

Dealing with the Emerging Popularity of Sham Trusts

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This article considers the doctrines of sham trusts and alter egos currently causing some controversy among trust lawyers. The author analyses recent decisions of the High Court involving allegations of sham trusts and alter egos and relevant authorities from other jurisdictions and assesses the legitimacy of the concepts in the context of established trusts law. While the author accepts the existence of sham trusts, she advocates for a narrower ambit limiting their application only to ab initio shams and rejects both emerging shams and alter egos. Further, the relevant intention with which sham trusts are concerned is only that of the settlor and there should therefore be no requirement of a common sham intention as a prerequisite to finding a sham trust.

Introduction

In *Target Holdings Ltd v Redferns*,¹ Lord Browne-Wilkinson said of the trust that “in the modern world [it] has become a valuable device in commercial and financial dealings”.² The express trust is a popular mechanism used by many in their business and personal asset planning structures. Unfortunately, the rise of cases alleging sham trusts, “alter egos”, and similar claims indicates that the use of express trusts may not be altogether legitimate or, at the very least, properly understood. Added to this is the present uncertainty in the law that surrounds the scope and application of the concepts of sham and alter ego³ resulting from conflicting judgments in the area and, in New Zealand, judgments that lack any real analysis of the relevant principles at all.

While the sham concept was initially recognised in a contractual context,⁴ its origins in trusts law are in matrimonial and de facto property dispute cases.⁵ The typical claim is that brought by a wife or de facto partner against her spouse and is in two parts: the secondary claim that property settled by him on trust is nevertheless controlled by him as if he were the absolute owner and should accordingly be treated as his for the purpose of the primary claim that she is entitled to an award of some portion of his property.⁶ In *Prime v Hardie*,⁷ Salmon J found that the trust which had owned both the family homes and some rental properties was the alter ego of the husband and thus its assets could be treated de facto as the husband’s property. On separation, the wife claimed an interest in the properties based on a *Lankow v*

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¹ [1996] 1 AC 421 (HL).

² Ibid at 435.

³ These concepts will be defined and explained further herein.

⁴ The most well known definition of sham comes from Diplock LJ in *Snook v London & West Riding Investments Ltd* [1967] 2 QB 787 at 802 where his Lordship was concerned with hire purchase and refinancing agreements relating to a motor vehicle.

⁵ The most notable examples in New Zealand are *Prime v Hardie* [2003] NZFLR 481 and *Glass v Hughey* [2003] NZFLR 865.

⁶ Grounds for the primary claim may be in statute, for example, the Property (Relationships) Act 1976 or in common law principles, such as the *Lankow v Rose*-type constructive trust ([1995] 1 NZLR 277), but this is not of any real relevance to the secondary sham claim that is the focus of this article.

⁷ [2003] NZFLR 481.

Rose-type constructive trust.⁸ Salmon J's ruling that a constructive trust would extend only to the family home and not to other assets of the trust because the wife had made no relevant contributions to those assets correctly divides up the two separate aspects of the plaintiff's claim. The claim involves establishing, first, that assets owned by a trust should be treated as assets of the defendant, in fact, and, secondly, that the plaintiff can show some ground that justifies, as against the defendant, an equitable interest in the defendant's property.

The importance of recognising this distinction is evident in *Miller v Stewart*⁹ where the plaintiff de facto wife made separate claims against the husband and the trustees respectively on the basis of a *Lankow v Rose*-type constructive trust. A direct claim against the trustees required that the plaintiff establish the *Lankow v Rose* elements of contribution and mutual expectation in relation to the trustees, rather than just as against the husband. Young J, in the High Court, dismissed her claim against the trustees because her contributions were "better regarded as contributions to [the husband] and his position vis-à-vis the trust rather than to the trust itself".¹⁰ Further, there was no mutual expectation between the trustees and the plaintiff that she would receive an equitable interest in properties owned by the trust. His Honour found in favour of the plaintiff in relation to the claim against the husband but it is possible, given his finding that "the trust has been under the substantial control of [the husband]",¹¹ that she would have been awarded greater relief had she pursued only the claim against the husband but with the additional allegation that the trust was a sham (or alter ego) and the assets should have been treated as belonging to the husband.

In addition to standard matrimonial property claims, the potential for similar sham allegations to be made against the settlor by other interested parties is slowly being realised. It is not only an ex-wife who may be adversely affected by a settlor's move to place his assets in trust. In *Official Assignee v Wilson & Clyma*,¹² upon the bankruptcy of the settlor of a family trust, the Official Assignee claimed that the trust was a sham and that trust property should be made available to the bankrupt's creditors. The claim was unsuccessful on the facts.

The potential of the sham trust/alter ego doctrines to be invoked against otherwise apparently legitimate trusts is significant, particularly if they are to be given effect in a wider context than only matrimonial property. Their ability to provide creditors with an additional, and often more effective, method of accessing recovery of debt to the general insolvency regime will make them attractive to the commercial lawyer and her client.

Given their significance to trusts both in family property and in commerce, it is important that the concepts of sham and alter ego are well understood both theoretically and in their application. Their elements must be consistent with the remainder of the law of trusts so that our system of property is not rendered arbitrary and incoherent. In that light, this article seeks

⁸ The *Lankow v Rose*-type constructive trust arises in de facto relationships where only one party in the relationship is the legal owner of the relevant property and the other claims a constructive trust over the property. Two factors must be established: the claiming party must have made a contribution, direct or indirect and of significance, to the acquisition, maintenance or improvement of the property and both parties must have a reasonable expectation that the claimant will share in the property.

⁹ [2000] NZFLR 433.

¹⁰ Ibid at 450.

¹¹ Ibid at 441.

¹² [2006] 2 NZLR 841.

to analyse the role and content of sham trusts and the alter ego idea within the framework of trusts law. It will be argued that shams created from the beginning do justify rejection of the trust in favour of recognition of the settlor as the real owner, but only on the basis that in such situations no valid trust exists in equity. In the case of so-called emerging shams, the answer is quite the opposite. A valid trust exists and no amount of conduct in breach of the trust by the trustees or the settlor/controller can overthrow its existence. In such circumstances, relief must be obtained in other ways, which are considered in some detail herein. This is the most appropriate approach because it enforces and protects pre-existing property rights – it recognises that once property rights are created by the trust, both legal and equitable, wrongdoing by an outside party (the settlor) cannot justify their reversal. Any suggestion that the alter ego idea amounts to a separate doctrine through which a trust can be disturbed is also rejected.

Understanding Shams and Alter Egos

1 *Sham transactions*

Generally, a court is obliged to accept the effect of documents or transactions that appear genuine and cannot go behind them to some real or underlying meaning.¹³ However, in the words of Lord Wilberforce, a court is not compelled “to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs”.¹⁴ The allegation of sham is one area where the court will readily look to the context of the transaction and consider the subjective rather than objective intentions of the parties to the transaction. The most oft-cited statement on the meaning of sham is that of Diplock LJ in *Snook v London and West Riding Investments Ltd*.¹⁵

...[I]t 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 sham concept initially arose in the context of commercial transactions, particularly involving hire purchases and lending agreements.¹⁶ A sham is said to arise where the transaction or document is a mask, cloak or façade of the true position between the parties.¹⁷ There is however no sham where the parties have merely exercised a preference for one form of a transaction over another if both are equally available to the parties.¹⁸ “The freedom to

¹³ *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1.

¹⁴ *W T Ramsay v Inland Revenue Commissioners* [1982] AC 300 at 323.

¹⁵ [1967] 2 QB 786 at 802.

¹⁶ In New Zealand, see, for example, *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794, affirmed on appeal to PC at [1971] NZLR 929; *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164; *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136; *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586. See further McLauchlan, “Agreements to Buy One’s Own Goods – Implied Preceding Sale or Sham?” (1995) 1 NZBLQ 21.

¹⁷ *Paintin and Nottingham Ltd*, *ibid* at 168; *Bateman Television*, *ibid* at 803.

¹⁸ *Bateman Television*, *ibid* at 813-814 per Turner J.

choose the form of transaction into which [an individual] shall enter is basic to the maintenance of a free society.”¹⁹

A sham could thus be described as a transaction the true effect of which is not its represented effect. The documentation and appearance of the transaction is but a cloak or façade for another. The true intention of the parties need not be unlawful for the transaction to amount to a sham.²⁰ All that is necessary is that the real or underlying position of the parties is not that which appears in the purported transaction. Where the courts have discussed the meaning of sham in the context of trusts, Diplock LJ’s exposition has generally been adopted in its entirety.²¹

In determining whether a trust (or a company or other arrangement) is a sham, care must be taken not to become overzealous in assuming a sham on the slightest suspicion. An Australian bankruptcy case serves as a good illustration of this point. In *Sharrment Pty Ltd v Official Trustee in Bankruptcy*,²² Mr Wynyard died insolvent and his estate was put into administration. Wynyard had earlier engaged in a complex series of transactions with companies and trusts controlled by him. The effect of the transactions was to create a liability incurred by Wynyard to one of the companies for which he had received no benefit. A house was then purchased by one of the companies and that same company was also made beneficiary of one of the trusts and in turn took the benefit of Wynyard’s debt. The house was later sold and the Official Assignee claimed the proceeds of sale as part of Wynyard’s estate on the grounds that the transactions were a sham intended to create the appearance of a debt and that the funds provided for the purchase of the house were in reality Wynyard’s funds.

Lockhart and Beaumont JJ, with whom Foster J concurred, both gave detailed consideration to the concept of sham and what was required to establish one. Lockhart J described a sham as

something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.²³

Beaumont J emphasised that in determining whether something is a sham or not, it is necessary to ascertain what the genuine intentions of the parties concerned were. Only if it can be concluded that “the parties intended that their dealings have an operation which was different from that which would flow from the terms of the documents employed”, can the transaction be said to be a sham.²⁴

¹⁹ *Commissioner of Taxation v Westradars Proprietary Ltd* (1979) 144 CLR 55 at 60-61 per Barwick CJ.

²⁰ *Official Assignee v 15 Insoll Avenue Ltd* [2001] 2 NZLR 492 at 497 per Paterson J. His Honour was there concerned with documents creating a company which contained forged signatures and directors of the company being effectively puppets of the fraudster. The intention of the fraudster, to protect his assets from attack by future creditors, could have been achieved legitimately but the particular method employed by the fraudster was not legitimate and therefore a sham.

²¹ *Shalson v Russo* [2005] Ch 281; *In re Esteem Settlement* [2003] JLR 188 (Jer CA); *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449.

²² (1988) 18 FCR 449.

²³ *Ibid* at 454.

²⁴ *Ibid* at 469.

The artificiality or significant complexity of a transaction does not render it a sham. It is the intended meaning of the parties to the transaction that is determinative. If any other legitimate explanation for the transaction is a possibility, a finding of sham will be unlikely. In the *Sharrment* case, the alternative inference to a sham that could be drawn from the facts was that Wynyard did indeed intend to incur a personal liability and benefit his family through his family trusts and companies at his own expense. Thus it could not be said with sufficient certainty to justify a finding of a sham that he intended something other than what the transaction actually achieved.

In the New Zealand trust cases, no attempt has thus far been made to explain sham trusts or to consider whether they are distinct in any way from shams generally. In addition, no sham trust cases have yet proceeded beyond the High Court. An added complication of the New Zealand cases is a general tendency on the part of judges to make concurrent use of the alter ego concept when considering sham trusts. It becomes necessary, then, in order to explain the workings of sham trusts to examine also alter egos. The leading cases, reported in the same year, are *Glass v Hughey*²⁵ and *Prime v Hardie*.²⁶

2 The “alter ego” concept

Glass v Hughey concerned a de facto relationship that had lasted four and a half years and which was not covered by the Property (Relationships) Act 1976.²⁷ One of the claims made by the de facto wife was against the trustees of the family trust for a constructive trust over trust assets based on her contributions and the reasonable expectations of the parties (a *Lankow v Rose* claim). The husband, assisted by the wife, ran a franchising business. Put briefly, the business was sold to a company, the shares of which were owned by a family trust formed by the husband (the beneficiaries were not identified in the judgment). This occurred prior to separation and hence, at separation, the husband did not legally own any business assets to which the wife could make a claim. The wife argued that the trust structure should be ignored and the company recognised as, in reality, one controlled by the husband, the assets of which were thus relevant to any de facto property settlement between the parties.

Priestley J, in the High Court, found that prior to the settlement of the trust, the wife had acquired an equitable interest in the husband’s business assets by virtue of contributions she had made, and that accordingly a mutual expectation existed between the parties. That equitable interest could then be traced to assets now owned by the trust. His Honour went on, however, to say that an alternative basis available for granting proprietary relief to the wife was that the trust had “for all intents and purposes been disregarded by the husband so far as his operation of [the company] is concerned and, so far as the wife’s claim is concerned should be regarded as a sham or more particularly the husband’s alter ego”.²⁸ Accordingly, the trust property could be considered that of the husband and it was not essential for the wife to establish an equitable interest in it prior to its transfer to the trust. Priestley J referred to two significant factors. First, the trustees (including the husband) had entered into an

²⁵ [2003] NZFLR 865.

²⁶ [2003] NZFLR 481.

²⁷ The relationship had ended prior to the Act’s commencement.

²⁸ Above n 25 at 879.

agreement which expressly stipulated that the trust would “at some time in the future” transfer its shares in the company to the husband absolutely. The husband was thus intended to become the legal owner of the shares in respect of which the wife therefore claimed an interest. Secondly, the husband had received direct financial benefit from the trust’s asset, the shares.

Hence, it would appear that in determining whether a trust is a sham, that is, something that is not what it purports to be, the de facto control of the trust’s assets by someone who is not a sole trustee and the receipt of benefits from the trust’s assets by the controller will be significant factors.

In *Prime v Hardie*, Salmon J based his decision specifically on the alter ego concept. The plaintiff had been in a de facto relationship with the defendant. Over the course of the relationship the parties lived in houses held in the name of a trust. The plaintiff claimed an equitable interest under a constructive trust over the property belonging to the trust on the ground of contributions made to the property. Salmon J, in the High Court, noted the difficulty facing the plaintiff given that the property was owned by the trust and not by the de facto husband. An allegation by the plaintiff that the trust was a sham had been made too late in the proceedings and thus the defendants (including the trustees) successfully objected to its use. Nonetheless, Salmon J ruled that the trust was effectively the husband’s alter ego and imposed a constructive trust over the trust assets based on the wife’s contributions and the parties’ mutual expectations. Factors establishing the alter ego character were that the defendant husband was the principal beneficiary of the trust; he had borrowed funds which enabled the trust to purchase its assets; he paid the expenses incurred by the trust assets (rates, insurance and interest on the mortgage); his personal income return included a fictitious rental income for the house, against which he claimed deductions for the aforementioned expenses; and the houses owned by the trust had been successively used by him as his family home. The husband clearly shouldered both the burdens and benefits of the trust property.

The judgments in both *Glass* and *Prime* are somewhat bare on analysis of the concept and application of an alter ego.²⁹ They fail to identify the difference between shams and alter egos, if any, and give no indication whether an alter ego can only operate from the inception of the trust or whether it can also arise later on during the life of the trust. It is also unclear what the effect of an alter ego ruling is on other transactions entered into by the trustees involving trust assets.

Alter ego literally means another side of oneself or a second self.³⁰ In the present context, the term describes a situation where a structure (such as a company or a trust) is used and controlled by an individual to such an extent that it is recognised, in fact, as an extension of that person and not as a separate identity. Chisholm J, in his judgment in *Official Assignee v Wilson & Clyma*, referred to the alter ego as a puppet.³¹ The reality of the situation is that the company or the trust is the persona of the controlling individual, notwithstanding that the technical legal position appears otherwise. “Sham” is potentially wider in that, while it can

²⁹ *Official Assignee v Wilson & Clyma* above n 12 at para [59].

³⁰ *Shorter Oxford English Dictionary* (5th ed, 2002) Vol 1, 62.

³¹ Above n 12 at paras [56] – [59].

encompass an alter ego situation, it also covers arrangements that obfuscate different dynamics. The alter ego concept is therefore fundamentally about control, but it is possible to distinguish between two types of control that may be present in trust cases.

First, the alter ego claim may be made in relation to de facto or factual control. In the trust context, this would arise where a controller has assumed power over trust property without any legal right to exercise such power or authority. The alter ego, as factual control, should be an impotent, meaningless concept. In the eyes of the law, factual control has no effect on legal ownership. Indeed, a stranger who takes control of trust assets will be considered a trustee *de son tort* and liable to account for the property to the beneficiaries.³² Factual control of trust property cannot justify recognition that the controller thereby owns the trust assets.

Beaumont J addressed this issue in his judgment in *Sharrment v Official Trustee*.³³ His Honour ruled that property owned by the companies and trusts could not become Mr Wynyard's property by virtue of the control he exercised:

[I]t does not follow from the use, or even abuse, of control of the companies' affairs that their controller acquired any of the companies' property by some informal process. A misfeasance could hardly effect an acquisition of property. A breach of his fiduciary duties may, of course, mean that a controller will be held liable to indemnify a company for its loss.

...

Since neither de jure nor de facto control of the affairs of a company [or trust] confers upon the controller any proprietary interest in the corporation's assets, it must follow that Mr Wynyard's domination of the operations of the Wynyard family companies could not, of itself, give him any right to their assets.³⁴

The alter ego concept, as it relates to factual control, serves to attribute an individual's actions to those of the organisation that he is controlling. It is not a mechanism whereby an individual can appropriate property to him or herself by virtue solely of the control he or she exercises. To allow the alter ego concept to operate in that way would wreak havoc on our system of property law and the rules it has formulated for the creation and transfer of property rights. Acquisition of property solely by factual control is generally foreign to our society, yet this is exactly what the alter ego concept is being employed to do in some cases.

This incompatibility of factual control with established property law is particularly obvious in situations where the controller is not the settlor of the trust and thus had no initial property right to the assets settled on trust for the beneficiaries. An entirely conceivable example could arise in the context of a family trust settled by, say, a grandfather for the benefit of his grandchildren, with his wife and solicitor as trustees. The settlor passes away and, in time, the settlor's daughter begins to exercise control over the trustees regarding their powers and discretions under the trust deed. If the alter ego concept was given effect to, and extends beyond the creation of the trust to its period of operation, and the controlling daughter was recognised as the de facto owner of the trust assets, the property in this case would become vested in someone who had no earlier right to it before the trust broke down, as a settlor would have had; and furthermore, it passes to someone who was not intended by the settlor to

³² *Mara v Browne* [1896] 1 CH 199; *DFC NZ Ltd v Goddard* [1992] 2 NZLR 445.

³³ Above note 22.

³⁴ *Ibid* at 470-471.

receive any beneficial interest. Factual control alone cannot, quite clearly, be sufficient for the controller to obtain title.

For these reasons, the alter ego notion, where it concerns a claim of factual control, is not a claim that the trust is a façade or sham.³⁵ It is only a claim about the factual control of the trust. The trust may be genuine and valid, but is controlled by a party not entitled so to do.

The de facto alter ego is not, therefore, to be treated as analogous to the sham trust. However, the alter ego idea is nevertheless relevant to the extent that it can aid in establishing a sham trust on the particular facts of a given case.³⁶ This is so because although de facto control does not, of itself, effect transfer of trust property to the controller, it may serve as evidence of the settlor's lack of intention to create a genuine trust such that the trust is a sham. Given that it is the settlor's intention that is determinative of whether a trust is actually a sham,³⁷ any control exercised over the trust will only be relevant to the trust's validity if it is relevant to the settlor's intention, objectively determined. In other words, the control must be exercised by the settlor him or herself or by a third party at the request or encouragement of the settlor, thus indicating that the settlor did not intend to relinquish control of the trust property to its alleged legal owners, the trustees. In this way, the alter ego concept is relevant to the law of sham trusts – but at most as an evidentiary tool.

The second type of control with which the alter ego concept may be concerned is legal control. Legal control of a trust occurs where the trust deed itself confers the relevant powers on the controller such that they are legally valid. For example, in the case of the grandfather's family trust above, the daughter may have been granted the power to distribute assets to beneficiaries and even to appoint herself as a beneficiary. Legal control may vest in the controller extensive powers to remould the trust and to recover assets at a later date should he or she so desire.

The potential for legal control to change drastically the operation and even intention of a trust does not offend against the requirements of a valid trust. The trust can still have sufficient certainty of intention, subject matter and object and yet confer a power so extensive that it may appear fatal. The trust is nonetheless validly created. It is not a sham and the concept of alter ego as it refers to legal control cannot be used to attack the validity of the trust at its point of creation.³⁸

This distinction between sham and the alter ego by way of legal control is apparent in *Marriage of Bowman*.³⁹ In that case, in the Australian Family Court, Nygh J accepted the alter ego concept as a separate ground upon which to recognise the settlor as the owner in fact

³⁵ *Marriage of Gould* (1993) 17 Fam LR 156 at 165 per Fogarty J. See also *Official Assignee v Wilson & Clyma* above n 12 at para [58] where Chisholm J rejects alter egos as automatic shams, but for the erroneous reason that common intention to create a sham is also required.

³⁶ *Sharrment v Official Trustee*, above n 21 at 471 per Beaumont J; *Official Assignee v Wilson & Clyma* above n 12 at paras [56] and [59].

³⁷ Some cases suggest that the relevant intention is that of the settlor *and* the trustee/s. This is refuted in the next section of this article.

³⁸ *Marriage of Gould*, above n 34 at 167. But see, however, comments of Beaumont J that both de facto and de jure control are ineffective, cited earlier at text to n 34.

³⁹ (1984) 9 Fam LR 619.

of the trust property. His Honour ruled that the assets of a trust over which the wife had power and control should be treated as hers on the basis that the company trustee and the trust were her alter ego. Mrs Bowman's control arose from her positions as principal beneficiary of the trust giving her the right to appoint a new trustee and as majority shareholder in the trustee company giving her the ability to deal with the assets and income of the trust as she pleased. Nygh J did not regard the trust as any sort of sham or façade, saying that it was in the "usual form of discretionary trust".⁴⁰ The trust itself was accordingly not invalid, but the effect of the legal powers conferred on Mrs Bowman and as she exercised them was to give her the benefit of the trust property such that it could rightly be considered hers in law.

In the case of a legal alter ego, the trust is legitimate and where the court recognises ownership by the controller of property apparently otherwise owned by the trust, it is not usurping the trust but rather recognising the effects of valid exercises of power conferred by the trust itself. Trusts which, by their terms, allow the possibility of legal alter egos should be immune from attacks that are based on claims of sham. This does not, of course, mean they are immune from all claims. Trusts allowing legal alter egos are subject to the same requirements of any express trust: powers must be exercised in accordance with the trust deed and with any attached fiduciary obligation and the requisite loyalty to the beneficiaries which this entails. Thus, while a power may be validly vested, its exercise may be subject to a claim, for example, of fraud on a power⁴¹ or unreasonable exercise.⁴²

The foregoing analysis of the concepts of sham and alter ego clearly show that they are not the same and should not be used interchangeably as has been the prevailing tendency in New Zealand decisions.⁴³ In summary, shams are arrangements whose appearances do not reflect the underlying actual intention or purpose of the relevant parties. In the trusts context, a trust will be a sham where the settlor did not actually intend to create a trust. The doctrine of sham trusts is hence an aspect of the law relating to certainty of intention required for a valid trust. Where the settlor did not intend to create a trust, no trust exists because the required certainty of intention is absent. The alter ego concept is about control and should be separated into the categories of de facto alter egos concerned only with factual control, and alter egos proper which are concerned with legal control. The former has, on its own, no legal effect. Factual control alone cannot justify the appropriation of trust property to the controller. It is, however, relevant in sham trusts to the extent that it evidences a lack of true trust intention. Legal control, on the other hand, cannot be used in any way to challenge the legitimacy of a trust's creation. While extensive legal powers may seem to undermine the purpose or intention of an express trust, as long as such powers are exercised in accordance with the trust deed and any attached fiduciary obligation, they are legally effective. Given this framework, it can be seen that the de facto alter ego is not a substantial concept in its own right but plays a supportive role to the concept of sham trusts. The legal alter ego is a concept in its own right but it does not work to challenge the validity of the trust itself and thus is not of interest in the remainder of this article. To avoid confusion in the future, courts and commentators

⁴⁰ The same sort of finding was made regarding the trust in *Miller v Stewart* [2000] NZFLR 433 at 441 to the effect that it was a common trust arrangement in New Zealand notwithstanding the husband's control.

⁴¹ *Wong v Burt* [2005] 1 NZLR 91.

⁴² *Craddock v Crowhen* (1995) 1 NZSC 40,331.

⁴³ See, for example, *Glass v Hughey*, above n 25 at 879; *Official Assignee v 15 Insoll Avenue Ltd* [2001] 2 NZLR 492 at 497 per Paterson J; Kearns, "A Spurious Imitation – Sham or Alter-Ego Trusts" *New Zealand Law Society Trusts Conference 2005* (CLE, 2005) 171.

should refrain from referring to de facto or factual control as alter ego. The alter ego label should be used exclusively for instances of legal control.

The remainder of this article is devoted to considering the particular elements of proving a sham, when a sham may arise, and the effect of a sham.

Sham Intention

As was made clear by Diplock LJ in *Snook* the sham concept concerns the intention of parties to the transaction - an intention to make the transaction appear to be something which they do not intend it to be. Rather than intending the transaction as it appears, the parties intend something else.

1 Common intention

Diplock LJ specifically spoke of a *common* intention: “all the parties [to the sham] 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”.⁴⁴ *Snook* concerned contracts of hire purchase and financing of a motor vehicle and thus the requirement of a common intention of a sham was appropriate because of the contractual context. Contracts are based on agreement. Commonality of intention is essential to the creation of a contract – there must be *consensus ad idem*. Thus the relevant intention necessary to create only the appearance of a contract, which is in fact a sham, must also be the intention of all the parties to the sham contract. Common intention to create a sham contract is required because a contract itself requires common intention and if it is intended to be merely an appearance, those who are party to it must share that intention.

In contrast, in the case of trusts, the intention of only the settlor is pertinent to the creation of a valid trust. Although no one can be compelled to act as trustee, it is a basic equitable principle that a trust will not be allowed to fail for want of a trustee.⁴⁵ Where a trustee disclaims his or her appointment, the trust property reverts in the settlor but he or she holds it upon the trust of the initial settlement because the provisional vesting in the trustees until disclaimer is sufficient to constitute the trust.⁴⁶ Further, where there is no trustee, the court will almost always appoint one except where the appointment of a particular person as trustee is crucial to the intended purpose of the trust.⁴⁷ The identification, and therefore the intention, of the trustee are irrelevant to the existence of a valid trust, apart, of course, from his or her intention to accept the office of trustee. A valid trust is created upon the intention of the settlor alone.

For this reason, only the objectively determined intention of the settlor should be relevant in determining whether the trust is actually a sham. The trustee’s intention is irrelevant to the valid creation of a trust, and likewise it is irrelevant to the creation of the appearance of a

⁴⁴ Above n 4 at 802.

⁴⁵ *Re Lysaght* [1966] Ch 191.

⁴⁶ *Mallott v Wilson* [1903] 2 Ch 495. See also Mowbray et al, *Lewin on Trusts* (17th ed, 2000) para 12-19.

⁴⁷ *Re Lysaght* above n 45; but in such a case, the property will revert to the settlor on a resulting trust.

trust (or what is otherwise the non-creation of a trust). If no mutuality of intention is required to create a valid trust, it is conceptually incoherent to require mutuality to create a sham trust.

In the case law there is, however, little support for this rejection of the mutuality requirement in the trust context. In several cases,⁴⁸ judges have specifically addressed the issue and required common intention of the settlor and trustee in order to amount to a sham trust.

*Shalson v Russo*⁴⁹ concerned a fraudulent investment scheme operated by the defendant, Russo. Two other defendants who had been joined by order of the court to the proceedings between the plaintiff and Russo were a businessman, Mimran, who had also made investments through Russo, and Mimran's company. Both were victims of Russo's fraud. These defendants made claims against Russo, first, to trace money paid by them through Russo's bank and into further assets acquired with that money, and secondly, that a settlement of property by Russo to a Jersey company on trust was a sham and that such property should thus be recognised by the court as Russo's own and subject to claims made against him personally.

On this latter claim concerning a sham, Rimer J, in the English High Court, ruled that a sham required that both the settlor and the trustee must have intended the settlement to be a sham. A common intention is justified, according to Rimer J, on the basis that the creation of a trust involves the settlor divesting himself of trust assets and the trustee accepting them on the basis of the trust. Both parties are significant to the creation of the trust and a settlor's sham intention must be shared by the trustee.⁵⁰ On the facts, the trustee had intended the settlement to be genuine and thus no sham existed. The acts or intentions of one party alone could not, according to Rimer J, have made the transaction a sham without the common intention of the other.

In his judgment, Rimer J did not refer to an earlier decision in the High Court which was on point, *Midland Bank PLC v Wyatt*,⁵¹ where David Young QC⁵² held that common intention was not a necessary element of sham trusts. In that case, Wyatt had led the banks and others to believe that he still had a beneficial interest in the family home which was held in the joint names of himself and his wife at a time when they had previously executed a declaration of trust over the house in favour of his wife and their two minor daughters. The declaration had been left in the safe in the family home "for a rainy day". The evidence was that Mrs Wyatt, as joint settlor and trustee, had signed the declaration unaware as to its purpose and not really knowing what she was doing. Wyatt accordingly argued that there was no common intention as was required to amount to a sham and that the trust must be valid and the house protected from his personal creditors. Young QC ruled, however, that the common intention requirement was not a necessary requirement of all sham transactions. Instead, "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.

⁴⁸ *Shalson v Russo* [2005] Ch 281; *In re Esteem Settlement* [2003] JLR 188; *MacKinnon v The Regent Trust Company Ltd* [2005] WTLR 1367. Jersey cases are significant in this area given Jersey's prominent role in off-shore trusts. In New Zealand, see *Official Assignee v Wilson & Clyma* above n 12.

⁴⁹ *Ibid.*

⁵⁰ *Ibid* at 341-342.

⁵¹ [1997] 1 BCLC 242.

⁵² Sitting as a Deputy Judge of the High Court.

Such a person would still be a party to the sham and could not rely on any principle of estoppel such as was the case in *Snook*.⁵³ Mrs Wyatt's lack of intention to create a sham did not defeat the sham allegation made against Wyatt.

In *In re Esteem Settlement*, the Royal Court of Jersey interpreted Young QC's comments as "simply confirming that a party who goes along with a sham neither knowing or caring what he is signing (i.e. who is reckless) is to be taken as having the necessary intention" and thus the requirement of common intention remains.⁵⁴ Yet this is clearly not what Young QC meant. He expressly rejected the mutuality requirement. The carelessness of a party who is not the shammer does not amount to intention to create a sham. Rather carelessness is relevant because it may prevent that party from defending itself against the somewhat harsh consequences of a sham finding. The consequence of a sham trust, as will be discussed below, is that the trust is void *ab initio* and the alleged trustee is required to account for all the trust property. The alleged trustee may be able to defend him or herself against any such claims on the basis of estoppel or change of position, but only if he or she has acted in good faith. The carelessness of a party is relevant not to whether a sham exists, but to whether that party can escape the consequences of the sham.

Further support for the argument that the intention relevant to a sham trust is only that of the settlor can be found in some of the leading commentaries on the law of trusts, on the basis that the trust is a unilateral transaction which concerns only the settlor's intention.⁵⁵ However, academic opinion is not unanimous on the point. Waters writes, "intent without the compliance of the other as trustee, however, is inoperative"⁵⁶ and points out that it would be strange to declare a trust void as a sham on the basis of the settlor's deceptive intent alone when the trustee has not been party to the deceit and has operated the trust in accordance with the stated terms of the trust instrument such that "no deception has occurred". In my opinion, there are two weaknesses in this argument. First, in such a case, it is wrong to conclude that no deception has occurred. The settlor has, with the necessary sham intent, effectively deceived an otherwise innocent trustee into believing the trust is a valid one. The common intention approach however favours a fraudulent settlor: the more successful the settlor's deception of the trustee, the less likely the court will find a sham. Secondly, and more importantly, the focus on the deception of the trustee reveals a misunderstanding of the sham concept. The deception is the trust itself and is generally directed at misleading those who have dealings with the settlor in his individual capacity and not with those who have dealings with the trust.

A particularly significant case on this issue is *In re Esteem Settlement*,⁵⁷ given the Court's detailed analysis of shams therein. The case concerned a sheikh who was the chairman of a company. Over a period of two and a half years, in a conspiracy with others, the sheikh stole US\$430 million from the company, of which US\$120 million was his share. The company

⁵³ Above n 50 at 245. See also *Minwalla v Minwalla* [2004] EWHC 2823 (Fam) para [54].

⁵⁴ [2003] JLR 188 at para 59.

⁵⁵ *Lewin on Trusts*, above n 46 at para 4-23; Oakley, *Parker & Mellows The Modern Law of Trusts* (8th ed, 2003) 50-51; Hayton, *Hayton & Marshall Commentary and Cases on the Law of Trusts and Equitable Remedies* (11th ed, 2001) 158.

⁵⁶ Waters et al, *Waters' Law of Trusts in Canada* (3rd ed, 2005) 147.

⁵⁷ [2003] JLR 188, (sometimes referred to as the Abacus case) approved by the Jersey Court of Appeal in *MacKinnon v The Regent Trust Company Ltd* [2005] WTLR 1367.

obtained judgment against him in the English High Court but he was insolvent. The judgment was registered in Jersey and the company sought access to property which had been settled on trusts in Jersey by the sheikh. The property was untainted in the sense that it had been contributed to the settlement out of the sheikh's own assets for legitimate tax and inheritance planning reasons at a time before the sheikh commenced his fraud and therefore when the company was not his creditor. One of the claims made by the company was that the settlement was a sham. The company contended that, in the case of sham trusts as distinct from bilateral transactions, there is no requirement for a common intention because a trust is essentially a unilateral transaction. In rejecting this contention in favour of a requirement of mutuality, the Royal Court of Jersey gave several reasons, none of which are, in my opinion, conclusive.⁵⁸

First, the Court said the effect of previous authority is that common intention is required. This alone, while persuasive, should not be determinative where the issue has not yet been conclusively decided at an appellate level.

Secondly, it was stated that a requirement of mutuality would "seem to be consistent with logic and principle" because the consequence of unilateral sham would be that the gift or settlement would be subject to invalidity if the donor/settlor secretly intends something other than a gift or settlement. The donee or the trustee should be protected in the security of their receipt. Two arguments can be made in response to this claim. First, as was submitted by counsel, and as has already been referred to, the donee or trustee is adequately protected. He or she can rely on an estoppel defence as against the settlor and on restitutionary defences as against any other parties alleging a sham (where he or she has changed his or her position). Secondly, it is unclear why an alleged donee or trustee should benefit from the enforcement of the settlement if there was no real intention on the part of the settlor so to benefit them. If a donor or settlor chooses not to pass title, although he appears to and indeed may deceptively intend to appear to, then title does not pass. A personal action may lie against the donor or settlor on account of his deception, but neither a donee's reliance nor a donor's fraud justifies interference in the proprietary title vested in the donor.

The third reason given by the Court is specifically in relation to trusts. It is the same argument made by Waters referred to above - to require a sham intention only on the part of the settlor would result in "extraordinary consequences" where the trust is administered properly by the trustee and he does not succumb to the settlor's attempts to control the trust and yet the trust is still capable of being attacked as invalid by third parties because the settlor's real or secret intention was to retain beneficial ownership. "It follows that a trust will still be a sham because of the settlor's secret intention even if he has been singularly unsuccessful in achieving his objective of retaining beneficial ownership."⁵⁹ This seems a compelling argument, but it ignores fundamental trust principles: the settlor's intention is a necessary element of a valid trust. Where there is no intention by the settlor to create a trust, there cannot be a trust. A trustee's proper trust management does not justify the existence of the trust. The sham allegation attacks the very formation of a trust and the apparent trust's maintenance and operation is irrelevant. Extraordinary consequences are nevertheless unlikely given that the settlor's intention is determined objectively. A settlor will be held to

⁵⁸ Ibid at 216 – 222.

⁵⁹ Ibid at 217.

the objective manifestation of his intention and, in a situation where the trust appears to have operated properly and without interference from the settlor, it is unlikely that a contrary intention on the part of the settlor will be upheld in the absence of any confirmatory objective evidence.

Fourth, and in response to counsel's submission that there are other actions to set aside gifts made into trusts such that there is no difficulty in principle in doing so, the Court suggested that gifts should not be invalidated solely on the basis of intention. Some prejudice is required in order to reject the validity of a formal legal document. Again, this reasoning fails to appreciate that the sham trust does not operate merely to set aside a trust. Rather, a sham finding means there was no valid trust in equity in the first place. The presence of a formal document does not necessarily mean that a trust is valid. It must first comply with the three certainties, including an intention to create the trust. It is not the document that creates the trust, but the existence of actual intention, even if this needs to be objectively ascertained. The document, at most, merely evidences the intention.

Further, the Court directly refuted the view that a trust is a unilateral transaction. It noted previous authorities and comments in *Lewin*⁶⁰ that support the unilateral nature of a trust but questioned their correctness in circumstances where a settlor could not possibly be the replacement trustee where the intended trustee disclaims (because, for example, the settlor does not reside in the country in which the trust is settled or the trust deed expressly prohibits the settlor being trustee). Perhaps aware that these arguments could be rebutted,⁶¹ the Court held that even if the trust is a unilateral transaction, the other reasons it had relied on in favour of common intention apparently outweighed this point. As I have just argued, however, those other reasons are less than convincing.

As a matter of authority, the majority opinion in the courts appears to be that common intention is a necessary prerequisite to a sham trust finding. However, as a matter of principle, the requirement of mutuality has no place in the context of trusts in contrast to the sorts of bilateral transactions that Diplock LJ envisaged when he required a common intention in *Snook*. Within the conceptual framework of trusts, a requirement of intention to enter into a sham trust by anyone other than the settlor is unnecessary. Shams negate the necessary intention to enter into a transaction and, in the case of trusts, the necessary intention is only that of the settlor, objectively ascertained. The rejection of common intention as a requirement of sham trusts does not, however, render the trustee's intention altogether irrelevant. Evidence of the trustee's intention, while not a necessary element of a sham trust, may be corroborating evidence of the settlor's intention. In that regard, the trustee's intention plays the same evidential role as any control of the trustee by the settlor plays.⁶² A trustee's knowing complicity in the settlor's deception will, for example, support the primary determination that the settlor has established a sham. "It is the intention of the settlor that is crucial, for if the settlor had no proper intent the trust will fail regardless of the

⁶⁰ Above n 46.

⁶¹ Where an appointed trustee disclaims, the reversion of the trust to the settlor should be considered a temporary measure until an alternative trustee is appointed. The scenarios suggested by the Court do not therefore pose any real threat to the view of a trust as a unilateral trust of which acceptance by the trustee is not an essential element.

⁶² See text above accompanying nn 36-37.

intent of the trustee; but the intent of the trustee could be important in showing the intent of the settlor; and the cases increasingly show that their intent is more readily to be interpreted from their subsequent conduct in administering the trust than it is from the words of the trust instrument alone.”⁶³ The settlor’s intention is objectively ascertained and these additional factors may contribute to a manifestation of the settlor’s objective intention.

Regardless of whether a sham trust is established solely by reference to the settlor’s intention or whether it also requires the same intention on the part of the trustee, as many cases have held, it is necessary to consider what sort of intention is required.

2 Nature and quality of the sham intention

The necessary intention to justify an allegation of sham requires consideration.⁶⁴ It has been variously described as an intention to mislead or deceive;⁶⁵ an intention to give a false impression;⁶⁶ and more specifically an intention to “give a false impression to a third party or parties that the assets had been donated into the settlements and were held on the terms of the trust deeds”.⁶⁷ While all of these suggest some fraudulent element, Deputy Judge Young QC opined in *Wyatt* that the requisite intention to create a sham need not necessarily contain any fraudulent quality.⁶⁸

In *Wyatt*, His Lordship found that while Wyatt had executed a trust deed as a “safeguard to protect his family from long-term commercial risk should he set up his own company”,⁶⁹ he had no intention when he executed the trust deed of endowing his children with his interest in his house (which was the effect of the trust) and thus it was a sham. The fact that he had executed the trust deed with the benefit of legal advice and therefore may not have been acting dishonestly or fraudulently was irrelevant. In New Zealand, it has been held that it is not necessary to prove breach of trust, or fraud or dishonesty in a criminal sense, in order to satisfy the quality of intention required for a sham.⁷⁰ A trust is a sham “if it was not intended to be acted upon but was entered into for some different or ulterior motive”.⁷¹ A sham trust arises where the settlor intends something other than a trust but uses the form of a trust to mask the appearance of the true intention. While this is likely to be conducted with a fraudulent or deceptive intention, such fraud or deception is not a necessary precondition of a sham intention.

3 Evidence of intention

⁶³ Wadham, *Willoughby’s Misplaced Trust* (2nd ed, 2002) 31.

⁶⁴ See further Brownbill, “When is a Sham not a Sham?” [1993] JITCP 13.

⁶⁵ *In re Esteem Settlement*, above n 48 at 223; *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794 at 813-814 per Turner J.

⁶⁶ *In re Esteem Settlement*, above n 48 at 223; *Hitch v Stone* [2001] STC 214 at 230.

⁶⁷ *MacKinnon v The Regent Trust Company Ltd*, above n 48 at 1375.

⁶⁸ *Midland Bank PLC v Wyatt*, above n 51 at 253.

⁶⁹ *Ibid* at 252.

⁷⁰ *Official Assignee v Wilson & Clyma* [2006] 2 NZLR 841 at para [54].

⁷¹ *Midland Bank PLC v Wyatt*, above n 51 at 253. This aspect of the judgment may be considered *obiter* because His Lordship went on to rule that Wyatt had misled interested third parties as to his legal position vis-à-vis the house, which was presumably indicative of a fraudulent intention in relation to the creation of the trust.

This article has argued that in order to establish a sham the party relying on the allegation must show that the settlor intended to create something other than a trust, the existence of which the trust was to disguise. The real intention was not to create the trust, but something else.

As has been previously discussed, while factual control does not itself justify rejection of the trust structure in favour of recognising the controller as the true owner, it may nevertheless provide strong evidence that a controlling settlor never actually intended to create a trust and, in particular, to dispose of or share his beneficial title, such that the trust must be a sham. Intention to create a sham can be manifested by de facto control of the trust and it is in this way that the de facto alter ego concept can be employed in the law relating to shams. In *Abdel Rahman v Chase Bank (CI) Trust Co Ltd*,⁷² Rahman had retained significant power over a trust which he had created and, following his death, his widow brought proceedings challenging the validity of the trust. The trust had the effect of defeating her rights and those of his heirs. The Royal Court of Jersey held the trust to be a sham on the basis that from the date of purported settlement, the settlor

had exercised dominion and control over the trustee in the management and administration of the settlement...He treated the assets comprised in the trust fund as his own and the trustee as though it were his mere agent or nominee...the settlement was a sham on the facts, in the sense that it was made to appear to be a genuine gift when it was not.⁷³

The presence of factual control by the settlor is not the reason for declaring the trust a sham. Control is merely evidence of an absence of intention on the part of the settlor to divest property absolutely in favour of the trust. It is this lack of intention that is the reason for declaring the apparent trust a sham. Put another way, the degree of retained factual control by the settlor is only one factor in assessing the settlor's true intent.⁷⁴

The courts have considered other factors relevant to determining the content of the settlor's intention and whether trusts are shams. In *Prime v Hardie*,⁷⁵ Salmon J noted that the settlor was the principal beneficiary of the trust; that he had borrowed funds which enabled the trust to purchase its assets; that he paid the expenses incurred by the trust assets (interest on the mortgage, rates, and insurance); and that his personal income tax return included a fictitious rental income for the asset which should have accrued to the trust and he claimed deductions for the expenses related to the trust property; and the houses owned by the trust had been used by him as his family home. In *Glass v Hughey*,⁷⁶ significant factors in the finding of a sham trust were the settlor's direct financial benefit from trust assets and a shareholders' agreement concerning a company owned by the trust that the company's shares would be transferred from the trust to the settlor at some later unspecified date, such that he would become the legal owner of the trust's asset. In contrast, in *P v P*⁷⁷ the beneficiaries of the trust had indeed benefited quite significantly from the trust and Judge Strettell, in the Family

⁷² [1991] JLR 103.

⁷³ Ibid at 147.

⁷⁴ *Waters' Law of Trusts in Canada*, above n 55 at 62.

⁷⁵ [2003] NZFLR 481 at 486-487.

⁷⁶ [2003] NZFLR 865 at 879-880.

⁷⁷ [2003] NZFLR 925 at 945, appealed to the High Court at [2005] NZFLR 689 on other grounds.

Court, accordingly rejected the suggestion that the trust be ignored because the settlor father had treated the trust property as his own.

Effect of *Ab Initio* Sham Trusts

Where there was never any intention to create a true trust on the part of the settlor, but rather to create the appearance of a trust, whether fraudulently or not, the trust must be invalid because there is an absence of intention. “Trusts” that have always been shams from their initial creation are void *ab initio* for want of sufficient certainty.

Where the purported trust is declared by the settlor over property which he continues to hold as legal owner, such that no property was required to be passed to another party in order that the trust be constituted, a sham ruling simply recognises that the property has always been beneficially owned by the settlor and no trust was ever impressed upon it. However, in the case of purported trusts appointing someone other than the settlor as trustee, such that trust property must have been legally transferred to that party or parties, the void effect of a sham finding cannot automatically be instituted because the property, which should belong both legally and beneficially to the purported settlor, is legally vested in the trustee.⁷⁸ In such situations, the law may employ the resulting trust as the mechanism to ensure the property reverts back to the purported settlor on the basis that the transferor’s actual intention was not to transfer beneficial rights in the property to the transferee.

It has previously been argued in a commercial sham case that an institutional constructive trust, rather than a resulting trust, should be recognised or imposed over the sham property in favour of the shammer (who, in the trust context, is the settlor). In *Official Assignee v 15 Insoll Avenue Ltd*,⁷⁹ a Mr Russell fraudulently incorporated and operated a company, which purchased a property. Russell was adjudicated bankrupt and the Official Assignee claimed against the company that it was a sham and that it held the property on trust for the bankrupt’s estate. Paterson J, in the High Court found that the company was indeed a sham. His Honour, however, rejected the Official Assignee’s submission that an institutional constructive trust arose over the property based on the parties’ true intention that the company hold the property on trust for Russell. An institutional constructive trust in favour of Russell was inappropriate in the company context given that he was not a party to the proceedings and his own interests would have been in the opposite finding.⁸⁰ If the constructive trust existed, the property would vest in the Official Assignee by virtue of Russell’s bankruptcy and if it did not, the property would remain vested in the company from which Russell would benefit. Accordingly, the beneficiary of the suggested constructive trust, Russell, “would deny that it was intended that [the trustee] would hold the property as trustee for him”.⁸¹ Further, the concern of institutional constructive trusts for the intention of both the settlor and the trustee of the sham trust, to benefit the settlor rather than the express

⁷⁸ In some circumstances, it may be possible to argue that just as there was no genuine and effective intention to create a trust, there was also no intention to pass legal title in the property to the supposed trustee. In such a case, a declaration that the trust is void *ab initio* would be sufficient in itself to recognise the settlor as the true owner, both at law and in equity.

⁷⁹ [2001] 2 NZLR 492.

⁸⁰ For an institutional constructive trust to arise in this manner, it is necessary that the trustee of the apparent express trust (the sham) intend to hold the property on trust for the settlor.

⁸¹ Above n 79 at 502.

beneficiaries, makes it a particularly inapt remedy in trust cases given that the relevant intention for the creation of a sham trust is that of the settlor only.

While rejecting the institutional constructive trust as a response to shams, Paterson J did however accept another distinct form of constructive trust as an appropriate remedy.⁸² His Honour referred to it as equity's recognition of a present equitable property right belonging to Russell. "[B]ecause of the sham structure, the beneficial interest in the property was always vested in Mr Russell."⁸³ Thus a constructive trust, in this instance, is operating as a direct vindication of the existing equitable title held by the apparent settlor all along.⁸⁴ Where it is found that the settlor holds a beneficial interest in the property (because he never intended to pass the beneficial interest when he created the sham trust), nothing else is required (such as, for example, the trustee's intention to hold on constructive trust for the settlor) for the law to vindicate that equitable right by a declaration of constructive trust.

Although Paterson J allowed the Official Assignee to access the company's property on the basis that it was in fact owned by Russell, his Honour noted and approved of a concession made by the Official Assignee that the latter would not be able to obtain similar relief in relation to standard family trusts. The application of the judgment was "confined to the particular circumstances where a non-genuine structure, not operated genuinely either in accordance with its structure or according to company law principles, has been used as a front".⁸⁵ This should not, in my opinion, be interpreted as authority for the rejection of such recovery in all sham trust situations. His Honour was contrasting genuine structures from non-genuine structures. Unlike standard family trusts, which are genuine, sham trusts are not genuine and should be corrected by either a resulting trust or a constructive trust (on the basis of vindication of a pre-existing property right, not for reasons of unconscionability binding the trustee). Regardless of whether the sham trust arose in a specifically family trust context or in a commercial context, these remedies should be available to correct it.

Thus, both this form of the constructive trust, as a direct *vindicatio*, and the resulting trust are doing the same thing – recognising and giving effect to the settlor's retained beneficial interest which was never parted with because the trust was a sham. Such remedies are, therefore, entirely appropriate.

Of course, the effect of a sham finding and its accompanying remedy may be disastrous for a trustee, as one commentator notes:⁸⁶

⁸² For the different types of constructive trusts, see *Paragon Finance plc v D V Thakerar & Co* [1999] 1 All ER 400 at 408 per Millett LJ and Grantham and Rickett, *Enrichment & Restitution in New Zealand* (2000) 406-413. His Honour ultimately resolved the case by piercing the corporate veil of the company (a matter which is outside the scope of this article) but he nevertheless accepted the above as an alternative route. For criticism of the corporate veil approach and further support for employing a resulting or constructive trust, see Watts, "Piercing the Corporate Veil – A Device of Convenience or a Last Resort?" [2001] Comp & Sec Law Bulletin 93.

⁸³ Above n 79 at 503.

⁸⁴ *Boscawen v Bajwa* [1996] 1 WLR 328 at 334-335 per Millett LJ; Grantham and Rickett, above n 82 at 406.

⁸⁵ *15 Insoll Avenue Ltd*, above n 79 at 504.

⁸⁶ Duckworth, "Hazards for the Retentive Settlor and his Trustee - Sham, Mistake and Nudity" [1999] 7 JITCP 183.

Win or lose, a sham trust is likely to be bad for the trustee. Suppose in an orthodox discretionary trust the evidence shows that in regard to distribution and investment the trustee simply did as it was told by the settlor without exercising discretion. Suppose the trust investments did badly, and on the settlor's death the trustee distributed everything to the settlor's widow in accordance with the terms of the trust instrument. Now the settlor's heirs are claiming that there was never a valid trust and on the settlor's death the trustee should have given the property to the estate. If the heirs succeed in their sham argument, the trustee will be in a bad way; it will have given the property to the wrong person. If the heirs fail, the trustee will be in trouble of a different kind; its failure to exercise discretion in regard to investments was a breach of duty, so the widow can claim that the trustee should make good the investment losses.

The trustee's burden in relation to the bad investments is not a result of a sham trust, but rather is a result of the trustee acting in breach of his or her trust duties. These duties only apply if the trust is a genuine one and, as such, breaches of them are not the consequence of a sham trust. Where the trust is a sham, however, the trustee must account for the trust property to its true beneficial owner – the settlor. Any distributions made by the trustee will have been illegitimate and must be unwound. Fortunately, an innocent trustee who acted in good faith in making such distributions is not without a defence.

Where the trustee faces a claim for trust property brought directly by the settlor, the trustee may rely on estoppel principles to prevent the settlor from acting unconscionably because he or she has led the trustee to believe the trust was valid and genuine and cannot therefore rely on its invalidity as against the trustee. Equity's requirement that the settlor must come with clean hands will also provide a defence to the trustee.

Where a third party other than the settlor claims against the trustee for trust property which has since been dissipated by distributions, estoppel cannot be relied upon by the trustee to defend him or herself unless the third party knew of the settlor's sham intention when the trust was created. In the case of most third parties, who will generally be creditors of the settlor, they will not have known of the trust at all or, if they did, that it was not genuine. Their claims will be made on the basis that the trustee received property belonging to the settlor and is liable to restore that property. Where the property is dissipated,⁸⁷ the third parties are left with personal claims against the trustee, if appropriate, alleging the trustee's unjust enrichment. The trustee will be able to defend such claims on the basis that he or she has changed her position in good faith and, to the extent of that change, is not liable to make restitution of the property.⁸⁸

A trustee who has acted in good faith will therefore only be liable to the settlor, or to third parties claiming from the settlor to the extent that trust property is still retained in the hands of the trustee.

⁸⁷ Proprietary claims can be made using the rules of tracing to identify both the distributions made and the recipients of those distributions who will then become the objects of the proprietary claims (and who can only defend such claims if they are bona fide purchasers for value of the relevant property without notice). Where the property continues to be held by the trustee, direct proprietary claims may be made against him or her. See further *Foskett v McKeown* [2000] 2 WLR 1299.

⁸⁸ See generally *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548; *National Bank of New Zealand Ltd v Waitaki International Processing (NI) Ltd* [1999] 2 NZLR 211.

There is no recourse available to the beneficiaries of the sham trust, nor need there be. While beneficiaries may feel aggrieved, they were never in fact in receipt of the beneficial title to the trust property which always remained with the settlor because he or she had no intention to create a genuine trust. Having had no interest, they have suffered no loss.

The consequences of sham trusts being void *ab initio* are not, therefore, as dramatic as they may at first sight appear.

Emerging Shams

Quite apart from transactions which are intended to be shams from their inception, both judges and commentators have suggested that shams may emerge during the life of the transaction even where there is no obvious sham intention at the beginning.⁸⁹

The suggestion of an emerging sham may be applicable to contracts and commercial transactions that retain the involvement of all parties who formed the transaction throughout the life of the transaction. In such a case, it is possible that the transacting parties may later agree to something other than what appears on the face of the transaction and those adversely affected by it may claim relief from the sham.

However, the emerging sham notion is not compatible with trusts. The act of settling the trust by the settlor determines the rights and obligations which flow from the trust and these are not affected by an emerging sham intention on the part of the settlor part-way through the life of the trust. The settlor can have no more say in the operation of the trust after settlement except where such power is expressly reserved to him by the trust deed. The introduction of control by the settlor also does not affect the validity of the trust or the property rights of the trustee and beneficiaries. As has been explained above, the assertion of control, whether it began when the trust was created or much later in the trust's life, does not grant the controller title. Neither does a trustee's inappropriate handling of the trust property or submission to the control of another amount to a sham. The trust is established at the time of creation and the validity of its existence is not affected by maladministration or misfeasance of trustees. A trustee's breach of his duty over genuine trust property does not justify depriving beneficiaries of their interest. Either the asset has been validly vested in the trustee (and should not be regarded as other than a genuine trust asset) or it has not. In either case, it cannot be considered the settlor's property by reason solely of his emerging control or his changed intention.⁹⁰

The nature of the obligations created by the trust cannot be affected by a subsequent change of mind by the settlor even if acquiesced in wrongly by the trustees. Such misconduct by the trustees and/or the settlor cannot change the provisions of the trust and cannot somehow transfer the beneficial interest in the trust assets to the settlor.⁹¹

⁸⁹ In New Zealand, Richardson J has been the primary advocate of this view in the commercial context: *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 at 168; *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 at 587-8; *Mills v Dowdall* [1983] NZLR 154 at 159-160; *Walker v Walker* [1983] NZLR 560 at 572. In relation to trusts in particular, as emerging shams, see *Official Assignee v Wilson & Clyma* above n 70 at para [53] per Chisholm J, and Holmes, "All a Sham" [1999] NZLJ 462, 465.

⁹⁰ *Shalson v Russo* [2005] Ch 281 at 352-353.

⁹¹ *In re Esteem Settlement* [2003] JLR 188 at 243.

The emerging trust argument has been made by some on the basis of an analogy drawn with piercing the corporate veil in company law.⁹² In *In re Esteem Settlement*, counsel for the company seeking recovery of the money it had lost by fraud submitted that if the trust established by the fraudulent sheikh was found to be validly established, the court should nevertheless disregard the trust structure by reason of the sheikh's subsequent control in relation to the trust which justified piercing the veil of the trust and enabling the settlor's creditor to have recourse against the trust assets. Conceding that there was no previous authority to support the approach, counsel argued it was nevertheless "a logical development of the law on piercing the veil of companies".⁹³

However, the analogy between trusts and companies is a specious one and cannot justify a doctrine of emerging shams. Trusts and companies are very different creatures, as the Deputy Bailiff in the Royal Court of Jersey makes clear in the Court's judgment in *In re Esteem Settlement*.⁹⁴

Subject only to their fiduciary duty owed to creditors, directors owe a duty to the sole shareholder. His interests and those of the company are in reality synonymous... In other words, the control of a shareholder is a lawful control conferred upon him by company law which enables him quite legitimately to procure that the company acts as he wishes (subject only to any duty owed to creditors). ... But in the case of a trust, the position is quite different. The settlor has no power to direct the trustees in anything (unless conferred by the trust deed). Any control exercised over the trustees by the settlor is unlawful.

The settlor has no power over the trust once it has been created and where the settlor so acts and the trustees comply with his or her control, the result is simply a breach of trust by the trustees. The ultimate economic interest in the trust does not lie with the settlor, and his or her control and the trustees' acquiescence do not justify expropriation of that interest from the beneficiaries to the settlor. To accept otherwise could lead to dominating settlors having trust assets re-vested where it is in the settlor's interests to unwind the trust.

In addition, to allow the trust's so-called veil to be pierced would effectively ratify the trustees' breach of trust in submitting to the settlor's control. The trustees' breaching actions are, on orthodox principles of trust law, voidable and it would be an abuse of those principles if the conduct in breach were indirectly given effect to by piercing the veil between settlor and trust. "Thus the [third party] is in effect asking the court to give effect to and enforce a deemed appointment (to the settlor) which would itself be a breach of trust and liable to be set aside by the court."⁹⁵

⁹² Ibid. Cf *Official Assignee v 15 Insoll Avenue Ltd* above n 79; *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449.

⁹³ Above n 91 at 228.

⁹⁴ Ibid at 240.

⁹⁵ Ibid at 241.

Indeed even in the modern company cases, courts have taken a restrictive approach to piercing the corporate veil,⁹⁶ particularly on the basis of control. Piercing the veil of incorporation is appropriate in some circumstances, but not as a response to domination of a company's operations or assets.⁹⁷ As discussed earlier, a misfeasance does not effect an acquisition of property. Emerging sham trusts are not justified, or even explained, by attempted analogies with the company law doctrine of piercing the corporate veil.

An alternative argument that could perhaps be made in support of emerging shams is one based on public policy. Trusts can be rendered void when they offend against public policy⁹⁸ and one such offence is when a trust is used as an instrument of fraud. The emerging sham doctrine may thus be used to prevent a trust which was initially valid from *becoming* an instrument of fraud. The trust could be deemed void from the moment it becomes a fraudulent vehicle and the trust property is thus held on a resulting or constructive trust⁹⁹ in favour of the settlor. However, to recognise this situation as a sham trust and identify the settlor as the true beneficial owner is in fact giving effect to the very purpose of the fraud. The property had been validly vested in the trustee and beneficiaries and to deny the operation of the trust and instead revert ownership to the settlor reinforces the fraud.

While this article rejects the notion of the emerging sham, this is not to say that there is no relief available for parties affected by a settlor who, subsequent to creating a valid trust, treats the trust property as if it is his. Beneficiaries may be adversely affected by a settlor and subservient trustees who act in a manner which reduces the value of the trust property available to be distributed to the beneficiaries.¹⁰⁰ Third party creditors are generally adversely affected where the settlor has treated the trust property as her own leading creditors to believe she has adequate security for her debts. Hence in circumstances where the trust becomes controlled by its settlor, whether trust property is dissipated from the trust or is retained in the trust, some party generally stands to be harmed. Actions exist for both parties in these situations without having to force the emerging sham concept on to the law of trusts.

For beneficiaries, the obvious action is one against the trustee for breach of his trust duty by failing to consider and act in the best interests of the beneficiaries and instead merely following the settlor's directions.¹⁰¹ In an "emerging sham" scenario, the trust does not cease to exist but the trustees have nevertheless breached their trust and are liable to the beneficiaries. The breach may be, at one end of the scale, merely a failure to administer properly, or, at the other, a breach of the trustee's core obligation to perform trusts honestly and in good faith.¹⁰² As against the settlor, the beneficiaries may logically bring actions in

⁹⁶ *Adams v Cape Industries Plc* [1990] Ch 433; *Ord v Bellhaven Pubs Ltd* [1998] BCLC 607; *Trustor AB v Smallbone (No 2)* [2001] 1 WLR 1177. There is no principle that the veil is to be pierced merely because it is necessary to achieve justice.

⁹⁷ *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449 at 469-470 per Beaumont J.

⁹⁸ *Bowman v Secular Society Ltd* [1917] AC 406; *Re Great Berlin Steamboat Co* (1884) 26 Ch D 616. See also Pettit, *Equity and the Law of Trusts* (10th ed, 2006) 194.

⁹⁹ In the forms discussed above at text accompanying nn 82-85.

¹⁰⁰ It is possible that in some instances a settlor's intervention will not have harmed the interests of the beneficiaries – where assets have been retained by the trust and/or where the trust's assets have appreciated in value. In such situations, there can be no demand for relief.

¹⁰¹ *In re Esteem Settlement*, above n 91 at 248.

¹⁰² *Armitage v Nurse* [1998] Ch 241 (CA).

dishonest assistance and knowing receipt for the accessorial liability of the settlor to the trustee's breach of duty.

For third parties (usually creditors, spouses or the Official Assignee of the settlor), courts have mentioned, specifically against the trustee, proprietary claims; actions to set aside transfers as being in fraud of creditors or against bankruptcy legislation; and restitutionary claims.¹⁰³ It is doubtful that most of these would be effective in an emerging sham scenario because the trust property will have been initially validly settled. More likely to succeed are causes of action that relate to the trustee's failure to comply with his trust duties. Currently a topic of debate among equity lawyers is whether parties who are not beneficiaries and who do not have an interest in the trust property can nevertheless enforce the trust.¹⁰⁴ If it is accepted that they can, it is conceivable that a third party in this situation could claim breach of trust or fraud on a power. More difficult are the related questions of whether harm must be proved, whose harm is relevant and to whom any relief granted belongs. Another possible action could exist against the trustee in tort for his assumption of responsibility for the third party where it is reasonably foreseeable that the trustee's actions in deferring to the control of the settlor could cause harm to the third party.

In relation to recovery as against the settlor, Rimer J, in *Shalson v Russo*, opined that the settlor would be liable for the misappropriation of trust assets.¹⁰⁵ Presumably, by this is meant accessorial liability in the form of dishonest assistance and knowing receipt.

Some may find this approach somewhat harsh and unjust in that it may leave third parties who have been adversely affected by the settlor's actions struggling to persuade a court to grant them relief out of the trust assets where the settlor took control of such assets and acted as if they were his *after* the trust had been formed. However, it must be borne in mind that the determination of whether there should be a doctrine of emerging shams requires confronting the conflict between the desirability of providing relief to third parties adversely affected by the settlor's deviant conduct and the desirability of a clear and reliable system of property rights. This article accords priority to property rights and the rules for their creation and transferral. Validly created trusts and the property rights and obligations which they bestow (on trustees and beneficiaries) should not be ignored in favour of providing proprietary relief to third parties who have suffered adverse consequences because of the conduct of the prior owner of the trust property where his or her actions occurred after he or she relinquished the property to the trust. The notion of emerging sham trusts is, in effect, a mechanism to usurp proprietary rights and ought to be abandoned.

Shams in Relation to Particular Trust Property

This article has, thus far, considered shams only as applicable to trusts in their entirety. It is possible, however, that only certain assets within a trust are held on the basis of a sham.

¹⁰³ *In re Esteem Settlement*, above n 91 at 239.

¹⁰⁴ See further Hayton. "Developing the Obligation Characteristic of the Trust" (2001) 117 LQR 96; Matthews, "From Obligation to Property, and Back Again? The Future of the Non-Charitable Purpose Trust" in Hayton (ed), *Extending the Boundaries of Trusts and Similar Ring-Fenced Funds* (2002) 203; Parkinson, "Reconceptualising the Express Trust" [2002] CLJ 657; Hilliard, "On the Irreducible Core Content of Trusteeship" (2003) 17 TLI 144.

¹⁰⁵ *Shalson*, above n 90 at 353.

These types of sham trusts have been described as “partial shams”¹⁰⁶ and their existence was accepted by both counsel in *In re Esteem Settlement*.¹⁰⁷

As with regular sham trusts, only those partial trusts which are shams from their inception should be recognised as sham trusts. Determination of a partial sham claim should be carried out in the same way as for regular sham trusts and the preceding conclusions drawn in this article about the nature and quality of sham intention apply.

The use of partial shams can enable courts to distinguish between different types of property subject to the same overall trust and make findings that more accurately reflect the true intentions of the settlor. For example, a settlor may have placed both his business assets and the family home on a trust of which he is the trustee. He may have intended the home to be the subject of a valid trust and in that regard he may have acted throughout in the interests of the beneficiaries (say, himself and his children) in respect of it. There can be no suggestion that the house is held on a sham trust. On the other hand, the evidence may establish that in relation to the business assets the settlor clearly did not intend the trust to be genuine but rather to serve as a façade masking his true beneficial ownership so that the assets would not be vulnerable to claims of his creditors. The creditors could quite rightly expect the court to find that the business assets are the subjects of a sham trust and should be treated as owned absolutely by the settlor.

7. Conclusion

Express trusts are an acceptable legal device to ring-fence one’s property but the settlor must have the necessary intention to create a valid trust. If she does not intend to part with her beneficial interest, the trust is not valid despite its appearance as a trust. Where the intention of the settlor is not to create a genuine trust, but rather one which masks or cloaks the true situation, the apparent or purported trust is nothing more than a sham. Hence, sham trusts are concerned with the requirement of intention necessary to form a valid trust.

Unlike contracts and most other commercial transactions, the trust is a unilateral transaction by the settlor and it is only her intention which is relevant to the validity of the trust. For this reason, the general requirement of a common intention to create a sham is not applicable in the context of sham trusts. Only the settlor need have a sham intention for a sham trust to arise.

The alter ego concept refers to situations in which control is being exercised by an outsider (the settlor in the trust context) and that control may be either legally or factually assumed by the controller. Proof of a settlor’s sham intention can be evidenced by several post-settlement factors including the settlor’s factual control of the trust. In this way, the notion of a factual or de facto alter ego is relevant to sham trusts but it is not a ground in itself for declaring a trust void. Factual control alone cannot justify appropriation of property held by a trust to the settlor. Legal control, on the other hand, legitimates the controller’s actions and is not a

¹⁰⁶ Brownbill, “Sham Trusts” unpublished paper. Accessed online at <http://www.assotrusts.it/Pagine/Articolo%20di%Browmbill.pdf> on 26 September 2006 (Barrister of Lincoln’s Inn).

¹⁰⁷ Above n 91 at 224.

ground for setting aside a trust. In this way, legal alter egos are neither similar to, nor part of, the doctrine of sham trusts.

Given that the concern of sham trusts is with the intention to *create* a trust, a sham can only exist where there was a sham intention at the inception of the apparent trusts. A valid trust cannot be transmitted into a sham trust because the settlor's changed intention has no binding effect on the trust post-settlement. The emerging sham concept should not be employed as a mechanism to avoid what is otherwise a valid trust.

Any apparent unfairness that this causes to third party creditors who have been adversely affected by the actions of a settlor after a valid trust has been created is merely that: apparent. The third party has legal recourse against the settlor which will give him or her in personam rights of relief.¹⁰⁸ Simply because the settlor's pockets are not deep enough does not justify interference with the property rights of the trustees and beneficiaries of a trust in which the controller was wrongfully involved.

The desirability of giving the third party proprietary relief is not an adequate justification for subverting the law of express trusts. There is no real justice in giving such relief to third parties if that relief is obtained by abandoning the certainty and resulting security that property law provides in our society. Moreover, it must be remembered that the effect of an emerging sham trust is to divest the beneficial interests of the intended beneficiaries. A unified, consistent framework of property law is surely a greater good to be achieved than individual justice which distorts the trust concept. This article has provided a sound conceptual basis upon which to consider sham trusts and, particularly, to reject emerging shams. If courts nevertheless wish to employ the concept of emerging sham to provide relief to those affected by a settlor's actions, it is hoped that, at the very least, they will be mindful of the need to develop a principled understanding of the emerging sham to deal with the criticisms contained herein.

¹⁰⁸ It is possible, although not yet confirmed, that third parties could also seek in personam relief from the trustees, as was discussed above at text accompanying nn 87-88.