

Sham Self-Employment Contracts: Taking a Liberty?

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Abstract

Sham self-employment reduces employer liability, limits workers' rights and cuts tax revenues. This article considers the restrictions on contractual freedom in the context of employment contracts, focusing on sham self-employment. The parol evidence and signature rules are examined in detail, assessing that over time the strength of these contractual principles has been eroded by judicial decisions about the nature of employment contracts. I then turn to the public policy considerations of sham self-employment including the protection of vulnerable workers from economic duress and the collection of taxes. The need to balance contractual liberties with public protection leads me to a proposal for the introduction of a further stage in contractual relations. This would entail an explanation and summary of the terms by the dominant party in order to help address the unequal bargaining powers ubiquitous in employment relationships. Furthermore, I recommend that a contract of employment should be presumed into a work contract, so as to provide further safeguards for the public whilst not unduly restricting the sanctity of contractual freedom.

I. Introduction

'A contract of employment is...radically different from a contract to purchase a chocolate bar'¹ but there is much controversy over the extent to which contract orthodoxy should apply in the context of a contract of employment, particularly as regards 'sham' self-employment. This essay will examine what sham self-employment entails and how it interacts with established principles of contract law, such as the parol evidence rule and the signature rule.

¹ Ewan McKendrick, *Contract Law* (8th edn Palgrave Macmillan, Kilbride 2009) 2.

The discussion will also consider the development of contractual principles in the context of employment and public policy. This will be done with a view to proposing some measures to maintain a delicate equilibrium between freedom of contract and the protection of employees.

II. Sham Contracts Defined

In order to assess the optimum scope of contract law in employment status, it is first necessary to investigate what is meant by sham self-employment. Sham contracts were defined by Lord Diplock in *Snook v London & West Riding Investment Ltd*² as those contracts whose terms were 'different from the actual legal rights and obligations (if any) which the parties intend to create.'³ That is to say, a sham contract exists where the written agreement does not accurately reflect the de facto agreement made between two (or more) parties. Therefore it can be seen that the concept of a sham contract is a well-established principle of contract law.

This principle was expressly extended in the sphere of sham self-employment where it was held that the terms must reflect the reality of the situation 'not only at the inception of the contract but...as time goes by.'⁴ As a result, the present definition of a sham contract differs in employment law from traditional contract orthodoxy. As far as contract law is concerned, the parties must intend a contract to be a sham from the outset for it to be classified as such.⁵ A further difference in definition is that in contract law, 'all the parties...[to a contract] must have a common intention'⁶ to deceive the courts or a third party as to their true intentions, whereas in the context of employment it is

2 [1967] 2 QB 786.

3 (n 2) 803.

4 *Firthglow Ltd (Protectacoat) v Szilagyi* [2009] ICR 835, 846.

5 *Shalson v Russo* [2003] EWHC 1637.

6 (n 2) 802.

more often the case that the weaker party 'may be the victim of the deceit himself.'⁷ This reflects the disparity between a commercial contract (where it is in the interests of both parties that the contract reflects the true agreement) and an employment contract (where there is greater inequality of bargaining power), which justifies the difference between the definitions.

III. Parol Evidence Rule

Where an agreement between two parties has been committed to writing as a contract, it is a general presumption of contract law that the terms contained therein are the only terms to be considered in interpreting the contract⁸ as it is 'intended by the parties to constitute the whole agreement.'⁹ This literal approach is the traditional means by which the terms of a contract are interpreted. Its primary advantage is that the boundaries of investigation are clearly laid out and thus anything that lies outside of them can be dismissed without consideration. Whilst this leads to greater certainty in the contracting process, a number of concerns have been raised about it as an approach in a contemporary context. Firstly, employment contracts are typically drafted by employers with 'armies of lawyers,'¹⁰ allowing them to exclude a number of terms without the knowledge of the other party. Secondly, the principle has been weakened by the growing number of exceptions to its application¹¹ and thirdly, 'the contents of documents may bear little relationship to the practice of a particular employment relationship.'¹² Therefore, it would seem inappropriate to

7 Anne Davies, 'Sensible Thinking About Sham Transactions' [2009] ILJ 318, 319.

8 *Jacobs v Batavia & General Plantations Trust Ltd* [1924] 1 Ch 287.

9 Alan Bogg, 'Sham Self-Employment in the Supreme Court' [2012] ILJ 41(3) 328, 334.

10 *Consistent Group v Kalwak* [2007] WL 1425696 [57].

11 *McKendrick* (n 1) 148.

12 Simon Deakin, 'Interpreting Employment Contracts: Judges, Employers, Workers' [2004] IJCLIR 20 201, 217.

apply the rule strictly when 'a strong employer can easily impose a contract'¹³ on unfavourable terms.

This judicial move towards a more purposive interpretive approach has largely been driven by the proliferation of sham terms in written documents, particularly in employment¹⁴ where the 'relative bargaining power of the parties'¹⁵ plays a pivotal role in contract negotiations. However, the Courts have at times been at pains to state that they do not 'seek to recast the contracts'¹⁶ but rather discover 'what the actual legal obligations in the employment contract were.'¹⁷ This includes bogus substitution clauses, often inserted to seek to avoid employment status being declared by the Courts.¹⁸ In a number of cases there has been an express term in a contract to the effect that an individual need not perform the work themselves, in an attempt to circumvent the requirement of personal service which is necessary for a contract of employment.¹⁹ Whilst cynical uses of these substitution clauses in an attempt to escape employer liability may be struck down,²⁰ the simple fact that a right to substitution was not exercised is not enough to render it a sham.²¹

This can be seen as the Courts attempting to tread a delicate line between established contract law principles on the one hand and the need to protect workers on the other. However, the relaxation of the parol evidence rule, with the increased adoption of the purposive approach of contract

13 Guy Davidov, 'Who is a Worker?' [2005] ILJ 34(1) 57, 67.

14 Gerard McMeel, 'The Principles and Policies of Contractual Construction', in A Burrows and E Peel (eds), *Contract Terms* (OUP, Oxford 2007) 27, 45.

15 *Autoclenz v Belcher* [2011] ICR 1157, 1168.

16 *Autoclenz v Belcher* [2009] EWCA Civ 1046 [106].

17 Spencer Keen, 'Things Are Seldom As They Seem' [2011] NLJ 161(7481) 1235, 1236.

18 *Glasgow City Council v MacFarlane* EAT/1277/99.

19 *Express & Echo Ltd v Tanton* [1999] ICR 693.

20 (n 18).

21 *Premier Groundworks Ltd v Jozsa* UKEAT/0494/08/DM.

interpretation is open to attack as 'words on a page provide order'²² whereas permitting other evidence to be included creates uncertainty and undermines predictability.²³ As a result, whilst Courts should take account of 'the reality of the relationship,'²⁴ further erosion of the parol evidence principle would be detrimental to employers and workers alike. Nevertheless, it is clear that such a stance remains tenable only whilst the increasing formalism of employment relationships continues; for example, through 'the proliferation of standard form [employment] contracts.'²⁵

IV. Signature Rule

The signature rule holds that when a document has been signed, 'the party signing it is bound'²⁶ by the terms expressed therein. Whilst a contract of employment is often made orally, sham self-employment contracts are typically committed to writing in an attempt to shore up their legal weight. A major issue with a strict application of this rule is that often an individual will have little understanding of the document they are signing, particularly the implications of being classified as self-employed. This can be demonstrated by evidence from a survey that showed that the majority of homeworkers who were classed as self-employed did not realise the tax advantages of their position and as such were 'doubly disadvantaged.'²⁷ From this, it would seem unjust to permit this contract law principle to penetrate into the sphere of employment contracts beyond what could reasonably have been understood by the workers. However, that in itself

22 Peter Linzer, 'The Comfort of Certainty: Plain Meaning and the Parol Evidence Rule' [2002-2003] 71 FLR 799, 802.

23 Bogg (n 9).

24 Davidov (n 13) 64.

25 Hugh Collins, 'Legal Responses to the Standard Form Contract of Employment' [2007] ILJ 36(1) 2.

26 *L'Estrange v Graucob* [1934] 2 KB 394, 403.

27 Trade Union Congress Report, *Hard Work, Hidden Lives* <<http://www.vulnerableworkers.org.uk/cove-report/full-report/index.htm>> accessed 20 November 2012, 181.

could raise further problems, given the high proportion of sham self-employed migrant workers whose grasp of English is likely to be limited.²⁸ Furthermore, since the signature rule 'underpins the whole of commercial life,'²⁹ it 'must be presumed that the parties realised the importance of the written document.'³⁰

Nonetheless, it would be remiss to dismiss the problem entirely. The principle issue lies in the lack of understanding of the terms of the contract. This allows unscrupulous companies to take advantage of vulnerable workers. As such, two potential paths present themselves for ensuring that the sanctity of contract is protected whilst also providing an adequate level of cover for workers. The first option would be to permit the use of the *non est factum* defence in a wider range of employment cases. This defence voids a signed contract where a signatory 'has not brought a consenting mind'³¹ to the bargain due to lack of comprehension, particularly illiteracy. Whilst this defence has been given a narrow definition in cases such as *Saunders v Anglia Building Society*,³² this has largely been due to the need to protect innocent third parties. However, sham employment contracts are typically bilateral agreements and therefore such objections are less persuasive. Nevertheless, this route would not be ideal as it would merely render a contract void and thus if this defence were to be expanded then there would need to be changes made so as to only void the written document and not the contract itself. Instead the Courts could use 'subsequent conduct evidence'³³ to infer the actual contract.

28 (n 27).

29 *Peekay Intermark Ltd & Anor v Australia and New Zealand Banking Group Ltd* [2006] 1 CLC 582, 598.

30 Bogg (n 9) 338.

31 *McKendrick* (n 1) 150.

32 [1971] AC 1004.

33 Bogg (n 9) 333.

Another, more appealing, option would be to maintain the contractual principles of offer and acceptance for employment contracts but with an additional requirement of explanation. For many workers there is a 'considerable disjuncture between what someone thinks their status is and what it actually is.'³⁴ Often, workers will be induced into signing up as self-employed but are 'never...told what that means.'³⁵ This could be remedied rather simply by requiring that, in the context of contracts relating to work, the dominant party be obliged to provide an explanation of the salient terms such that a reasonable layperson could understand them.

This could be, for example, a summary at the start of the written contract, clearly explaining the terms of the working relationship. Whilst there are many proponents of the view that 'parties should...be free to contract as they see fit,'³⁶ this proposal does not undermine the freedom to contract but merely enshrines a more equal understanding of the terms of the agreement, thereby ensuring protection for the vulnerable party. This summary would not vary the terms, though if there were disparity then the summary would take precedence and *contra preferentum* be applied. Moreover, this proposal is not such a divergence from contract law orthodoxy as might be assumed; it has long been established that 'the basic aim of contract law...is to deter people from behaving opportunistically toward their contracting parties.'³⁷ Therefore this proposal can be seen not as a revolutionary change but rather a natural progression of orthodox contractual principles in a contemporary context. There would remain an element of uncertainty as to

34 Deakin (n 12) 202.

35 (n 27) 152.

36 Samuel Engblom, 'Equal Treatment of Employees and Self-Employed Workers' [2001] 17 *IJCLIR* 211, 225.

37 Richard Posner, *Economic Analysis of Law* (7th edn Aspen Publishers, New York 2007) 94.

which are the 'salient terms' but this is a concept that could be developed judicially.

V. Public Policy

Despite the statement of Gibson LJ that 'public policy has nothing to say'³⁸ about sham self-employment relationships, there are 'huge implications'³⁹ in terms of the protection of vulnerable people, avoidance of legislative duties, and tax. These issues will be dealt with in turn, firstly in the context of unwanted sham contracts, forced on the worker by a party seeking to avoid employer liability, and secondly in terms of mutual shams, where both parties wish to avoid employee status being established.

A. Unwanted Shams

The 'fundamental problem'⁴⁰ of resting employment rights on a contract is that it potentially excludes a large proportion of the workforce from statutory protection. Whilst the Employment Rights Act 1996 voids any clause in an employment contract which excludes or limits protection under the Act,⁴¹ it does nothing to void a sham contract which is falsely set up as that of a self-employed contractor. As such, if contractual freedom were allowed to apply unfettered, many vulnerable people for whom Parliament had intended to provide protection would suffer a detriment. Indeed, they are likely to suffer not only financially and with less protection from unjust treatment, but also 'sites using bogus self-employment have a higher rate of injuries and fatalities.'⁴² As a result there is a clear public interest here in ensuring that people are not only afforded the correct label in law but also in practice, so as to encourage further training

38 *Calder v Kitson, Vickers and Sons Ltd* [1988] ICR 232, 250.

39 Patricia Leighton and Michael Winn, 'Classifying Employment Relationships – More Sliding Doors or a Better Regulatory Framework?' [2011] ILJ 40(1) 5, 24.

40 Bob Hepple, 'Restructuring Employment Rights' [1986] ILJ 15(2) 69.

41 Employment Rights Act 1996, s 203(1)(a).

42 (n 27) 182.

and better safety provisions. In this context it can be seen that some limitations on orthodox contract principles are necessary to prevent them being a 'barrier to effective employment protection'⁴³.

Whilst there are those who argue that the law should not be about providing 'material justice,'⁴⁴ unconscionability is a well-established feature of contract law⁴⁵ and as such, it does not require a great divergence from established contractual principles (despite the claims of some academics who see freedom of contract and employment protection as almost mutually exclusive concepts⁴⁶). Therefore, whilst it is necessary for the Courts to take a more interventionist approach to provide adequate cover for workers, this is not to say that orthodox contractual principles must be disregarded.

B. Mutual Shams

Mutual shams are where, far from being taken advantage of by an unscrupulous employer, a would-be employee seeks to declare him or herself as self-employed. There are two primary motivations for this: tax and terms. An employer who will not be liable for a worker and is not limited by unfair dismissal laws for example, will be more willing to offer more favourable terms to a worker. Here it can be seen that there is a trade-off between rights and resources. By declaring themselves to be self-employed, workers may be able to ensure a greater rate of return for their work; however, this short-term gain carries high risk potential, due to the potential costs of any injuries sustained and the lack of job security. Nonetheless, if a worker should wish to assume those risks, there is little persuasive reasoning

43 Douglas Brodie, 'Employees, Workers and the Self-Employed' [2005] ILJ 34(3) 253, 256.

44 Engblom (n 36) 217.

45 *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125.

46 Davidov (n 13).

why they should not be free to do so, despite the 'constant erosion'⁴⁷ of the freedom to contract.

Where public policy is more concerned however is in the tax implications of sham self-employment. Whilst the Courts have generally been persuaded to intervene in a contract where everything but the label has suggested a contract of employment and there has been an element of unequal bargaining power, they have been less willing to do so when both parties have applied the label of self-employment willingly. In *Massey v Crown Life Insurance*,⁴⁸ where an employee had arranged a new contract so as to become self-employed for tax purposes, this label was held to be valid despite many indications that the claimant was working under a contract of employment. This judgment is troubling since it essentially permits the employer/employee relationship to be changed simply for the purpose of avoiding tax, a difficult position to justify. It would seem from a public policy point of view that whilst changing the employment status to redistribute the risks and rewards can be justified under freedom of contract, tax avoidance here seeks merely to harm a third party and therefore cannot be justified.

VI. Conclusion

Whilst there are many who advocate a simpler relationship between contract and employment law,⁴⁹ such a position cannot be easily established. It is submitted that if an employment relationship were presumed into most contracts relating to work,⁵⁰ then the bulk of orthodox contractual principles could be applied with little restraint. This is because the Courts could consider the nature of the contract, rather than its written form. If the parties wished to

47 Simon Honeyball, 'Employment Law and the Primacy of Contract' [1989] 18(2) 97, 99.

48 [1978] 1 WLR 676.

49 (n 27).

50 International Labour Organisation Conference Report, 'The Employment Relationship' [2006] Report V(1) [27].

refute the *prima facie* employment relationship then the onus would be on them to do so. Therefore, contractual liberty could be preserved whilst also ensuring that any negative impact upon workers would have to be expressed in unambiguous, certain terms. However, due to the great inequality of bargaining power (and the economic duress to which this amounts) it is important that the effects of contract law principles are limited. The introduction of a requirement to explain the terms of an offer before it can be accepted would be a move towards ensuring the long-standing principles of contractual freedom are upheld whilst also maintaining an adequate level of protection for vulnerable members of the workforce.

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