text book writers as well. One of the defining features of the German Civil Code was the 'General Part (*Algemeiner Teil*) where the the 19th-century Pandectist scholars' achievements were given an ample room for expression. There, F. v. Savigny's novel and original 'theories' of jural act (*Rechtsgeschäft*) and declaration of intention (*Willenserklärung*) were elevated to the rank of statutory provisions.[5]

Thus, § 116 of BGB deals with the problems of undeclared (hidden) intention of a party (*Geheimer Vorbehalt*).[6] § 117(1) deals with problems of a sham transaction (*Scheingeschäft*).[7] These two provisions found their way to Article 107(1) and Article 108 of Korean Civil Code. This is all fine. But due to these statutory provisions, legal analysis revolves around the concept of 'intention' and the difference between intention and 'true' intention.

There is a world of difference between what one intends and what one does. Between these, all sorts of ideas, hopes, worries, plans and calculations could sneak in – deliberately, hesitantly, timidly or willingly. One could pose a more fundamental question: Is it appropriate for the Court to base its analysis on the subjective intention of the party? Shouldn't the analysis rather be focused on the objective meaning of the parties' actions? The Court's task is to deal with what the parties 'did'. The 'intention' of the parties should be understood merely as a term of art. It simply refers to what the Court can, on the basis of what the parties did, justifiably attribute to the parties as 'their intention'. Whether to hold the parties to the contract they voluntarily produced should therefore be decided through an overall assessment of what the parties did; it cannot be decided by a specious psychiatric attempt to distinguish what they intended and what they 'truly' intended.

Common Law judges do not have to cope with codified theoretical provisions purporting to distinguish between intention and 'true' (hidden) intention. When they deal with sham transactions, they do not attempt to give a 'scientific' or 'psychiatric' treatment of the question of falsehood or intention. The falsehood is discussed as an ethical question rather than a 'boolean' question. A convenient example can be found in Midland Bank v. Green.[8]

5 German Civil Code (Bürgerliches Gesetzbuch; BGB), Book 1 (Algemeiner Teil), Ch. 3 (Rechtsgeschäfte), Title 2 (Willenserklärung). Michel Fromont, Alfred Rieg, *Introduction au droit allemand*, vol. 3 (Paris, 1977) pp. 64-68; H Coing, 'German Pandektistik in its relationship to the former ius commune', 37 *American Journal of Comparative Law* (1987) 9-15.

6 Eine Willenserklärung ist nicht deshalb nichtig, weil sich der Erklärende insgeheim vorbehält, das Erklärte nicht zu wollen. Die Erklärung ist nichtig, wenn sie einem anderen gegenüber abzugeben ist und dieser den Vorbehalt kennt.

7 Wird eine Willenserklärung, die einem anderen gegenüber abzugeben ist, mit dessen Einverständnis nur zum Schein abgegeben, so ist sie nichtig.

8 Midland Bank Trust Co. Ltd. and Another v. Green and Another [1978] 3 W.L.R. 149 (Chancery Division); [1980] Ch. 590 (Court of Appeal); [1981] A.C. 513 (House of Lords)

The case arose from a family dispute. Walter wanted his farm in Lincolnshire to go to his son Geoffrey. They entered into an option contract where Geoffrey would, for 10 years, have a right to purchase the farm at about half its market price. Something happened subsequently. Walter now wanted to be rid of this option contract. Walter's lawyer discovered that Geoffrey's option contract had never been registered. Walter was thus advised by his lawyer that if the farm should be sold, the purchaser would acquire a clean title unencumbered by the (unregistered) option contract. A quick sale was arranged. Walter sold his farm, which was then worth 60,000 pounds (in 1967; the farm was worth 454,500 pounds when the case came to the court), to his wife Evelyne at a price of 500 pounds. Conveyance was completed in a matter of days, with 'the almost unseemly haste'. If Evelyne was to be deemed 'a purchaser of a legal estate for money or money's worth' within meaning of Land Charges Act 1925, section 13 (2), Geoffrey's purchase option would not prevail over Evelyne.

Oliver, J. of Divisional Court rejected the plaintiff's argument that the sale between Walter and Evelyne was a sham, 'a disguised gift with a consideration put in merely to enable the statutory provisions of the Land Charges Act 1925 to be invoked'.[9] The judge found that Evelyne acquired the title; and the price she paid was found to be a genuine, albeit clearly inadequate, price. The motive for entering into such a sale transaction was, without doubt, to frustrate Geoffrey's purchase option. But that could not matter. 'The fact that [Evelyne] knew and indeed intended that the transaction should have a particular effect as regards Geoffrey's option does not ... make her any less a purchaser within the statutory definition of a purchaser for money or money's worth.' Oliver, J. came to this conclusion not through an attempt to distinguish between intention and 'true' intention. He came to the conclusion with 'full knowledge of the family quarrels' together with a careful analysis of the meaning and purpose of the Land Charges Act 1925. The judge did express his regrets: 'Geoffrey had a clear legal right which was deliberately frustrated by his parents in breach of the contract created by the option. Nevertheless I cannot, with the best will in the world, allow my subjective moral judgment to stand in the way of what I apprehend to be the clear meaning of the statutory provisions.'[10]

The decision of Oliver, J. was reversed in the Court of Appeal. Denning, MR, took the view that 'a purchaser ... for money or money's worth' should mean a purchaser who paid 'a fair and reasonable value'. Otherwise, 'it would open the door to fraud of the worst description'. He made use of a broad concept of 'fraud' to justify his conclusion. In his view, 'the agreement was made – and the conveyance executed – deliberately to deprive Geoffrey of the benefit of his option. That was a fraud upon Geoffrey. The mother was a party to the fraud. She cannot be allowed to take advantage of it to the prejudice of Geoffrey.'[11]

9 [1978] 3 W.L.R. 149 at 166.
10 Ibid., 166–167.
11 [1980] Ch. 590 at 624–625.

The broadly defined concept of 'fraud' -- as distinct from fraud actionable in tort -- was explained by Sir Edward Coke (1552-1634): 'any dishonest dealing done so as to deprive unwary innocents of their rightful dues'.[12] Such a vague and imprecise concept would be disconcerting to Korean lawyers and judges. But Denning's analysis does not rely on rigidly defined theoretical concepts. He resorts to a sense of outrage, moral indignation which will be produced by a detailed account of the factual circumstances of the dispute. He does not, and cannot rely on clear-cut, deontological operations as Korean judges would do. The persuasive power of his decision comes not from abstract, normative propositions from a code, but from the richness of facts. This is why his judgment begins by setting out the full details of the dispute:

> The Greens are a Lincolnshire farming family. This story might be called the Green Saga...[13]

Relying on the ethical sensibility of the reader, Denning presented his conclusion, re-iterating the following remarks of his own:

> No court in this land will allow a person to keep an advantage which he has obtained by fraud. No judgment of a court, no order of a Minister, can be allowed to stand if it has been obtained by fraud. Fraud unravels everything.[14]

House of Lords, in turn, reversed the majority decision of the Court of Appeal. Having canvassed the legislative history of Land Charges Act 1925, Lord Wilberforce concluded that the legislator's choice of the wording, 'a purchaser ... for money or money's worth' reflected a deliberate policy decision not to require good faith on the part of the purchaser. This was to encourage land charges to be registered and to avoid land title from being encumbered by hidden charges. Evelyne was aware that Geoffrey had an option which was unregistered. She purchased the land to defeat the option. But, His Lordship went on, 'it is not "fraud" to rely on legal rights conferred by Act of Parliament'. Referring to Lord Denning's emphatic assertion that the sale was done 'deliberately to deprive Geoffrey of the benefit of his option', Lord Wilberforce dispassionately observed as follows:

> Any advantage to oneself seems necessarily to involve a disadvantage for another: to make the validity of the purchase depend upon which aspect of the transaction was prevalent in the purchaser's mind seems to create distinctions equally difficult to analyse in law as to establish in fact: avarice and malice may be distinct sins, but in human conduct they are liable to be intertwined.[15]

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12 Twyne's Case (1601) 3 Co. Rep. 80b.
13 [1980] Ch. 619.
14 Lazarus Estates Ltd. v. Beasley [1956] 1 Q.B. 702
15 [1981] A.C. 513 at 530-531.

What interests me is the way the Common Law judges presented their conclusions. This was a case where difficult questions as to how the broadly defined concept of fraud should be applied to an apparently collusive transaction, and how statutory language should be interpreted. The absence of abstract theoretical provisions forces Common Law judges to tackle the factual details and to discuss their ethical worth in an open forum. Oliver, J. did this. Denning, MR, did this, of course. Lord Wilberforce too. Although the final outcome of this case was grounded upon Lord Wilberforce's reading of the Land Charges Act 1925, Law Lords did not avoid the ethical dimension of this dispute. They weighed the questionable conduct of the parents in this family dispute against the policy considerations regarding the need to encourage registration of land charges. In this sort of disputes, Common Law judges could not sweep the ethical questions under the carpet of abstract, theoretical provisions of a code. Korean judges can. And they often do. We see very little of Korean judges openly struggling with the finer shades of the ethical worth of the parties' collusive dealings. We see decisive, logical steps making inexorable strides towards the foregone conclusion.

I suppose -- and one can only suppose -- that Korean judges also tackle the ethical aspects of a sham transaction. But they do it in private, their justification given, if it is given, in a soliloquy which no one else can ever hope to hear. When they present their conclusions in an open forum, they keep silent about the ethical dimension of the dispute. Bland, abstract and concise statutory provisions are paraded instead. Minimalist factual account is given only to the extent necessary to justify the application of the chosen provision from the Code to the case at hand. The judges have no need to shoulder the moral responsibility for their decision because the terse, but fantastically broad provisions of Civil Code can say it with so few words.

The irony of this impersonal and ethically neutral (apparently!) decision is that the case is, in fact, decided by the judge's very personal and private ethical choices. Unlike Common law judges who have no other choice but to discuss their ethical stance in an open forum, the 'private' ethical choices of Korean judges are completely shielded from public scrutiny. The abstract and versatile language of Civil Code provides the impenetrable screen.

It is unfortunate that certain provisions of Civil Code should be used in this manner. About 200 years ago, when the codification movement produced its first fruit in Europe, judges were expected to play a far more positive role in giving contents to the law (élaboration de la loi)' than nowadays. Their role and the legislator's role were viewed as complementing each other. Code Civil was presented as a deliberately incomplete system which can only be completed by judges. Portalis, who played the leading role in drafting the French Civil Code, expressed this idea as follows:

> There is a science of legislation just as there is a science of adjudication. These two are different. Legislative science consists in finding in each subject matter the principles which are most conducive to the common weal: the adjudicative science aims to put these principles into practice, to ramify and to extend them through a wise and reasoned application in private disputes; and to study the spirit of the law when its letters are unable to express it; and not to allow oneself to become now a slave, now a rebel vis-a-vis the code; and not to disobey the code by slavishly applying it.[16]

As it is well known, the drafters of Code Civil merely attempted an 'intercourse between written law and the customary law (transaction entre le droit écrit et les coutumes). They offered a bare minimum which could serve as a basis on which law making and law finding could fruitfully intermingle and interact:

> It is through accumulation of experiences that the lacunae left by us will be filled. It takes time to make the code of a nation. Strictly speaking, however, it gradually makes itself.[17]

Codification was not meant to reduce judges into blind subservience to the code. However, more than a century of adulation and devotion to the code seem to have fundamentally altered the balance of power between the judges and the code.[18] While judges shun away from ethical dimensions of a dispute and pretend to solve the dispute according to the provisions of the code, the emptiness (les vides) of the code can only grow.

16 Portalis, *Discours préliminaire du premier projet du Code Civil*. Full text is available on-line: http://www.justice.gc.ca/fr/ps/inter/code/

17 C'est à l'expérience à combler successivement les vides que nous laissons. Les codes des peuples se font avec le temps mais, à proprement parler, on ne les fait pas.

18 On the rise of exegetical positivism in France, see Jean-Louis Halpérin, *Histoire du droit privé français depuis 1804* (Paris, 1996) pp. 45-81. More detailed account can be found in Julien Bonnecase, *L'Ecole de l'Exégèse en droit civil* (Paris, 1924).