



SHAM TRUSTS

A substantive sham is where the terms of a trust appear to create equitable rights in others, but in fact the terms do not represent the true terms. Substantive trusts can be divided into two different categories. Firstly, a total sham where there is no intention of the apparent settlor to transfer legal ownership and control to the trustee. Secondly, a partial sham where there is a real intention of the apparent settlor to transfer legal ownership to the trustee, but in reality, it is intended that the equitable beneficial ownership remains solely with the settlor rather than with the beneficiaries, and the trustees only manage and distribute the trust property as the settlor directs.

The substantive partial sham is the most common sham alleged in litigation in respect of offshore trusts. That is not to say that other types of sham might not be applicable to offshore trusts in appropriate circumstances.

Jersey case law

The leading offshore judgment is the Jersey judgment of Grupo Torras S.A. and Culmer v Al Sabah and Four Others (also known as In the matter of the Esteem Settlement). The Royal Court (looking to English case law for guidance) concluded it was necessary for all parties to have a common intention that the acts or documents do not create the legal rights and obligations which they give the appearance of creating. Therefore it is not sufficient that the trustee merely went along with the intention of the settlor, but if one party goes along with a shammer who does not either know or care what he is signing (i.e. who is reckless), then he is to be taken as having the necessary intention to create a sham. The Royal Court's findings found approval in the English High Court case of Shalson & Others v Russo & Others where Rimmer J. regarded the approach adopted by the Royal Court as correct. Furthermore the Jersey Court of Appeal in Mackinnon v Regent Trust Co. Ltd and Eight Others reiterated that the prerequisite to declaring a trust to be a sham is a common intention of a settlor and trustee to give a false impression to third parties, including other beneficiaries and the court. Therefore, it is necessary for a litigant alleging a sham to prove dishonesty.

How sham arises and guarding against it

The trust deed itself might assist to show evidence of a sham, but the court will also examine external evidence such as parties' explanations, their conduct and circumstantial evidence.

Evidence of sham can be demonstrated by control of the trust property being unilaterally vested in the settlor whilst the trustees exercise no independent discretion or take any actions consistent with the terms of trust deed. In addition, trustees will display reckless indifference if they do not take steps to check the valid source of property or ensure they become the legal owners of property transferred to them by the settlor.

However, trustees will not always have control of the trust assets if the settlor has statutory reserved powers. The reservation of statutory powers will not prove there is a sham. However, the more powers reserved to the settlor,

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the more creditability an argument of sham has because there is apparent evidence from the outset that the parties had a common intention that the trust terms show the trustee having possession of trust property, but either: (a) the settlor remains de facto legal owner; or (b) the equitable beneficial ownership remains solely with the settlor. Therefore trustees should be wary of agreeing to reserved powers and should ensure that powers revert to them in the event of incapacity or death of the settlor.

...trustees should be wary of agreeing to reserved powers

To further minimise any argument of sham, trustees should ensure that there is adequate credible evidence of the true position of the non-sham nature of the trust. The best evidence will be contemporary trust records. Therefore trustees should keep detailed minutes showing their proper independent consideration to matters in the exercise of their own discretion and that they were not subject to any improper influences of the settlor.

If trustees are being asked by a settlor to be involved in a transaction which is being led by the settlor (and perhaps principally for his benefit), it is of the utmost importance that the trustees do not stand passively in agreement, even if all appears to be well. In such circumstances, it is essential that the trustees demonstrate their independent evaluation of the transaction by, for example, undertaking a detailed risk analysis of the transaction, taking relevant professional advice independent of the settlor and considering the interests of other beneficiaries who might be effected.

Furthermore, it is imperative that trustees ensure that their records do not refer to the settlor as "the client." Once the trust is established, any notion that the settlor and trustee have a client relationship should cease.

Consequences

If the court finds a trust to be a sham, then the trust will be regarded as void and the settlor and trustee will not be able to rely upon the trust deed as representing the true position as to the rights between the parties. Consequently, the court can ignore the trust deed in determining what those rights are. It is likely that the trust property will be found to be held on a resulting bare trust for the settlor. This makes the sham argument attractive to tax authorities, family members or creditors wishing to make claims on trust property. A successful argument of sham will leave the settlor with absolute beneficial

interest in the trust property which is capable of being taxed, inherited or claimed.

On the other hand, if the court finds the trust to be valid and that the initial trust property was derived from an innocent defrauded third party, the trust will not be regarded as void. In such circumstances, the court will define the rights of the parties so as not to disadvantage the innocent third party. It is likely the court will find that the trustees will hold the trust property on constructive trust for the persons defrauded. It also means that the trustees are likely to face tracing claims as it is likely the property will have been mixed with other trust property.

Furthermore, if a court does find a trust to be a sham, trustees might find themselves subject to tax penalties whilst at the same time losing any protection afforded to them by indemnities or exoneration clauses. In addition, trustees might find themselves subject to an investigation by the financial services regulator into their conduct as trustees. At the very least, their professional reputation will suffer

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from the publicity surrounding the judgment and, if they had the benefit of a charging clause under the trust, the likely reimbursement of all fees charged to the trust fund. At worst their licence to conduct trust company business will be revoked with key persons possibly facing fines or perhaps criminal sanctions including prison.

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