

SETTLOR CONTROL: HOW MUCH IS TOO MUCH?

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INTRODUCTION

There is general concern in the context of trusts when there is evidence of a settlor retaining a large degree of control over trust property. Third party creditors of the settlor may feel frustrated when their rights are constrained by the trust structure. Due to the settlor divesting the legal ownership of the property at settlement, his creditors cannot access the assets as payment for debt owing and may be aggravated when the settlor is seen to continue controlling and enjoying the benefits from the property.

Control over property is commonly argued as a justification for that property being made available to creditors. However, there is a fallacy in this argument, for control over property that is not beneficially owned does not give the controller proprietary rights. To attribute proprietary rights in the property to the controller is to breach the void between control and ownership. Therefore access to the assets held on trust must be achieved in another manner, either through a statutory mechanism or through a claim in equity.

This paper seeks to explore the mechanisms for addressing settlor control, evaluating the different approaches taken under statute and available in equity. The issue of settlor control has traditionally been addressed through the doctrine of sham, following Lord Diplock's authoritative judgment in *Snook v London and West Riding Investments Ltd*.¹ Therefore, the paper also examines the doctrine, assessing whether it is effective to deal with the problem.

Chapter I establishes the context in which the issue of settlor control has become apparent. The increased capability of the Financial Markets Authority to hold financial directors accountable for breaches of the Securities Act 1978 has highlighted the use of trusts to shield assets from third parties and limit one's own ability to pay when compensation or pecuniary penalties are imposed. Recent cases have shown the limited options open to the courts to deal with settlor control when the trust appears objectively valid. The doctrine of sham is shown as ineffective, for its structural requirement of mutual intention is notoriously difficult to prove. The paradigm of the trust as a relationship impedes the operation of the doctrine of emerging sham, while the subjective evidence sought is often illusory.

¹ *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786.

Chapter II examines the various statutory approaches to dealing with settlor control over property held on trust. The primary method of intervention is regulating the circumstances in which dispositions into trusts can legitimately occur. Control is only expressly addressed in statutes where the ability of a party to benefit is calculated, but ownership not attributed. The chapter therefore seeks to understand the policy justifications for the provisions chosen, and evaluate whether the provisions would be effective within the context of the Securities Act.

The equitable principles that deal with settlor control are assessed in chapter III. The primary opportunity to address the problem of settlor control is argued to be at the point of trust formation, by requiring a stiffer test for the certainty of a settlor's intention. It is argued that the doctrine of alter ego, the maxim of *donner et retenir ne vaut*, and the concept of the irreducible core all potentially allow for independent tests for validity of a trust, but also may offer new approaches to better understand the intention of the settlor. This chapter also suggests a novel interpretation of the trust as an entity rather than relationship, allowing for better implementation of the test for alter ego and enabling the veil of the trust to be pierced, and assets attributed to the settlor. It is suggested the Court of Appeal in *KA No 4 Trustee Limited v The Financial Markets Authority*² shows a willingness to accept this interpretation of a trust within the context of the Securities Act. This would allow for a more realistic approach to be taken to the relationships and obligations surrounding property held on trust.

Chapter IV attempts to address the issues within the sham doctrine itself and argues for a broader test of sham. Currently objectively valid trusts, settled without a fraudulent intention but evidencing a large degree of settlor control are falling outside the test for sham, yet are causing the greatest problems. Therefore it is suggested the test could be shifted to focus on the effect of the settlement, rather than intent held by the parties. Chapter IV also looks at whether broadening the scope of the relationships that define a trust could alleviate the pressure on the sham doctrine, by allowing for subsequent settlors to be relevant to the validity of the trust.

It is my contention that as settlor control has not been accepted as a legal issue affecting the validity of trusts there will be no perfect solution. By allowing third

² *KA No 4 Trustee Limited v The Financial Markets Authority* [2012] NZCA 370.

party creditors of the settlor to gain access to trust property either through equity or through statutory trust busting provisions, beneficiaries inherently have their rights infringed. The question as to whose rights should trump, the avoided creditor or the volunteer beneficiary who holds a mere expectation to be considered by trustees, is outside of this paper's direct contemplation but is relevant when looking at the justifications for attributing ownership.

CHAPTER I – THE ISSUE OF SETTLOR CONTROL IN THE CONTEXT OF THE SECURITIES ACT 1978.

I. Introduction

Since the introduction of the Securities Act in 1978 and the Securities Market Act 1988, there has been a general shift towards greater regulation of the New Zealand financial markets. A new era of reform began in the mid 2000's, fuelled by the globalisation of financial markets, the sub-prime market collapse of the United States, and the introduction of Kiwi Saver, which has given “an increasing number of investors a stake in the capital markets”.³ The shift towards greater regulation can be seen in the introduction of the Financial Markets Authority Act 2011, which established the Financial Markets Authority (FMA)⁴ and broadened the powers of the financial markets regulator in terms of investigation and enforcement, empowering the FMA to take over civil actions on behalf of investors against financial markets participants, such as directors of financial institutions.⁵

The Financial Markets Authority (FMA) governs the Securities Act.⁶ Its primary objective is to “promote and facilitate the development of fair, efficient and transparent financial markets”,⁷ therefore encouraging “confidant and informed participation of business, investors and consumers”.⁸ The inherent risk of investment drives the traditional policy basis of securities regulation in New Zealand, with investor protection achieved by focusing regulation on the process of disclosure, to address the systemic problem of asymmetric information.⁹ A focus throughout the

³ Shelley Griffiths "The Secondary Market" in John Farrer (ed) *Company and Securities Law in New Zealand* (Brookers Ltd, Wellington, 2008) at 1134.

⁴ At the same time the Securities Commission was disestablished by s11 of the Securities Amendment Act 2011.

⁵ The Financial Markets Authority Act 2011, part 3.

⁶ The Financial Markets Authority Act 2011, ss6 and 9 and Schedule 1, part 1.

⁷ The Financial Markets Authority Act 2011, s8.

⁸ The Financial Markets Authority Act 2011, s9.

⁹ Gordon Walker "The Policy Basis of Securities Regulation in New Zealand" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 171.

Securities Act is on the required content and process when offering securities to the public,¹⁰ and “[i]n that way the Act is aimed at the protection of investors”.¹¹

Making an untrue statement in an advertisement or registered prospectus is capable of both civil and criminal liability under the Securities Act.¹² A person held civilly liable may be ordered to pay the Crown a pecuniary penalty,¹³ while s55G also allows for compensation to be awarded to investors who subscribed on the faith of the advertisement or registered prospectus, for the amount of loss sustained. A person may be liable to pay a penalty order and compensation if they are a director of the issuer or a director on whose behalf the offer document or prospectus has been signed.¹⁴

However, the increased capability to hold directors of companies accountable for their actions when issuing securities or offer documents is somewhat ineffective when coupled with New Zealand’s high number of personal trusts. There is estimated to be one trust for every 18 people in New Zealand, however this estimate is conservative, being based only on trusts required to file tax returns in 2008.¹⁵ The high number of trusts can be attributed to two factors in New Zealand. The first is the previous misalignment between the top trustee and personal income tax rates, which occurred following the increase of New Zealand’s top personal tax rate in 2000.¹⁶ The misalignment made it beneficial for a taxpayer to divert their income into a trust so to be taxed at the lower trustee tax rate.¹⁷ The repeal of Estate Duty in 1993 also made trusts attractive property holding devices. Prior to the repeal, settlors who retained control over trust property were subject to estate duty.¹⁸ Repeal removed this fetter on

¹⁰ For controls on advertisements, investment statements and prospectuses see ss38 – 38B, 38C – 38 F, and 39 – 43B respectively of the Securities Act 1978. For obligations of issuers in regards to information dissemination and accounting records see ss 51- 54F.

¹¹ *Re AIC Merchant Finance* [1990] 2 NZLR 385 at 391 per Richardson J.

¹² A distribution of an advertisement or a registered prospectus, which includes an untrue statement, may bring civil liability under ss 55A to 57. While criminal liability may be imposed under ss58 – 60 for a misstatement in an advertisement or registered prospectus.

¹³ A penalty may be ordered if the event materially prejudiced the interests of subscribers for the securities involved, or was likely to materially damage the integrity or reputation of any New Zealand securities markets, or it is otherwise serious (The Securities Act 1978, s55C(c)).

¹⁴ The Securities Act 1978, s56.

¹⁵ Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at 6.

¹⁶ Law Commission *Some Issues with the Use of Trusts in New Zealand - Review of the Law of Trusts: Second Issues Paper* (NZLC IP20, 2010) at 10.

¹⁷ This misalignment has since been remedied. The top personal and trust rates were realigned at 33% from 1 October 2010 (Law Commission, above n 15, at 10)

¹⁸ Law Commission, above n 16, at 18.

settlor control and encouraged previously hesitant settlors to use trusts as investment devices.

The issue is when a defendant under the Securities Act is required to pay compensation, or a pecuniary penalty under the Act but he is insolvent and his significant assets have been placed in a trust. Through settlement, the defendant has divested himself of his legal and beneficial interests in the property such that it is not available to satisfy third party claims. Concerns arise when there is evidence a settlor retains a large degree of control over the trust property. Third party creditors of the settlor may feel vexed when they cannot access these assets to satisfy their claims, yet the settlor enjoys control over them. Factual control of property means access is practically available and therefore assets under control should be available for repayment. However, there is a fallacy in this argument, for control over property that is not beneficially owned does not give the controller rights in that property. To attribute proprietary rights in the property to the controller is to breach the void between control and ownership. Therefore access to the assets held on trust must be achieved in another manner, either through a statutory mechanism or through a claim in equity.

II. Financial Markets Authority v Hotchin

A recent example is *Financial Markets Authority v Hotchin*.¹⁹ Mr Hotchin is under investigation for breaches of the Securities Act provisions above, in his capacity as director of companies within the Hanover Finance Group.²⁰ The FMA sought orders to preserve assets held on trusts, which had been previously settled by Mr Hotchin, while the investigations continue.²¹

Mr Hotchin was the settlor of two separate trusts, the KA3 trust and the KA4 trust. The KA3 trust was settled in 1999, with two separate trustees. The trustees have

¹⁹ *Financial Markets Authority v Hotchin* [2012] NZHC 323.

²⁰ *Financial Markets Authority v Hotchin* [2011] 3 NZLR 469; [2012] NZCCLR 2 (HC) at [1].

²¹ The Securities Act 1978, ss60G, 60H and 60I set out the preservation orders available under the Act. The FMA contended in *Hotchin* the property of the trusts in question was held on behalf of associated people of Mr Hotchin, namely his children. This claim succeeded at the earlier stages of the litigations and the assets are now subject to preservation orders pending the outcome of the trial. The FMA also pleaded the trusts were void for lack of intention, and alternatively they were shams and these pleadings are discussed throughout this paper.

changed over time and the trusteeship is held currently by KA3 Trustee whose sole director and shareholder is Mr Thomas. Mr Hotchin is a discretionary beneficiary, but he is neither the sole nor a final beneficiary. Mr Hotchin settled the KA4 trust in 2003 and he was the sole trustee at the time. The trustee is now KA4 Trustee, whose sole shareholder and director is also Mr Thomas. Mr Hotchin is not presently a discretionary beneficiary of the trust or a final beneficiary.

Upon settlement, Mr Hotchin retained a number of powers under both deeds. He has the power to appoint and remove discretionary beneficiaries, and to appoint and remove trustees. Both the trust deeds contain a prohibition against a trustee distributing trust property to himself and both include the ability for a trustee to amend the deed. Mr Hotchin appears to exhibit a significant amount of control over the trusts' property and the concern is Mr Hotchin's enjoyment of the property is free of the risks of legal ownership, including personal and statutory obligations to creditors, including under the Securities Act.²²

A. Legitimacy of the Hotchin trusts

Traditionally when third parties are faced with a trust blocking access to property, but the settlor exercises control in such a way so they appear to have retained beneficial ownership of the property, the assertion made is that the trust is void. But such claims are ineffective if the structure is held to objectively fulfil the requirements of a valid trust.

A settlement of trust requires certainty of intention, subject matter and object to be held as valid.²³ The settlor must intend to divest himself of the legal and beneficial ownership of the property being settled on trust, and therefore "there cannot be a trust if it is unclear that the settlor intended to create a trust".²⁴ When a settlor retains or exhibits control over trust property, the requisite intention is challenged.

²² *KA No 4 Trustee Limited v The Financial Markets Authority* above n at [29]. The Court of Appeal noted as relevant the Matapana Road transaction, where there was a transfer of property from the KA4 Trust to the KA3 Trust in exchange for a forgiveness of debt owed by the KA4 Trust to the KA3 Trust. KA3 Trust then provided an indemnity, including this Matapana Road property, to support Mr Hotchin's obligations in relation to the restructuring of the Hanover Group. The Court of Appeal also noted the personal investment by Mr Hotchin and favourable transactional history by both trusts in respect to the Paritai Drive property.

²³ *Knight v Knight* (1840) 3 Beav. 148 at 172.

²⁴ Matthew Conaglen "Sham Trusts" (2008) 67 CLJ 176 at 184.

The default determinant of a transaction's effect and substance is its objective appearance. The requirement of intention is therefore evaluated objectively, as "[w]hat counts is the objective meaning that the words of the document convey to the court when considered as a whole in the light of the surrounding circumstances... the admissible circumstances do not include the subjective intentions of the settlor".²⁵ Winkelmann J in the High Court upheld both trusts in *Hotchin* as objectively valid, primarily because of the inclusion of the prohibition on self-dealing in the deed.²⁶ Her Honour held that the insertion of such a prohibition evidenced an objective intention of Mr Hotchin to not be able to distribute trust property to himself and thereby not be able to benefit from the property.²⁷ The intention was to divest the beneficial ownership of the property for the enjoyment of the beneficiaries. Mr Hotchin's ability to amend the deed did not affect this finding, because according to Winkelmann J, any attempt to amend the clause prohibiting self-dealing would itself be a breach of the prohibition.²⁸ The ability to amend the deed was vested in the trustee, and therefore constrained by fiduciary duty. This is distinguishable to retention by a settlor of the power to revoke a settlement, which would be free from fiduciary duties, and allow beneficial ownership to be attributed to the settlor.²⁹

The level of control exhibited by Mr Hotchin over the KA3 and KA4 trusts is nevertheless troubling considering the intention required to create a trust. If the underlying intention of the settlor is not to divest the beneficial ownership, the objective theory of interpretation of the deed must cede itself at some point to account for this. Traditionally, this is where the sham doctrine has been applied, as it allows the court to look behind the objective appearance of a transaction and ascertain the subjective intentions of the parties.³⁰ It is invoked in situations where the trust in question is objectively valid but it is alleged, "the real or underlying position of the parties is not that which appears in the purported transaction".³¹

²⁵ At 181. See John Mowbray and others *Lewin on Trusts* (18th ed, Brookers, Wellington, 2008) at [6.08].

²⁶ *Financial Markets Authority v Hotchin*, above n 19 at [40] – [42].

²⁷ At [40].

²⁸ At [41].

²⁹ *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank & Trust Co (Cayman) Ltd* [2011] UKPC 17; [2012] 1 WLR 1721

³⁰ Jessica Palmer "Dealing with the Emerging Popularity of Sham Trusts" [2007] NZ L Rev 81 at 84.

³¹ At 85.

III. The Sham Doctrine

A sham arises where the parties to a transaction “intend to create one set of rights and obligations but do acts or enter into documents which they intend should give third parties... the appearance of creating different rights and obligations”.³² The transaction acts as a cloak or façade for the true legal arrangement between the parties.³³ Lord Diplock’s dicta from *Snook v London and West Riding Investments Ltd* is oft cited as the authoritative statement of the sham doctrine, holding a sham to be:³⁴

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 intended to create... all parties must thereto have a common intention that the acts or documents are not to create the legal rights or obligations which they give the appearance of creating.

Third party creditors of the settlor will be the ones likely to assert a claim of sham against the trust. Upon the finding of a sham, the property of the trust will be held on resulting trust for the settlor, giving access to third party creditors.³⁵ This occurs because the sham intent of the settlor means the requisite intention to create a trust was absent at settlement and the trust is void ab inito. The property is held for the settlor, for he never successfully divested himself of ownership of the property.³⁶

A. The Pleading of Sham in Hotchin

The FMA alleged in *Hotchin* that the KA3 and KA4 trusts were shams and the “[t]rusts were set up to conceal Mr Hotchin’s continued enjoyment of all the normal incidents of ownership in respect of the trust property. He maintained full and

³² *Hitch v Stone* [2001] EWCA Civ 63, [2001] STC 214 at [63].

³³ *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 at 168.

³⁴ *Snook v London and West Riding Investments Ltd*, above n 1, at 802.

³⁵ *Midland Park plc v Wyatt* [1995] 1 FLR 696 at 707; *Abdel Rahman v Chase Bank* 1991 JLR 103 at 168; Jessica Palmer “Sham Trusts” in Andrew Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomas Reuters, Wellington, 2009) at 403.

³⁶ There is academic debate whether the resulting trust is restitutionary in nature, or whether it arises because the mutual intention of the trustee indicates his conscience was pricked and he was aware ownership had not been divested. Discussed in *Official Assignee v Wilson* [2008] 3 NZLR 45 (CA) at [118] per Glazebrook J.

effective control over the assets”.³⁷ The pleadings were framed around the following particulars:

- (a) The trust was the alter ego for the defendant.
- (b) The trusts lent Mr Hotchin money, unencumbered.
- (c) The transactions of the trusts were done purely for the benefit of the defendant. The defendant could ensure such transactions were completed as he had retained powers enabling him to absolutely control activities associated with the KA3 and KA4 trusts.
- (d) The above is all evidence for the fact both trusts were void for lack of intention to create valid trusts.
- (e) Therefore, the property of the trusts was in fact the property of the defendant, and held on resulting trust by the trustees for him as settlor of the trusts.³⁸

The pleadings in *Hotchin* were ill constructed because effective pleadings for a sham should focus on the existence of a sham intention. It is this intention, “to create different rights and obligations from those appearing from (if any) the relevant document”,³⁹ which infers a lack of subjective intention to create a trust. Evidence of a sham intention can include control of the trust property, and the transactional history of the trust. The pleading of sham succeeded at the interlocutory stages in *Hotchin* in regard to the KA4 Trust. However the pleading has been struck out in relation to the KA3 Trust because the Court found no evidence to support the allegation the trust was settled with a shared intent to deceive.⁴⁰

In the wider jurisprudential context of trusts, the claim of sham has only been rarely found, for “the finding of a sham where a trust is involved should not be lightly made... there are beneficiaries involved and a finding of sham will deprive them of their rights under the trust”.⁴¹ A finding of sham results in the trust being held void ab initio for want of sufficient certainty to create a trust. Therefore if the trust is held a sham, the beneficiaries are held as ever having had any rights in the first place.

³⁷ *Financial Markets Authority v Hotchin*, above n 19 at [52].

³⁸ At [51].

³⁹ *Hitch v Stone*, above n 32, at [66].

⁴⁰ *Financial Markets Authority v Hotchin*, above n 19, at [54].

⁴¹ *Official Assignee v Wilson*, above n 36 at [112] per Glazebrook J.

The sham doctrine is also arguably ill suited to the problem of settlor control. This is not only because of the reluctance of the court to deprive beneficiaries of their rights, but due to the structural requirements of the sham doctrine, which may be difficult to prove in the context of a trust.

B. The Requirement of a Common Sham Intention

For a transaction to be held a sham, the intention for the document to create the appearance of rights and obligations, which are not representative of the true legal arrangement between the parties, must be shared between all parties to the transaction.⁴² This requirement greatly reduces the effectiveness of the sham doctrine in regulating settlor control.

The necessity of ‘common intention’ stems from the doctrine of sham being of general application, originally crafted within the framework of commercial contractual obligations.⁴³ The doctrine has “its own independent doctrinal features, and is accordingly distinct from the particular requirements of individual transaction types”.⁴⁴ This independence means consistency is not required between the form of the underlying transaction and the elements of the sham itself. The conclusive paradigm of a trust need not be decided, for the sham doctrine is independent in its requirements and separate from the underlying form of the trust. This independence means a sham trust still requires common intention, even if the express trust is seen as a structured transfer of property, dependent only the intention of the settlor for valid formation. The sham doctrine would still be effective, because the finding of a sham is irrespective of the finding of a trust.⁴⁵

⁴² *Snook v London and West Riding Investments Ltd*, above n 1, at 802; *Official Assignee v Wilson*, above n 36 at [38], interpreted *Midland Park plc v Wyatt*, above n 35, at 699-700), which held a sham would include instances where one of the parties “merely went along with the ‘shammer’ not either knowing or caring about what he or she was signing”, to have broadened the scope of the required intention rather than hold a common intention is not required. Recklessness or ignorance on the part of the trustee is tantamount to intention.

⁴³ See *Snook v London and West Riding Investments Ltd*, above n 1, which was a case concerning hire-purchase agreement of a motor vehicle. The sham doctrine has also been applied to gifts, see *Chase Manhattan Equities Ltd v Goodman* [1991] BCLC 897; and trusts, see *Midland Park plc v Wyatt*, above n 35.

⁴⁴ Jessica Palmer "Theories of the Trust and What They Might Mean for Beneficiary Rights to Information" [2010] NZ L Rev 541 at 544.

⁴⁵ At 542.

The mutual intention test for sham has also been supported in cases where the doctrinal independence of sham has been overlooked. Rimer J in *Shalson v Russo*⁴⁶ indicated a preference for the paradigm of the trust as a consensual relationship, holding both the settlor and trustee are significant in the formation of the trust. His Honour held settlement consists of more than the settlor simply divesting himself of the assets but also includes the acceptance of obligations by the trustee.⁴⁷ Therefore, a common intention must be required for a sham, as a common intention is required to form a valid trust. O'Regan and Robertson JJ in *Official Assignee v Wilson*, in contrast held a valid trust and a sham do not fall into combination.⁴⁸ They are mutually exclusive and therefore cannot practically occur together.

Irrespective of the justification stated for the requirement, the need for a common intention is settled in international jurisdictions.⁴⁹ However the issue is still technically open in New Zealand, for the comments of the Court of Appeal in *Wilson* as to whether a common intention between the settlor and trustee is required were obiter dicta. The High Court and Court of Appeal in the *Hotchin* litigation have however suggested if the sham pleading is carried through to substantive trial, the requirement of a mutual intention will be necessary.⁵⁰ Where the trust is instead settled unilaterally, so that the settlor is also the trustee at the time of settlement, it is only the settlor's intention that will be relevant.⁵¹

The requirement of common intention raises the threshold for a finding of a sham trust.⁵² It is a difficult requirement to prove, primarily because of the paradigm of the trust as a relationship. The terms of the relationship are determined at the time of settlement, when the property vests and therefore for a trust to be a sham, the sham intention must be held by both the settlor and the trustee at the time of settlement. This makes proving the existence of the sham intent difficult, for it is the conduct of

⁴⁶ *Shalson v Russo* [2005] Ch 281.

⁴⁷ At 342. To some degree this discussion is dependent on whether an express trust is considered a unilateral proprietary mechanism or a bilateral relationship, consisting of a set of obligations voluntarily undertaken by the trustee. However, for the purposes of this discussion there is no need to elaborate further.

⁴⁸ *Official Assignee v Wilson*, above n 36, at [48].

⁴⁹ See, for example, in England, *Minwalla v Minwalla* [2004] EWHC 2823; in Australia, *Rafiland Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* 238 CLR 516; [2008] HCA 21; in Jersey, *Grupo Torras S.A. and Culmer v Al.Sabah and four others* [2003] JLR 188.

⁵⁰ *Financial Markets Authority v Hotchin*, above n 19 at [49]. The pleading of sham against KA3 trust was struck out, as the requirement of mutual intention was not proved, at [56].

⁵¹ *Official Assignee v Wilson*, above n 36, at [41].

⁵² At [53].

the current trustee that is often in question, rather than that of the trustee at the time of settlement.

The difficulty in proving mutual intention is seen in *Hotchin*, in regard to the KA3 trust. While the transactions entered into by the KA3 trust were “undoubtedly... to benefit Mr Hotchin”, there was held to be no evidence that could support an allegation that the trustees at settlement held an intention to set up the trust as a sham.⁵³ The court refused to place any weight on the fact that the trustees had only once ‘pushed back’, or declined to do what Mr Hotchin had requested with the assets of the trust.⁵⁴ The KA3 and KA4 trust were very similar in structure, had the same trustee at the time of trial, and had jointly entered transactions together, however, the mere fact one was a unilateral settlement and the other bilateral a decade ago, distinguished them. While this is consistent with the doctrine of sham, it appears an irrational answer. It was the trustee’s recent behaviour that was identified as suspicious, yet the original trustees’ intentions at settlement were determinative.

Proof of mutual intention will also be difficult to find, for “the mere fact the trustee has abdicated some of its decision-making powers to the settlor after the trust was created does not necessarily indicate that the trust was a sham when it was originally created”.⁵⁵ While examination of subsequent conduct is allowable, it is relevant only when providing evidence of a subjective sham intention of the parties,⁵⁶ and “the inference of a sham in the absence of direct evidence needs compelling material”.⁵⁷ The settlor carries the benefit of the doubt, as if there is a viable alternative explanation for the transaction, it will unlikely be found a sham.⁵⁸ As a finding of sham is comparable to a claim of fraud,⁵⁹ there is an assumption as to the trust’s validity and conclusive evidence is required.⁶⁰

⁵³ At [54].

⁵⁴ At [52].

⁵⁵ Conaglen, above n 24 at 197.

⁵⁶ *Official Assignee v Wilson*, above n 36, at [110].

⁵⁷ At [92].

⁵⁸ *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794 at 813-814.

⁵⁹ *Financial Markets Authority v Hotchin*, above n 19, at [47].

⁶⁰ Glazebrook J notes in *Wilson* that the civil standard of proof applies to a claim of sham. Therefore, the rule that the more serious the allegation the stronger the evidence must be to prove it applies, as there is an assumption that is less likely to have occurred. As a claim of sham is equivalent to a claim of fraud, the standard of proof is high.

C. The Examination of the Subjective Intentions of the Parties

The value of the sham doctrine is it allows for examination of the subjective intention of the parties to the transaction, because “after all, the whole point of a sham is that it is intended to have an effect other than the effect it would have if looked at objectively”.⁶¹ Therefore, in “examining whether an arrangement is a sham, it is inevitable that the parties’ subjective intentions must be considered”.⁶²

Matthew Conaglen suggests the justification for the courts to step outside the ordinary limits of evidentiary material by ignoring the objective appearance of the document and instead having regard to the subjective intentions of the parties is the requirement of a shared intention between the settlor and the trustee.⁶³ Robertson J held in *Wilson* that the court would “only look behind a transaction’s ostensible validity if there is a good reason to do so, and ‘good reason’ is a high threshold, since a premium is placed on commercial certainty”.⁶⁴ His Honour continued by stating that the requirement of a sham intention commonly held between the settlor and trustee might qualify as an example of this high threshold.⁶⁵ Sham transactions are irregular by nature and do not conform to the requirements of the transactional category to which they appear to belong. Therefore departure from the default principle of analysis is required in their assessment.⁶⁶

However, there is no method to examine the subjective intentions of parties to a sham. The parties are estopped from testifying to their subjective intentions, as “no unexpressed intentions of a ‘shammer’ should affect the rights of a party whom he or she deceived”.⁶⁷ Practically the courts are confined to looking to objective manifestations of the subjective intent of the parties, and this limits the courts to the same form of objective inquiry had when looking at trust validity. The only difference is the scope of evidence assessed, for the courts will not be held to the four corners of the document but may look to subsequent conduct of the parties to infer subjective

⁶¹ *Official Assignee v Wilson*, above n 36, at [108] per Glazebrook J.

⁶² *Financial Markets Authority v Hotchin*, above n 19, at [49].

⁶³ Conaglen, above n 24, at 189.

⁶⁴ *Official Assignee v Wilson*, above n 36, at [52].

⁶⁵ At [53].

⁶⁶ At [50]. See also, Inland Revenue Department *Interpretative Guideline:IG 12/01 - Goods and Services Tax: Income Tax "Sham"* (2012) at [22].

⁶⁷ *Official Assignee v Wilson*, above n 36, at [109]; *Snook v London and West Riding Investments Ltd*, above n 1, at 802.

intention.⁶⁸ However, Arden L.J. warned in *Hitch v Stone*, that departure from an agreement does not necessarily mean the intention was the document would not be binding.⁶⁹ Additionally for sham, the court must also have regard to the trustee's intention, for they too must intend to create a sham, as discussed above.

D. The Inability to Claim an Emerging Sham within the Context of Trusts

The paradigm of a trust as a relationship rules out the availability of a claim of an emerging sham. An emerging sham occurs when a document “was bona fide at inception but the parties have departed from their initial agreement and have yet allowed its shadow to mask their new agreement,”⁷⁰ so the transaction transforms into a sham midway through its existence.⁷¹ It was held in *Official Assignee v Wilson* that unless the sham intention occurred at the point of settlement, a trust must remain valid,⁷² for once a trust has been validly created, “a subsequent agreement between trustee and settlor that the trust will be a sham merely exposes the trustee to a claim for breach of trust”.⁷³ Therefore, where trusteeship has changed during the life of a trust, the intent of the later trustee(s) will be irrelevant to the inquiry of a sham. Reinforcing this analysis is the fact a finding of sham will mean the trust was void at settlement, so the subsequent trustees intentions or actions are logically irrelevant in the context of the sham.

There is however an ability to isolate certain dispositions of property onto trust as shams, for every disposition into a trust is conventionally a new settlement.⁷⁴ Where property is transferred subsequent to the original settlement, and the “true intention is that that asset should not be so held, the transfer of that asset into the trust will be held to be a sham”.⁷⁵ A sham in this nature, or transaction sham, allows the trust to be a sham in respect to that property only, while the remainder of the trust remains valid.⁷⁶ This also means the intention examined in an inquiry of sham for that particular

⁶⁸ Conaglen, above n 24 at 193.

⁶⁹ *Hitch v Stone*, above n 32, at [68].

⁷⁰ *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 at 588 per Richardson J.

⁷¹ Palmer, above n 30, at 104.

⁷² *Official Assignee v Wilson*, above n 36, at [57].

⁷³ Conaglen, above n 24, at 193.

⁷⁴ Lionel Smith "Mistaking the Trust" (2011) 40 HKLJ 747 at 764.

⁷⁵ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 224.

⁷⁶ *Official Assignee v Wilson*, above n 36, at [57].

property would be of the trustee at the time of that individual settlement, rather than the original trustee from the original settlement of the trust.

IV. Conclusion

The ability to hold directors accountable for breaches of the Securities Act 1978 has increased recently. However an apparent issue occurs when defendants escape statutory obligations of compensation and pecuniary penalties through the settlement of their property on to trust. The ability of the defendants to control the trust property suggests that the avoidance of the statutory obligations has been achieved without any limits being imposed on their enjoyment of the trust property.

Control over trust property, as seen in *Hotchin*, suggests the trust in question may not be validly settled, for the enjoyment of the property by the settlor infers a lack of subjective intention to divest beneficial ownership. However, a trust's validity is dependent only on its objective appearance, and therefore once held valid, the primary tool for third party creditors of the settlor to access the property is to claim the trust is a sham. There is however a difficulty with the claim of sham, for it requires that a common intention to deceive be shared by the settlor and the trustee at settlement. The examination of subjective evidence also does not offer any new scope to the investigation, while the actions of trustees appointed after settlement will not be relevant.

Therefore there is still an issue of the defendant controlling and enjoying property held on trust, yet avoiding statutory obligations. Either statutory provisions must be introduced to address this avoidance, or the principles of equity must provide an answer.

Chapter II - The Use of Statutory Mechanisms to Address the Problems of Trust Use

I. Introduction

Chapter I introduced a major policy issue in regards to the use of trusts. The settlement of assets onto trusts enables protection from third party claims and the avoidance of statutory obligations. However it is the continued control by a settlor over a trust, enabling the settlor to access and enjoy the property without any burdens of ownership that causes additional concern. Government policy regards the use of trusts in this manner as inappropriate and potentially inequitable in particular circumstances and there are a variety of legislative responses within different contexts to address the issue.⁷⁷ The primary method of intervention is statutory regulation of the circumstances in which dispositions into trusts can legitimately occur, so to limit the instances of where the settlor can assert he is no longer the legal owner of the property. There is also regulation to limit the ability of a settlor to control and enjoy trust assets while achieving the avoidance of a statutory obligation or enjoying a statutory benefit, however these provisions are more difficult to enforce.

The particular measures are dependent on the underlying contextual considerations and the purpose of the statutes. The Insolvency Act 2006 and the Property Law Act 2007 both allow for the cancellation of dispositions into trusts to enable third parties access to the assets in question, however each use a different method. The Insolvency Act uses an effects based approach, cancelling dispositions of insolvent settlors within specific time periods prior to insolvency.⁷⁸ In contrast, the Property Law Act 2007 focuses on the intent of the party making the disposition, looking to find intention to defeat creditors.⁷⁹ However, neither addresses the issue of settlor control over trust property.

The Income Tax Act 2007 has a distinct structure, as it looks to reveal the true economic situation of the taxpayer, using the general anti avoidance and

⁷⁷ Law Commission, above n 16, at 17.

⁷⁸ The Insolvency Act 2006, part 3, sub-part 7.

⁷⁹ The Property Law Act 2007, part 6, sub-part 6.

reconstruction provisions of the Act to adjust the taxpayer's income where a tax avoidance arrangement is considered to exist.⁸⁰ Elements of settlor control are not expressly considered by the statute, but may be considered judicially, depending on the structure of the arrangement. A trust within a tax avoidance arrangement will remain valid but will be reconstructed fiscally and then taxed accordingly.⁸¹

The Legal Services Act 2011 has a similar purpose. It looks at the ability of the applicant to benefit from a trust and in doing so it has express regard to elements of control and the structure of the trust. The assumption is of the trust's validity and rather than seeking its avoidance, the statute seeks to attribute to the applicant any potential benefit that would likely be gained if immediate distribution was to occur.

The Securities Act 1978 does not contain any provisions instructing the Court on how to manage circumstances when a defendant to charges laid under the Act has significant control of assets they have previously settled on trust.⁸² As the Legislature has chosen to act within these other statutory contexts, but not within the Securities Act, an evaluation of the provisions may help determine the reasons for such pragmatism. If similar policy considerations can be identified as to those within the Securities Act then perhaps similar provisions can be adopted to solve the issue of settlor control within the Securities Act.

II. The Insolvency Act 2006

The Insolvency Act is “a collective means to provide for the efficient collection, and equitable distribution, of an insolvent's property amongst creditors”.⁸³ The Act addresses the use of trusts by looking at the interests of an insolvent under a trust, as well as looking at dispositions made by an insolvent within certain time periods before insolvency. The Act however has no provision to address settlor control of

⁸⁰ The Income Tax Act 2007, s BG 1 and GB; Law Commission, above n 16, at 28.

⁸¹ The Income Tax Act 2007, s GB 1.

⁸² Ss60G and 60H of the Securities Act 1978 establish the rules governing the orders that may be made to preserve assets of a “relevant person” (defined under s60G, as including someone subject to an FMA investigation, prosecution or civil proceeding under the Act or other financial markets legislation involving offers of securities to the public). *Financial Markets Authority v Hotchin* [2011] 3 NZLR 469; [2012] NZCCLR 2 affirmed by the Court of Appeal in *Hotchin v Financial Markets Authority* [2012] NZCA 155, held assets held on discretionary trust for the relevant person or an “associated person” (as defined under s2) may be subject to such orders.

⁸³ Justice Paul Heath and Michael Whale (eds) *Insolvency Law in New Zealand* (LexisNexis NZ Limited, Wellington, 2011) at [1.2].

legitimately disposed trust assets. The provisions of the Act are triggered by the adjudication of bankruptcy.

A. Addressing Beneficial Interests of the Insolvent

Upon bankruptcy, property of the insolvent vests immediately and absolutely in the Official Assignee.⁸⁴ Section 104 holds only the property the bankrupt has a beneficial interest in will be available to the Official Assignee. Therefore, any interests vested in the insolvent as a beneficiary under a trust are treated comparably to property of the bankrupt and vest immediately, while property of a third party, held by the insolvent as a trustee, does not vest. Property is subject to vest depending on precise elements of legal ownership and equitable beneficial interests, while objective elements, including control of an asset are irrelevant.

B. Irregular Transactions Before Adjudication

The Insolvency Act addresses an insolvent disposing of property onto trust by empowering the Official Assignee under part 3, sub-part 7, to cancel transactions depending on certain objective criteria. Following cancellation, the assets are added to the collective pool to be distributed to the unsecured creditors.

Gifts made within two years of the adjudication of bankruptcy may be set aside without proof of insolvency,⁸⁵ as well as any gift made two to five years prior to adjudication.⁸⁶ Sections 194-195 of the Act set out the “insolvent transactions” which may be set aside by the Official Assignee within two years of adjudication and these include ‘conveying or transferring property’, or ‘paying money’, both common forms of disposing of property into trusts. The provisions apply if the transaction was entered into at a time when the debtor was unable to pay his due debts and the transaction enabled a creditor to receive more towards satisfaction of their debt than they would have received, or have been likely to receive, in the bankruptcy.⁸⁷

Preference law aims to address the reality that by the time the formal process of insolvency has begun the individual has already been insolvent for a period of time. Therefore transactions that have occurred within the window leading up to insolvency

⁸⁴ The Insolvency Act 2006, s101.

⁸⁵ The Insolvency Act 2006, s204.

⁸⁶ The Insolvency Act 2006, s205.

⁸⁷ The Insolvency Act 2006, s195.

are seen as contrary to the collective policy of the insolvency regime. The regime is also generally creditor sympathetic. Insolvency of the debtor is presumed under the gifting provisions for the entire five years prior to adjudication. However, a gift made more than two years before official insolvency may be reinstated if the transferee can prove the debtor's solvency at the time of the gift.⁸⁸ For all other transactions, there is a presumption the insolvent is unable to pay due debts in the six months prior to adjudication, while in the 18 month period prior to this, the Official Assignee must prove the debtor's inability to pay.⁸⁹ The adequacy of valuable consideration must be quantifiable in monetary terms and if no consideration can be identified then the transaction will be considered a gift, making it easier to cancel.⁹⁰ It is important to note that any disclaimed beneficial interest by the insolvent will be deemed to be a transfer of the interest to the next entitled beneficiary and may therefore become open to attack by the Official Assignee as an irregular transaction.⁹¹

Provisions governing antecedent transactions are historically founded on three policy underpinnings: debtor deterrence, creditor equality, and creditor deterrence.⁹² The general purpose and scheme of the current statute prioritises the policy of creditor equality and preventing "a creditor from jumping in front of the queue of general unsecured creditors, all of whom should be paid equally and rateably".⁹³ The scheme recognises the primary policy of voidable preference law is, "to secure equal participation in such company's property as available in liquidation," and in lieu of this, the provisions are objective.⁹⁴ The principle of deterring debtors was seen previously in the Insolvency Act 1967, where the provisions regarding preferential transactions required proof the insolvent had at the time of the transaction a dominant 'intention to prefer' one creditor over another.⁹⁵ However, the shift away from evaluating debtor conduct and towards objective criteria reflects a hard-line approach of the Legislature against using trusts to avoid the repayment of creditors.⁹⁶

⁸⁸ The Insolvency Act 2006, s205.

⁸⁹ The Insolvency Act 2006, ss194 and 195.

⁹⁰ *Welch v Official Assignee* [1998] 2 NZLR 8; [1998] NZFLR 446.

⁹¹ Heath and Whale, above n 83, at [4.13].

⁹² At [20.2].

⁹³ At [20.1].

⁹⁴ *Countrywide Banking Corporation v Dean* [1998] 1 NZLR 385 (PC) at 195.

⁹⁵ *Re Cutts* [1956] WLR 728

⁹⁶ For example, the time periods of the gifting provisions (ss204-205) and the requirement of receiving more towards satisfaction of a debt than would have been received under the bankruptcy under s195,

The collective regime, though neutral to individual claims, is justified by its low strategic costs, its administrative efficiencies, and a clear focus on increasing the general pool of assets.⁹⁷ This policy of collective benefit is symbiotically related to the acknowledgment that insolvency law must be structured around the principle of *pari passu*.⁹⁸ The ability of the Official Assignee to challenge gifts and insolvent transactions represents a vital tool in ensuring creditors share pro rata post bankruptcy in accordance with the pre-insolvency financial matrix. It also ensures insolvents do not circumvent the principle by using trusts in order to affect their own preference to particular creditors or personally retain property.

The policy goal of creditor deterrence seeks to reduce the number of creditors who attempt to achieve repayment in the final months before insolvency and is witnessed in the protection of good faith creditors who have acted on the reasonable belief that the debtor was not, or would not become upon entering the transaction, unable to pay their debts.⁹⁹ In the context of insolvent dispositions onto trust, most will occur with the purpose of avoiding creditors, rather than repaying or favouring one creditor over another. The protection offered by s208 will not extend to a family trust to which the insolvent is a trustee, for his knowledge as the insolvent will invalidate the protection.

C. Regulation of Settlor Control over Trust Property

There are no provisions within the Insolvency Act to deal with control over assets within a legitimate trust. This is because insolvency law is concerned with ensuring unsecured creditors get access to the assets of the insolvent as they would have achieved prior to insolvency. Insolvency is deemed to occur in the period before official insolvency, therefore the antecedent transactions provisions allow for transactions within the period immediately prior to adjudication to be reversed.¹⁰⁰ Creditors at no point prior to insolvency have any rights to assets held on a legitimate trust but controlled by the settlor therefore they gain no better rights in insolvency. It is often suggested an appearance of ownership created by the settlor through elements

⁹⁷ Thomas H Jackson *The Logics and Limits of Bankruptcy* (Harvard University Press, Cambridge, 1986) at 3.

⁹⁸ General Policy Statement contained in the explanatory note to the Insolvency Law Reform Bill in Heath and Whale, above n 83, at [24.11].

⁹⁹ The Insolvency Act 2006, s208.

¹⁰⁰ See s196 which presumes a debtor was unable to pay his debts in the period of six months prior to adjudication. See also s204, which allows for the cancellation of a gift in the two years prior to adjudication.

of control may induce the giving of credit, however the Legislature has chosen within the insolvency context to not address the issue. For access to such assets, the doctrine of sham must be invoked.

D. Application of the Provisions in the context of the Securities Act

The provisions of the Insolvency Act could provide an effective model for application under the Securities Act. The primary purpose of the Securities Act is to promote and facilitate a transparent financial market, generating safe investment conditions for the general public.¹⁰¹ A comparison can be made to the indirect form of protection of creditors the collective regime of the antecedent transactions sections of the Insolvency Act provides.

The lack of intention required for liability under the Securities Act makes the effect-focused provisions of the Insolvency Act 2006 an apt fit. Effective provisions under the Securities Act could allow for dispositions into trusts to be cancelled if they are of a certain value and within a certain time period prior to a breach of the Securities Act. For example, if property of over \$10,000 was disposed into a trust within five years immediately prior to a breach of the Securities Act, the disposition could be cancelled and made available to creditors of the settlor. The Insolvency Act provisions however do not address the issue of settlor control. Therefore, while the issue of a settlor getting rid of property to avoid personal or statutory obligations would be addressed, the main issue of a settlor retaining control following a legitimate disposal onto trust would not.

The Insolvency Act deals with the fact that the cancellation of transfers of property to trusts effectively denies beneficiaries their rights by allowing recipients of property to prove the insolvent was able to pay their debt at the time of the transfer.¹⁰² If this cannot be proven, then the abrogation of beneficiaries' rights is justified by the policy that the transferor was insolvent and therefore should not have been able to participate in the transaction and settle such property on trust. There is no equivalent justification in the context of the Securities Act so disturbing the rights of the beneficiaries would have to be done sparingly.

¹⁰¹ The Financial Markets Authority Act 2011, s8.

¹⁰² Although a gift made within two years of adjudication will not be able to be reinstated.

III. The Property Law Act 2007

The purpose of the Property Law Act is to address certain aspects of the law relating to real and personal property.¹⁰³ Although transferring an asset into a trust is a well-known method of protecting property, only part 6, sub-part 6 of the Act provides assistance for a creditor of a settlor who has disposed of their property into trust but still exhibits control over it.¹⁰⁴ Sections 344 – 350 of Act enable property or equivalent value, transferred through a prejudicial disposition by the debtor, to be restored for the benefit of the debtor's general pool of creditors.¹⁰⁵ The control over the property is relevant only to infer intent under the provisions.

A. Setting Aside Dispositions that Prejudice Creditors

The general purpose of this sub-part is to capture transactions carried out with the intent of limiting creditors' right to recourse. For the purposes of the sub-part, a disposition is deemed to prejudice a creditor if it hinders, delays or defeats the creditor in their right of recourse in respect to property.¹⁰⁶ Section 346 establishes the dispositions to which the sub-part applies. Section 346(2) requires the dispositions be made by a debtor, who,

- (a) is insolvent at the time of transfer or became insolvent as a result of the transfer; or,
- (b) was in the process of completing, or about to complete a business transaction for which his remaining assets, given the nature of the transaction, were unreasonably small; or,
- (c) intended to incur, or believed, or reasonably should have believed they would incur, debt beyond their ability to repay.¹⁰⁷

The dispositions must also have been made with either an intent to prejudice a creditor, by way of gift, or made without receiving a reasonably equivalent exchange

¹⁰³ The Property Law Act, s3.

¹⁰⁴ Elizabeth Toomey "Gifting the family home to a trust" (2009) New Zealand Law Journal 131.

¹⁰⁵ The Property Law Act, s344.

¹⁰⁶ The Property Law Act 2007, s347(1)(a). The inclusion within an 'intent to defraud' of a purpose to delay as well as defeat creditors is a recodification of the principle from the original statute 13 Eliz, c 5 (1571), incorporated into the common law by *Re Hale (a bankrupt)* [1989] 2 NZLR 503n.

¹⁰⁷ The Property Law Act 2007, s346.

in value.¹⁰⁸ There is no time limitation for application; a historical disposition may be overturned as long as the requirements as to intention and knowledge are proven.

The 2007 Act applies only to dispositions made after 31 December 2007. Alienations of property made prior to this date will be assessed under the Property Law Act 1952, which requires intent to defraud,¹⁰⁹ of which the Supreme Court's decision of *Regal Castings Ltd v Lightbody*¹¹⁰ is the leading authority. The 2007 Act codified an 'intention to defraud' as an intention to "hinder, delay or defeat" creditors under S345(1)(a), and *Regal Castings* applied this interpretation to the 1952 statute.¹¹¹ The court also introduced a wider interpretation of 'intent', holding knowledge that an alienation of property would detrimentally affect the ability of the pool of creditors to have recourse to their debt would be held to be equivalent to intent.¹¹² The rationale for this interpretation is, "if there is an intention to prejudice creditors by putting an asset wholly or partly beyond their reach then that will be an intent to defraud creditors".¹¹³

The Property Law Act 2007 also codified the rule from *Freeman v Pope*¹¹⁴ by deeming a gift or transfer of property without equivalent value by an insolvent an act prejudicial to creditors.¹¹⁵ The Court in *Regal Castings* was split as to whether the rule, that dishonest intent would be irrebuttable where an insolvent debtor gifted away his property, would apply retrospectively.¹¹⁶ The rule is valuable when assessing dispositions into family trusts, however Heath J in the High Court concluded in *Taylor v Official Assignee*¹¹⁷ that the presumption would not apply to dispositions pre 2008. However, when a transferor's financial position is precarious it is objective evidence of an intention to defraud if he acts to put property beyond the reach of

¹⁰⁸ Heath and Whale, above n 83, at [20.40].

¹⁰⁹ The Property Law Act 1952, s60.

¹¹⁰ *Regal Castings Ltd v Lightbody* [2009] 2 NZLR 433.

¹¹¹ At [53]. This original interpretation has its origin in the original Statute of Elizabeth (13 Eliz 1, c5), which dealt with the recovery of property transferred by a debtor with a purpose of putting it beyond the reach of general creditors.

¹¹² At [54] per Blanchard J.

¹¹³ *Re Hale (a bankrupt)*, above n 106, at 508, as adopted by Elias J in *Regal Castings Ltd v Lightbody*, above n 110 at [10].

¹¹⁴ *Freeman v Pope* (1870) LR 5 Ch App 538.

¹¹⁵ The Property Law Act 2007, s346(1)(b); Law Commission, above n 16, at 15.

¹¹⁶ Heath and Whale, above n 83, at [20.49]; see also R. J. Sutton *The Law of Creditors' Remedies in New Zealand* (Butterworths, Wellington, 1978); *Regal Castings Ltd v Lightbody*, above n 110 at [40] and [55].

¹¹⁷ *Taylor v Official Assignee* HC Auckland CIV-2006-404-7115, 26 August 2009.

creditors.¹¹⁸ *Regal Castings* also reaffirmed the rule from *Re Ridler*¹¹⁹ meaning a guarantor of a debt must be treated as if the guaranteed debt was due and owing when a disposition, that has the effect of defeating creditors, is assessed.¹²⁰

Prior to *Regal Castings*, when the Estate and Gift Duties Act 1968 was in force, it was common for an asset to be sold to a trust and the consideration given as a debt back which was periodically forgiven.¹²¹ The Insolvency Act had little application with its strict time limits while the objectively equivalent consideration would mean capture under the Property Law Act 1952 was also avoided. However, the unforgiven portion of the debt could be demanded by creditors to satisfy their claims.¹²² *Regal Castings* dealt with this gap in the property law regime by holding such a transfer is realistically a transaction at undervalue, as well as allowing knowledge to equate for intention.¹²³ With the repeal of the gift duty meaning settlors will transfer property without retaining a debt back, creditors will not be able to demand the unpaid balance of the debt to satisfy their claims and the core ratio of *Regal Castings* will be of increased importance to creditors.

B. Application of the Provisions to the Context of the Securities Act

Provisions as modelled on the Property Law Act have potential to be effective under the scheme of the Securities Act. However they do not deal with the issue of settlor control and instead look only at the action of the original disposal. The wide statutory definition of ‘dispositions’ under the 2007 Act is however likely to capture a greater range of dispositions and the Property Law Act(s) do not have time limitations.¹²⁴

It is noted that inserted sections under the Securities Act could be adjusted to fit the requirements of that particular context, however a provisional test can be done with

¹¹⁸ *Freeman v Pope*, above n 114, at 545 per Gifford LJ. Other indications of fraud also include transferring property to family members, transactions at undervalue, and alienations where the beneficial interest is retained, while secrecy is a “well recognised badge of fraudulent intent” (*Twyne’s case* (1601) 3 Co Rep 80b, 76 ER 809 at 812 – 813). An arrangement to prefer one set of creditors to another is not evidence from which intent can be inferred. (*Lloyds Bank Ltd v Marcan* [1973] 1 WLR 1387 at 1392.)

¹¹⁹ *Re Ridler* (1883) 22 ChD 74 (CA)

¹²⁰ Toomey, above n 104 at 104; *Regal Castings Ltd v Lightbody*, above n 110 at [66].

¹²¹ Repealed on 1 October 2011. Gifts made post 1 October 2011 are no longer liable for gift duty, however gifts made prior to this date are still subject to the duty. Under the statute as it stood, gift duty applied when the value of all gifts made by a person exceeded \$27000 in a year.

¹²² Vanessa Bruton, Stephen Tomlinson and Prof Mark Henaghan “Trusts Under Attack - will your fortress hold?” (2012) (Property Law Conference 2012) NZLS CLE Ltd 269 at 273.

¹²³ *Regal Castings Ltd v Lightbody*, above n 110, at [60].

¹²⁴ The Property Law Act 2007, s4.

the provisions as they stand under the Property Law Act. Taking an example of a defendant to a breach of the Securities Act for signing an offer document containing an untrue statement. One month prior to signing the document, he settled all of his significant assets including his house on trust.

The defendant would likely fulfil the requirements of s346. To begin with, s346(1)(a) would be satisfied because the options of s346(2) would capture the defendant. The third parties would be taking action primarily because of the defendant's insolvency, meaning s346(2)(a) would likely apply. Section 346(2)(b) could also operate, with signing a prospectus substitutable for 'engaging or about to engage in a business transaction'. A defendant who is about to sign a prospectus and disposes all of his significant assets onto trust would know that if the document was incorrect his remaining assets would be 'unreasonably small' if called upon to pay a fine or compensation. Section 346(2)(c) would also likely apply, as it could be reasoned that the defendant in disposing of the property should have believed debts might be incurred beyond his ability to pay if the document held an untrue statement.

If the disposition were by gift, a transfer without a reasonably equivalent exchange in value (which is strictly interpreted following *Regal Castings*), or the defendant made the disposition with the knowledge "he or she was exposing [the creditors] to a significantly enhanced risk of not recovering the amounts owed to them", then s346(1)(b) would capture the transaction.¹²⁵ Therefore, the disposition by the defendant would fall under the subpart.

A historical disposition would be more difficult to bring under the provisions, so objective events could be used to give perspective or infer knowledge. For example, where a defendant had secured employment that required he sign offers under the Securities Act and then immediately disposed valuable property onto trust, knowledge of potential future creditors could be inferred. The primary issue with these provisions is they are only concerned with assets that have been disposed of by the person in question. Assets acquired by the trust are not within the provisions' contemplation. Therefore the general issue of settlor control over trust property is not addressed by the Act.

¹²⁵ *Regal Castings Ltd v Lightbody*, above n 110, at [54].

IV. The Income Tax Act 2007

The Income Tax Act 2007 regulates how a taxpayer's assets may be structured in terms of ascertaining taxable income and associated tax liabilities. A general policy issue within this particular context is the settlement of income earning assets onto trusts for the purpose of reducing taxable income and qualifying for a lower personal income tax rate. The purpose of taxation legislation is to raise funds to carry out the functions of government, and therefore there is a substantive issue when taxpayers are able to distort the calculation of taxable income so that their taxable liability is reduced to the injury of the taxpaying collective.¹²⁶ A taxpayer may use a trust to achieve this, settling an income-producing asset onto trust to reduce the appearance of income, although still continuing to benefit from distributions from the trust. The Act is also concerned with settlor control, as it may increase the ability of a taxpayer to benefit under a trust structure while they simultaneously avoid the burden of the tax liability.

Section BG 1 is the general anti avoidance provision, and is "meant to be the principal vehicle by means of which tax avoidance is addressed".¹²⁷ Section BG 1 and the associated reconstruction powers authorise the Commissioner to sidestep a tax avoidance arrangement, and adjust the taxpayer's taxable income to reflect the true fiscal arrangement.¹²⁸ If the tax avoidance arrangement is structured around a trust, reconstruction of the arrangement for the purposes of taxable income will not void the trust structure. The tax regime has no need to dismantle trust structures where beneficial enjoyment or control is witnessed. The purpose of the tax regime is instead to levy citizens according to their true accessible resources, so the process is to leave the trust structure in tact, but assess and tax the true fiscal arrangement.

A. The General Anti Avoidance Provision

The policy objective of the test for avoidance under the Income Tax Act is similar to what is sought under the Securities Act. Both contexts seek to limit instances where the imposed statutory obligation is avoided. The test for avoidance under the Income

¹²⁶ *Higgins v Smith* (1940) 308 US 473 at 476-477, cited by Woodhouse P in *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA) at 687.

¹²⁷ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115; [2009] 2 NZLR 289.

¹²⁸ Law Commission, above n 16, at 28. See also the Income Tax Act 2007, ss BG 1(2) and GB(1).

Tax Act looks to whether the disputed transaction, when viewed in a commercially and economically realistic way, falls within what Parliament contemplated when structuring the taxation system.¹²⁹ In evaluating Parliament's intention as to what constitutes an appropriate structure, the enquiry evaluates what sacrifice would have been intended by Parliament as deserving of mitigation of the tax obligation. The Privy Council distinguished avoidance from allowable mitigation in *Challenge Corporation Ltd v Commissioner of Inland Revenue*.¹³⁰ Tax mitigation was held as legitimately reducing one's income or incurring expenditure so to reduce the associated tax liability. Avoidance occurs however, when an arrangement allows for a taxpayer to reduce their tax liability without suffering the loss of income or burden of expenditure, which would legitimately entitle the reduction in tax liability.¹³¹ The distinction can be seen in settling capital as a source of income in a trust. If the settlement results in the taxpayer suffering a reduction in their income, then a reduced tax liability has been legitimately achieved. There is a direct causal nexus between the reduced income and the consequential reduction in tax liability. However, where a settlor continues to benefit greatly from such capital through resulting distributions, the taxpayer has reduced their taxable income without suffering loss or any increased expenditure, therefore signifying tax avoidance.

The test for tax avoidance has shifted from focusing purely on whether the scheme and purpose of the Act allows for the arrangement in question, to assessing the commercial reality and the economic affect of an arrangement, looking at elements of artificiality and contrivance.¹³² These terms however are merely touchstones for the consideration of parliamentary contemplation, for an artificial or commercially unrealistic arrangement would not have been contemplated by Parliament.

B. Addressing Settlor Control under the Act

When the test for avoidance was applied to trust arrangements in the Supreme Court case of *Penny and Hooper v Commissioner of Inland Revenue*¹³³ the element of control was significant. The Court accepted the company/trust structure was an "unobjectionable business structure" and it was the step of setting the salaries of the

¹²⁹ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 127, at [107] – [108].

¹³⁰ *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 555 (PC).

¹³¹ At 562.

¹³² See Law Commission, above n 16 at 30; and, James Coleman "Tax Update" (July 2012) NZLJ 186.

¹³³ *Penny and Hooper v Commissioner of Inland Revenue* [2011] 1 NZLR 433.

taxpayers at artificially low levels that constituted the step of avoidance.¹³⁴ Setting artificially low salaries could only be tax avoidance if done because of a greater than incidental consideration of tax obligations, and this could only be ascertained by evaluating the effects of the arrangement.¹³⁵ Looking at the effects, the Court held that the trust did no more to protect the two surgeons from negligence claims than their previous corporate structure. But by diverting their income into trusts and setting their personal salaries at a commercially unrealistic level, both taxpayers set to gain from a reduction in their taxable income. Their artificially low salary attracted a reduced tax burden, while their income diverted to the trust was taxed at the lower trustee tax rate.

What was important was that to benefit from the arrangement both taxpayers depended upon appointment of trust income in their favour by the trustees. The Supreme Court, referred to the fact that “each could naturally expect that the trustees whom they had chosen would act as in fact they did”.¹³⁶ The successful implementation of the tax avoidance scheme was thus dependent on the taxpayers retaining a large degree of control or influence over the trusts, so that the trust would operate in a way that was beneficial to the taxpayer.

Consideration of control is relevant to determine whether a taxpayer can control the trust and therefore secure access and enjoyment of the trust property. The authorities will have issue when enjoyment and access to the trust property can be achieved at the settlor’s discretion but without the burden of the tax liability. Once it is held the taxpayer has the benefit of the assets and liability is imposed, it is inconsequential whether the taxpayer exercises their control over the trust to secure the assets to discharge the liability, or whether it is paid by another manner.

The rights of other beneficiaries are taken into account when figuring out the taxpayer’s realistic ability to benefit under the trust. The imposition of the liability may itself indirectly harm the rights of beneficiaries, for the taxpayer may have to exercise control over the trust to secure income to pay the tax. However, the discretionary calculations take the rights of these beneficiaries and their potential to benefit into account and if the beneficiaries have an established expectation to benefit then liability that infringed on this expectation would be unlikely to be imposed.

¹³⁴ At [33].

¹³⁵ At [34].

¹³⁶ At [35].

The Supreme Court in *Penny and Hooper* considered the control had by the defendants over the trust property, and the enjoyment and access to the property realized because of the control. These factors are similar to those considered when determining a settlor's intention to divest beneficial ownership at the point of trust formation. Therefore, a parallel can be evoked with both the test for certainty of intention and the test for a sham transaction. It is not clear whether the Supreme Court intended the evaluation of control over the trusts in *Penny v Hooper* be substituted for the general evaluative test of avoidance, and become separate analysis when looking at the actions of taxpayers in relation to trust assets. Alternatively, the element of control may have been merely supportive to the finding of avoidance under the Income Tax Act.

Prior to *Penny and Hooper*, settlor control had not been relevant to tax avoidance law and only appeared in tax cases where sham was plead as an alternative. Tax avoidance and sham transactions are not correlatives and the existence of one will not necessarily infer the presence of the other.¹³⁷ A sham in the context of taxation seeks to intentionally deceive the Inland Revenue Department to think the “documents do not reflect the true nature of what the parties have agreed” in order to obtain a more favourable taxation outcome than would have otherwise eventuated.¹³⁸ While artificiality and contrivance may indicate avoidance, they are emphasized as not being indicia of sham, for the focus when establishing a sham is the parties' subjective intentions.¹³⁹ The distinction between a claim of sham and a claim of tax avoidance is important, as there is a stark contrast between the “precision of the test for sham compared with the impressionistic nature of the test for tax avoidance”.¹⁴⁰

The sham is a useful tool for the Inland Revenue Department as transaction documents are void and unenforceable to the extent that they are shams.¹⁴¹ The division between tax avoidance and sham is therefore most critical when looking at the consequences of each finding. Upon the finding of a tax avoidance arrangement, a trust will remain valid. However, when a sham trust is found, the trust will be held void ab initio and the true legal arrangement as intended by the parties will then be

¹³⁷ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 127, at [34].

¹³⁸ At [34].

¹³⁹ Inland Revenue Department, above n 66, at [68].

¹⁴⁰ Coleman, above n 132, at 134.

¹⁴¹ *Buckley and Young Ltd v Commissioner of Inland Revenue* (1978) 3 NZTC 61,271 (CA) at 61,276.

ascertained and taxed accordingly.¹⁴² Voiding the trust is representative of the policy behind the sham doctrine. It seeks to ascertain instances of deceptive conduct, appreciated in the requirement of the parties' sham intention, and prohibit the product of such conduct. The tax regime however seeks only to ascertain the true economic reality of the situation.

Sham is a difficult and labour intensive strategy for the tax authorities, for an "allegation of sham, being akin to an allegation of fraud, should not be lightly made".¹⁴³ It is the requirement of sham intent, imputing dishonesty, which invokes rule 13.8 of the *Rules of Conduct and Client Care*.¹⁴⁴ The rule, requiring full pleadings when proceedings are initiated, acts as a constraint on the IRD and tempers the number of proceedings made under the sham heading.

As *Penny and Hooper* illustrates, the shift towards considering elements of artificiality in the test for tax avoidance has begun to blur the line between the two pleadings. James Coleman argues in the New Zealand Law Journal that 'artificial' can have two quite separate meanings.¹⁴⁵ If used in the context of 'commercially abnormal', then the case will clearly fall outside the constraints of rule 13.8. However if 'artificial' is used to imply a situation in which documentation is enacted purposefully in a particular form and the parties have the intention to act contrary to the documents, the claim of tax avoidance converges with an allegation of sham.¹⁴⁶ This occurred in *Glenharrow Holdings Ltd v Commissioner of Inland Revenue*¹⁴⁷ when a tax avoidance arrangement was found under the GST Act. The arrangement consisted of a series of payments deliberately structured to artificially increase the price of the asset which the parties had no intention of paying. The claim of artificiality in this case came very close to being an allegation of sham.

¹⁴² Inland Revenue Department, above n 66, at [76].

¹⁴³ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 127, at [39].

¹⁴⁴ Rule 13.8 specifically provides that "A lawyer may not be a party to the filing of any document in court alleging fraud, dishonesty, undue influence, duress, or other reprehensible conduct, unless the lawyer has taken appropriate steps to ensure that reasonable grounds for making the allegation exist". Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008, rule 13.8.

¹⁴⁵ Coleman, above n 132, at 186.

¹⁴⁶ At 187.

¹⁴⁷ *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359.

The Australian case of *Raftland Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*¹⁴⁸ suggested a broader definition of sham could be used in the context of revenue law to cover the situation where there is “an apparent discrepancy between the entitlements appearing on the face of the documents and the way in which the funds were applied...[that could give] rise to a question whether the documents were to be taken at face values”.¹⁴⁹ This expanded concept of sham would allow for consideration of the commercial and economic reality of the situation, and give more width than the current narrow approach to sham which focuses on the subjective intent of the parties. However, the High Court of New Zealand in *R v Connolly*,¹⁵⁰ when faced with a submission by the Crown that circular transactions were shams due to their fiscal fiction, dismissed the suggestion, stating instead that New Zealand courts adhered to the classic narrow definition of sham.¹⁵¹

C. Application of the Provisions to the Context of the Securities Act

The Income Tax Act 2007 is effective in dealing with instances of settlor control because of its discretionary nature. Consideration of artificiality means the realistic and practical relationship between a settlor and a trust can be assessed without a need to rely on the sham doctrine. The provisions consider the realistic relationship between the settlor and the trust property so liability can be imposed, however there is no requirement that the trust assets be used to discharge the liability. In other words, while the realistic nature of the control of the settlor is taken into account, there is no change in proprietary rights under the provisions, and the assets are never legally attributed to the settlor for access by third parties. This would feasibly work under the Securities Act, with the defendant’s ability to access property evaluated and then a fine imposed, but the defendant would be left to pay the fine by any means chosen.

However, in a situation where it is clear payment could only come from the trust property, this structure theoretically limits both the trustee’s discretion and the rights of the beneficiaries. In most instances the settlor will not choose to exercise his control in a manner to pay the fine, and therefore for effective implementation the order by the court would have to be directed at the trustee requiring them to make a

¹⁴⁸ *Raftland Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*, above n 49.

¹⁴⁹ At [33].

¹⁵⁰ *R v Connolly* (2004) 21 NZTC 18,884.

¹⁵¹ At [99]-[100].

distribution to the settlor. If the settlor is not a beneficiary then this is clear interference with trust principles, and such a distribution would be in breach of a valid trust. This would also breach the gap between control and ownership and allow proprietary rights to be created out of the exercise of control. While the Income Tax Act is legitimized by its public policy of state funding, there is no equivalent policy justification under the Securities Act for infringing the base principles and beneficial rights of a trust.

V. The Legal Aid Regime

The Legal Services Act 2011 and the Legal Services Regulations 2011 deal with an applicant's eligibility for legal aid. The Legal Services Act 2011 replaced the Legal Services Act 2000, however as much of the content was retained and reordered, previous cases are good law.¹⁵² Part 2, subpart 1 establishes legal aid may be granted when an applicant does not have "sufficient means" to enable him or her to obtain legal assistance, determinable on the basis of their income and disposable capital.¹⁵³ To determine the full extent of an applicant's income, their ability to benefit from a trust must be assessed and included.

A. Addressing the Applicant's Beneficial Interests

The definition of property under s4 of the Act is very wide, and includes "any estate or interest in any real or personal property". In determining the value of an interest to be included as income or disposable capital, cl 8 of the Legal Services Regulations 2011 allows for a wide discretion. The clause states, when assessing an interest under a trust, mandatory consideration must be had of,

- a. how the trust arose or was created; and,
- b. the terms and conditions of the trust; and,
- c. the person or person who have power to appoint and remove trustees or beneficiaries; and,
- d. the history of the trust's transactions, e.g. its distributions; and,
- e. any changes in the membership of the trustees; and,

¹⁵² David More, Margaret Sewell and Steven Zindel *Legal Aid Handbook* (Brookers, Wellington, 2011) at 1.

¹⁵³ The Legal Services Act 2011, ss8(1)(b), 8(3), and Schedule 1.

- f. any changes in the class of beneficiaries; and,
- g. the source of income or capital the trust receives.¹⁵⁴

Clause 8 allows for a wide interpretation of an applicant's ability to benefit, taking a practical approach when looking at the realistic likelihood of the applicant benefitting from the trust. The interest considered may be held jointly or in common and includes interests under discretionary trusts as well as vested or contingent interests.¹⁵⁵ The inclusion of an applicant's ability to benefit under a discretionary trust is significant, for traditionally the ability to receive income or capital under a discretionary trust is considered a bare expectancy rather than a proprietary interest.¹⁵⁶ Assets or income held on trust may also be treated as solely in the interest of the applicant, regardless of the existence of other beneficiaries under the trust.¹⁵⁷ Elements of control are directly considered under cl 8(4), where the powers of appointment and removal of both trustees and beneficiaries, the previous exercise of such powers, and the history of distributions are noted. The structure of cl 8 has similarities to the evidence examined in cases of sham under general trust law.¹⁵⁸

The realistic approach of the legal aid regime is emphasised by the ability to consider the resources of the applicant's spouse or partner as those of the applicant.¹⁵⁹ In *Petricevic v Legal Services Authority*¹⁶⁰ it was held that the applicant's wife's expectancy under a trust could be treated as a resource of the applicant under the Legal Services Act 2000. The applicant for legal aid was the trustee of the trust that the wife had an interest under. The applicant had the power and discretion to appoint income to her and therefore it was considered a realistic approach to consider the wife's ability to receive financial gain from the trust. The applicant's ability to appoint income to his wife meant he could indirectly benefit from his wife's ability to

¹⁵⁴ The Legal Services Regulations 2011, cl 8(4).

¹⁵⁵ The Legal Services Regulations 2011, cl 8(4).

¹⁵⁶ W M Patterson "When is a Trust a Trust?: A brief history of the express trust in New Zealand" (paper presented at the Legal Research Foundation Seminar, "A Modern Law of Trusts", Auckland, 28 August 2009) at 15.

¹⁵⁷ The Legal Services Regulations 2011, cl 8(5).

¹⁵⁸ New Zealand Law Society *Legal Aid Essentials: Life under the 2006 Amendment Act* (paper presented at NZLS Seminar, February 2007) at 29. The investigation is also similar to that had when assessing de facto alter ego. De facto alter ego occurs when a controller uses another separate entity as an extension of himself. It is discussed further in chapter III.

¹⁵⁹ The Legal Services Act 2011, Schedule 1, cl 4. While there is no definition of 'resources' under the statute, cls 2 and 3, which define income and disposable capital, are subject to cl 4, inferring in the scheme of the Act that income and capital are factors, which must be included when determining 'resources'.

¹⁶⁰ *Petricevic v Legal Services Authority* [2011] 2 NZLR 802.

access trust income. The Court in *Petricevic* also broadly interpreted the term ‘applicant’ in cl 8(4), to include as the applicant, their partner or spouse.¹⁶¹ This enabled the wife’s interest in the trust to be regarded the applicant’s own. Although the applicant was not a direct beneficiary, the fact his wife had an interest in the trust meant he was also held as having an interest in the trust. This was seen as a necessary interpretation, otherwise the “unprincipled and avaricious would seek their legal representation via the public purse”.¹⁶²

B. Assessing an Applicant’s Ability to Control Trust Property

The legal aid regime aims to identify what the applicant’s actual assessable income and capital is. The statute is not seeking to void or look through trusts, but rather to calculate what resources an applicant can likely access to pay for legal representation. The provisions allow for the assets an applicant enjoys or controls to be included in calculations of accessible income and capital, to work out if a party can practically access assets of the trust through effecting distributions. In a similar manner to the Income Tax Act, once the system has identified an ability for the applicant to benefit, they will deny aid. The system is not then concerned whether payment for legal services eventuates from the trust, or another source. The purpose of the legal aid regime is to provide access to justice through the provision of funding for legal services to people of insufficient means.¹⁶³ If an applicant has sufficient means to pay for such services, and these means are accessible through distributions made by a trust, then the applicant should not be eligible for legal aid. There is a general public interest to ensure public resources are not distributed to those who are capable of financing their own legal representation, to ensure adequate funding is available for those who are not. However the rights of beneficiaries are indirectly compromised. Where it is held an interest of a trust disqualifies the applicant from legal aid, the applicant’s only way to pay for representation may to ask the trustee for a distribution, therefore requiring preference over another beneficiary.

¹⁶¹ It was suggested this was necessitated by cl 4(1) of the First Schedule of the Act, which holds any resources of the applicant’s partner or spouse must be considered the applicant’s own unless a specific exception applies as listed.

¹⁶² *Petricevic v Legal Services Authority*, above n 160 at [50].

¹⁶³ The Legal Services Act 2011, s3.

C. Application of the Provisions to the Context of the Securities Act

The provisions of the Legal Services Act and Regulations provide a useful structure for evaluating a person's ability to benefit under a trust. There is an ability to consider the degree of de facto control and actual enjoyment the applicant has over and from trust property when assessing his income and access to capital.¹⁶⁴ No trust property is legally attributed to the applicant. This is could be suitable under the Securities Act, where a fine may be imposed and it be left to the defendant to secure access to the trusts assets. However, imposing an order to in this manner would be to interfere with the property rights under the trust, as such a court order would essentially be directed at the trustee and be limiting their discretion. Attribution of property is not required under the legal aid regime. To attribute legal ownership under such a scheme would mean trumping other beneficiaries' rights, and it would be a big jump from considering an applicant potentially able to benefit from property, to saying the property was owned by the applicant.

VI. Summary of the Statutory Provisions

There has been acceptance by the Legislature that "trusts ought not to be permitted to frustrate the fundamental policy objectives of particular legislation".¹⁶⁵ However, Parliament has shown an understanding that the use of trusts will often deviate from the traditional idea of a total alienation of property. A settlor's ability to control the trust, as well as a beneficiary's realistic ability to benefit under the trust is consistently accounted for. There is a strong argument therefore for greater discretion when looking at the settlement of assets on a trust.

The Insolvency Act 2006 and the Property Law Act 2007 both offer schemes to allow for the reversal of dispositions to a trust. The Income Tax Act 2007 and the Legal Services Act 2011 in contrast leave the trust structures in place, but look instead to the likelihood of the taxpayer or applicant respectively benefitting. Third party creditors however still face difficulties in gaining access to trust property that has been settled in a valid trust but is consistently controlled and enjoyed by the settlor. However, "collectively the provisions reflect a deliberate legislative policy aimed at abrogating

¹⁶⁴ Law Commission, above n 16, at 35.

¹⁶⁵ At 36.

the use of trusts to shelter assets and income where public policy considerations of equity and fairness are involved”.¹⁶⁶

¹⁶⁶ At 37.

CHAPTER III – EQUITABLE PRINCIPLES THAT ADDRESS THE ISSUE OF SETTLOR CONTROL

I. Introduction

Chapter II discusses contexts where the Legislature has instituted statutory provisions as a response to the practice of settling and controlling property in trusts, the action of which frustrates particular policy objectives. The provisions of the Insolvency Act and Property Law Act address instances where either the objective circumstances or the subjective intent of a settlor make settlement of property onto trust illegal. The Income Tax Act and Legal Services Act both look to elements of economic reality and control to calculate the likelihood of a settlor or beneficiary benefitting from a trust. This is done to enable correct taxation or the assessment of disposable income and capital respectively.

In contrast, this chapter analyses the possible equitable alternatives to deal with the situation when a settlor has factual control over either the assets of a trust or the trustee's ambit of discretion.

II. Attacking an (Apparently) Valid Trust Structure

Where a declaration of trust fulfils the three certainties of intention, subject matter, and object, it is held to be objectively valid.¹⁶⁷ Unless subject to specific statutory intervention, such as those contexts discussed in chapter II, trust structures that appear objectively valid yet are subject to a significant amount of control by the settlor, will nevertheless be held valid.¹⁶⁸

Instead, where it appears the settlor retains a significant degree of control over trust property, the common method of challenge is through a claim of sham. Robertson J emphasized this role of the sham doctrine in *Official Assignee v Wilson*, holding:¹⁶⁹

¹⁶⁷ *Knight v Knight* (1840) 3 Beav. 148 at 172.

¹⁶⁸ There are some additional statutory contexts in which the legislature intervenes including assessing income and capital of applicants for governmental assistance and the proceeds of crime context.

¹⁶⁹ *Official Assignee v Wilson*, above n[57].

Once a trust is validly created, the beneficiaries have an interest in the trust property that cannot be easily undone. Unless the later appearance of a sham can be traced back to the creation of the trust, the trust remains valid.

This judicial reluctance to attack suspect trust structures, as evident in *Hotchin*, illustrates settlor control is not thought to be a legal issue affecting the integrity of trusts. This is rather than reflect any sentiment of the courts as to the availability of alternatives within the general laws of equity. The courts also generally advocate for upholding property transactions, to encourage commercial certainty. The objective intention of the settlor is a decisive requirement of a valid trust, and therefore, if the other certainties are met, the courts will only intervene and disturb the transaction if the settlor held an intention to deceive at settlement.

The limited instances of judicial interference with established trusts may instead suggest the courts believe it is the role of Parliament to address settlor control as a discrete contextual policy issue. O'Regan and Robertson JJ noted in *Wilson* that within the context of an insolvent debtor, Parliament has introduced a number of statutory provisions to allow for the invalidation of specific dispositions, and if these mechanisms “are not sufficient, then it is a matter for Parliament”¹⁷⁰.

However, a preferable option may be to look to the principles of equity to find a solution to the issue of settlor control over a (objectively valid) trust. These principles could be applied uniformly across the different contexts and consequently there would be a reduced need for statutory intervention. Finding a solution in the general law of trusts may alleviate the pressure on the doctrine of sham to fill the gap where a trust looks objectively valid, but something about it seems ‘not quite right’. The orthodox rules and principles of equity already address trusts that are legitimate, and those that have been settled with sham intent. Objectively valid trusts that exist in the shadow of control of a third party are the ones currently giving rise to some vexing questions within the law of trusts as traditionally understood.

Settlor control is an issue because of the nature of the trust relationship. The trustee of a trust, “is not under the direction of the settlor or of the beneficiaries in administering the trust, unless there is an express provision to that effect,” and therefore, the trustee

¹⁷⁰ At [74].

is governed solely by the trust deed.¹⁷¹ Settlor control may interfere with the discretion of the trustee and in light of the trustee's duties to the beneficiaries, this may threaten the validity of the trust. The settlor does not have a role in the trust relationship, therefore settlor control or influence over the trust is an inappropriate addition to the trust structure.

Solving the issue of settlor control through equity is attractive because, as the Law Commission notes in its recent review of trust law, the commercially shaped sham requirements have an uneasy fit within the equitable jurisdiction of trusts.¹⁷² Additionally, the need for certainty weighs just as heavily within the context of trust law as it does in commerce, and therefore the trust structure should not be too readily invalidated by a doctrine, which bypasses the objective appearances of a transaction.¹⁷³ While there is an inherent difficulty importing equitable principles into the context of commercial law, which occurs when trusts are used in commerce, upholding commercial certainty should not be understood as merely upholding structures, especially if they appear suspicious and provoke ill trust.¹⁷⁴ Greater commercial certainty may instead be protecting creditors who have advanced money to a debtor on the appearance of control and access to property. The task is therefore to formulate foreseeable tests with balanced and predictable outcomes, while respecting the fundamental principle that equity operates on the conscience of the legal owner of the property.¹⁷⁵

A. Strengthening the Requirement of Certainty of Intention

Lord Langdale MR held in *Knight v Knight*¹⁷⁶ that for a declaration of trust to be valid, it is essential there be certainty of intention. The question is whether the words used exhibit a clear intention by the settlor to divest the beneficial and legal ownership of the property and settle it on trust. The Law Commission argues that one determinant to whether a trust is valid, is “the extent to which equity requires the relevant intention to exist”.¹⁷⁷ Therefore the degree to which intention must be proved determines whether a settlor, who never intended to give up control or beneficial

¹⁷¹ Mowbray and others, above n 25, at [1-17].

¹⁷² Law Commission, above n 16, at 59.

¹⁷³ At 58.

¹⁷⁴ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] A.C. 669

¹⁷⁵ At 705 per Lord Browne-Wilkinson.

¹⁷⁶ *Knight v Knight*, above n 23, at 105.

¹⁷⁷ Law Commission, above n 16, at 59.

ownership of his assets despite the appearance of settling the property in a trust, will be held as having settled a trust. The exercise of control is good objective evidence of the lack of intent to divest beneficial ownership. Therefore a stricter test of validity would more likely capture suspect trusts, and reduce the need to rely on the ill-fitting doctrine of sham.

No particular words or phrases are required to establish a trust as the equitable maxim, ‘equity looks to intent rather than form,’ dictates.¹⁷⁸ Accordingly, the trust is not created by execution of the trust deed, but rather by the intention of the settlor to divest the legal and beneficial ownership of the property.¹⁷⁹ However, the test for intention is nevertheless an objective one. The difficulty is that although it is the subjective intention being sought to be ascertained in the deed, the subjective intentions of the settlor are irrelevant in construction of the undertaking.¹⁸⁰ The meaning of the deed is ascertained objectively by determining what the instrument would convey to a reasonable person having all the background knowledge that would have been reasonably available to the parties at the time of settlement. Therefore the only true intent required of the settlor is intention to enter into the arrangements which themselves objectively appear to create a trust, and he need not appreciate the arrangements have this appearance. Issues arise when a declaration of trust is uncertain, or when objective actions of the settlor, such as control over trust property, appear to contradict the declaration of settlement.

Wigram VC held in *Hughes v Stubb*¹⁸¹ that it may be of great difficulty to ascertain if a trust has been constituted in situations where “a person not intending to give or part with the dominion over his property may retain such dominion, notwithstanding he may have vested the property in trustees and declared a trust upon it in favour of third persons”.¹⁸² Where a settlor has vested his property in trustees, but has not intended to give up beneficial ownership of the property, the settlement should arguably be invalid. The objective nature of the test for intention will not necessarily capture this situation. However, the justification for the objective nature of the test for intention, and for general document construction, is that parties to a transaction should not be

¹⁷⁸ Mowbray and others, above n 25, at [4.01]

¹⁷⁹ Palmer, above n 30, at 91.

¹⁸⁰ *Twinsectra Ltd v Yardley* [2002] 2 All ER 377.

¹⁸¹ *Hughes v Stubb* (1842) 1 Hare 476.

¹⁸² *Hughes v Stubbs*, as cited in *Financial Markets Authority v Hotchin*, above n 19, at [38].

held to the mercy of the unexpressed subjective intentions of the parties that have not been reasonably conveyed. There is a general tension between the objective nature of document interpretation, and looking for subjective intentions of parties to ensure transactional validity.

An example of this is seen in *Hotchin*, where Winkelmann J held the inclusion of a prohibition on self-dealing was objective evidence Mr Hotchin had the requisite intention to form a trust. Although his retention of control could be suggested as an indication he did not intend to part with his beneficial ownership, objective nature of the test meant the trusts were held valid. The FMA therefore needed to revert to the sham doctrine to bust through the trusts.

If the proper legal characterization of a transaction could be found at the first instance, through a more rigorous requirement of settlor intention, there may be less of a need to revert to the sham doctrine, which is often called upon in an attempt to get past what appears to be an objectively certain intention. However, invalidating a trust due to a lack of requisite intention has clear advantages over trying to use the doctrine of sham. To begin with, *Official Assignee v Wilson* set a high bar to establish a successful claim of sham.¹⁸³ Additionally, while the sham doctrine requires the finding of a shared intention by both the settlor and the trustee to use the trust as a mask to conceal the real transaction, the requirement of certainty of intention concerns an examination of only the settlor's intention.¹⁸⁴

In the process of evaluating the settlor's intention, aspects of control will be relevant as objective indications of the settlor's intent. The retention of significant powers, or the fact the settlor maintains a large influence over the trust, are both however traditionally insufficient as individual reasons to find a trust instrument invalid. The Law Commission however states it is "arguable that there is a point where the degree of control that a settlor exerts over a trust is such that a trust cannot truly be said to exist".¹⁸⁵ There remains a question as to whether there is a threshold at which control by a third party should require the courts to step in and hold the third party the true

¹⁸³ *Official Assignee v Wilson*, above n 36, at 41.

¹⁸⁴ See *Paintin and Nottingham Ltd v Miller Gale and Winter*, above n 33, at 168; *Bateman Television Ltd v Coleridge Finance Co Ltd* above n 58, at 821 and *Marac Finance Ltd v Virtue* above n 70, at 587-588.

¹⁸⁵ Law Commission, above n 16, at 60.

owner of the trust property, due to the control being an indication of a lack of intention to divest beneficial ownership.

B. Extent of Allowable Settlor Control

“The reservation of settlors’ powers does not of itself compromise the integrity of the trust,” however, such retention may infer the settlor lacked the necessary intention to divest themselves of their beneficial interest in the property and create a valid trust.¹⁸⁶ The Hague Convention on the Law Applicable to Trusts and on their Recognition 1985, Article 2, although not ratified in New Zealand, captures the common law, providing that “reservation by the settlor of certain rights and powers...[is] not necessarily inconsistent with the existence of the trust”.¹⁸⁷ The Privy Council has recently established the upper limit as to the extent of powers a settlor may retain, holding a power to revoke a trust deed, unconstrained by fiduciary duty, was tantamount to ownership.¹⁸⁸ Extensive retention of powers by the settlor theoretically lessens the fiduciary duty owed by the trustee to the beneficiaries, and eventuates with a reduction in the value of the beneficiaries’ right to trustee accounting.¹⁸⁹

The equitable maxim of *donner et retenir ne vaut*, or ‘to give and retain is worthless’ is an alternative equitable claim that a settlor’s intention was insufficient for a valid transfer and was held applicable to trusts as well as outright gifts in *Abdel Rahman v Chase Bank*.¹⁹⁰ The maxim holds only full disposal of an asset will divest the donor of ownership, and therefore the retention of the ability to dispose of the asset will invalidate the original settlement. To be an invalid disposal and breach of the maxim, the power retained by the settlor must be able to be exercised freely by the settlor and if the trust contains an express power of revocation then the maxim will evidently be infringed.¹⁹¹ The power of revocation need not be over the whole settlement, and in *Abdel Rahman* it was held the ability of the settlor to revoke a third of the trust capital every year without the consent of the trustee was a breach of the maxim, for if utilized

¹⁸⁶ Jessica Palmer "Controlling the Trust" (2011) 12(3) Otago LR 473 at 479.

¹⁸⁷ The Hague Convention on the Law Applicable to Trusts and on their Recognition (opened for signature 1 July 1985 and entered into force 1 January 1992), art 2.

¹⁸⁸ *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank & Trust Co (Cayman) Ltd*, above n 29 (on appeal from the Cayman Islands).

¹⁸⁹ Donovan Waters "Settlor Control - What kind of problem is it?" (2009) 15(1) Trusts and Trustees 12 at 13.

¹⁹⁰ *Abdel Rahman v Chase Bank*, above n 35, at 114.

¹⁹¹ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 224 and 226.

to the full allowable extent annually, the destruction of the initial gift would occur within a decade.¹⁹² The *Esteem Settlement* suggests where the maxim is invoked because of de facto control the pleading of sham will cover the situation. This is because where the power to revoke is not expressly retained, the power will “necessarily be conferred by an arrangement or understanding that the trustees will do exactly as they are told to by the settlor”, which would of course be a sham.¹⁹³ Equally, it could be contended the maxim allows for an alternative approach to invalidate a trust. The maxim can be distinguished from both the requirement of an objective certainty of intention and of mutual sham intention between the trustee and the settlor. To find a breach of this maxim, the subjective intention of the settlor is examined and this allows for a finding that the settlor has retained beneficial ownership of the asset, all the while having settled an objectively valid trust, with an independent and well-intentioned trustee.

Abdel Rahman can be interpreted as holding the maxim may be breached by retention of such power through either construction of the settlement, or through factual retention by the settlor of dominion and control over the trust fund.¹⁹⁴ This interpretation would however be out of line with orthodox authority that holds factual control cannot alone justify granting ownership rights. An aid to interpretation is the statement by the Royal Court of Jersey that it was the “*existence* of a power to destroy the gift (e.g. a power of revocation) and not the fact of its *exercise* which attracts invalidity”.¹⁹⁵ As factual control cannot exist as a power to destroy a gift, while formal retention of power through a deed can, it can be deduced that the court must have referenced factual control only as an indicator of the intention of the settlor. Alternatively, the factual control mentioned might have been an element of the sham test, which was applied but not separately discussed, in the judgment.

C. The Doctrine of Alter Ego

The doctrine of alter ego is a common evidentiary tool used when looking for evidence of the settlor’s intention. It views the trust as an extension of the settlor and in the context of trust law, occurs when the settlor is deemed to have effective control

¹⁹² *Abdel Rahman v Chase Bank*, above n 35, at 145.

¹⁹³ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 226.

¹⁹⁴ *Abdel Rahman v Chase Bank*, above n 35, at 114.

¹⁹⁵ At 138, (emphasis the court’s own).

over the trust and/or trust property. *Official Assignee v Wilson* however confirmed the doctrine is not a separate cause of action in itself in New Zealand.¹⁹⁶ De facto control by the settlor over the trust is not in itself justification for finding ownership of trust assets residing with the settlor, and rather is an evidentiary tool when assessing whether a trust is a sham.¹⁹⁷ There are two fundamental objections to the application of the concept of alter ego to trusts and the consequential attribution of trust property to the controller. The first is the factual scenario in which the doctrine applies has a distinct remedy, an assertion against the trustee for breach of trust. The second is that the doctrine presupposes that the trust is something that can be controlled, therefore requiring the trust to be thought of as a separate entity.

1. Assertion of breach of trust due to factual control

Assumption of factual control by a settlor will lead to a claim of breach of trust against the trustee, who has ignored his fiduciary duty to act in the best interest of the beneficiaries and has either followed the settlor's directions, or allowed the settlor to take control.¹⁹⁸ If the trustee exercised his discretion in a particular way without regard to the benefit of the beneficiaries, merely acquiescing to a request of the settlor, such a decision would be in breach of his fiduciary duties.¹⁹⁹ The beneficiaries then have a personal remedy available against the trustee requiring him to make good the loss owing to the breach, for improper administration of the trust.²⁰⁰

However, a claim of breach of trust will be of no assistance to third party creditors of the settlor. Creditors have neither an expectation under the trust nor any interest in the trust property.²⁰¹ As the action lies in the hands of the beneficiaries and third parties cannot enforce rights under the trust, the creditors will not have any ability to access a remedy.

2. The asymmetric fit of the doctrine with the paradigm of the trust

As the doctrine of alter ego seeks to attribute the actions, assets or liability of one separate entity to another, it inherently relies on the principle of separate legal

¹⁹⁶ *Official Assignee v Wilson*, above n 36, at [70] – [71].

¹⁹⁷ At [72].

¹⁹⁸ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 248.

¹⁹⁹ *Palmer*, above n 186, at 479. Unless the settlor was also a beneficiary and there was provision for such an action within the deed.

²⁰⁰ *Mowbray and others*, above n 25, at [39.02].

²⁰¹ *Law Commission*, above n 16, at 61.

personality. This is seen in the commercial context, where a court can ‘pierce the veil’ of a company to attribute its assets or liability for an action to its shareholders.²⁰² However, this requirement of being a separate ‘entity’ does not fit naturally with the traditional trust structure. Trusts are commonly referenced as being a form of fiduciary relationship in respect to property, rather than a simple property mechanism.²⁰³ The common paradigm is a set of reciprocal obligations or voluntary undertakings, making a trust “really a description of the obligations which the trustees owe to the beneficiaries for whom they hold the assets”.²⁰⁴ This model is born from the fundamental principle that equity operates on the conscience of the owner of the legal estate.²⁰⁵ The foundation of a trust is on the conscience of the trustee as the legal owner of the trust assets and equity must therefore operate on the trustee himself as the holder of such obligations. It is conceptually awkward to hold a settlor as able to use a trust, in the form of a relationship, as his alter ego.

The doctrine of alter ego cannot get past the basic issue that factual control by an unauthorized third party will be not be a lone sufficient reason to justify looking through or invalidating a trust.²⁰⁶ While it makes sense in the commercial context to look to aspects of control and puppetry, within the context of trusts, control itself is not a legitimate individual reason to attribute the assets held on trust to the controller.

D. Assessing the Validity of the Trust through the Core Duties of the Trustee

An alternative method to assess whether the settlor had sufficient intent to create a trust is to look at the control retained legitimately through the trust deed. If it can be inferred the settlor did not intend to part with the beneficial ownership of the property, then a trust should not be found.

The power of investment of trust assets can be retained at settlement and its retention allows the settlor to exercise authorised control over the property of the trust. The characterisation of this power is contentious and regulation of its operation will depend on its classification as either fiduciary or personal. If the power is classified as

²⁰² See *Gifford Motor Co Ltd v Horne* [1933] Ch 935; *Jones v Lipman* [1962] 1 WLR 832; *Adams v Cape* [1995] Ch 443. Discussed in David Hayton "Shams, Piercing Veils, Remedial Constructive Trusts and Tracing" [2004] Jersey L R 6 at [7].

²⁰³ John Langbein "The Contractarian Basis of the Law of Trusts" (1995) 105 Yale LJ 625 at 627.

²⁰⁴ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 238.

²⁰⁵ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*, above n 174, at 705.

²⁰⁶ *Official Assignee v Wilson*, above n 36, at [70] and [126].

fiduciary, then the settlor is held to the same standards as the trustee, preventing self-dealing and requiring decisions be made prudently and with the benefit of the beneficiaries in mind.²⁰⁷ Classification as fiduciary makes retention less antagonistic to the trust structure, as the beneficiaries remain a visible consideration. However, the question of classification is one of construction and based solely on the objective words of the trust deed, making retention of a purely personal power an attractive option to a settlor.²⁰⁸ It is therefore likely a settlor would choose to retain a personal power of investment and be free of the constraints of the fiduciary obligations. This would allow for the power to be exercised in any way that serves the settlor's best interests, without reference or consideration of the beneficiaries.

An unlimited power to self-deal is analogous to an ability to revoke a settlement, for it enables the settlor to redirect the trust property to their benefit at their own discretion.²⁰⁹ Therefore such unlimited power would mean the settlement did not create a valid trust. However, the retention of a limited personal power to invest without any fiduciary duties still seems to contradict the traditional idea of a trust, where property is held for the benefit of beneficiaries. While trustees under general law must invest prudently, diversify adequately and avoid speculation, such retention enables the settlor to maintain control over the trust assets and pursue a speculative investment policy, for the assets are protected from third party claims. The settlor is able to invest in personal business ventures, for he is free of any duty to avoid conflicts of interest.

A trustee's duty to perform the trust could still encumber them with a duty to supervise the investments made by the settlor, even if absolved from the power itself. Tools such as Anti-Bartlett clauses²¹⁰ are used to relieve trustees from the duty to interfere with poor investment strategy, however O'Hagan argues the trustee will maintain a power to interfere unless expressly excluded, so must consider its exercise

²⁰⁷ R. P. Austin "Moulding the Content of Fiduciary Duties" in A. J. Oakley (ed) *Trends in Contemporary Trust Law* (Oxford University Press, New York, 1996) at 158. Also note the trustee is subject to statutory investment duties under the Trustee Act 1956, including among others duties to invest with due diligence and care (s13B) and prudence (s13G).

²⁰⁸ *Lord Vestey's Executors v Inland Revenue Commissioners* [1949] 1 All ER 1108; [1949] 31 TC 1.

²⁰⁹ at ; Patrick O'Hagan "The reluctant settlor - property, powers and pretences" (2011) 17(10) *Trust and Trustees* 905 at 911.

²¹⁰ Described by O'Hagan as: "The draftman's response to the statements of Brightman J in *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515, 533-34 regarding trustees' obligation to receive an adequate flow of information in time to intervene to prevent loss by use of their controlling shareholding in a company." O'Hagan, above n 209 at 914, footnote 40.

on occasion.²¹¹ This would enable the trustee to distribute required information, as the removal of such power would make the trustee a mere custodian of the trust estate. However, if such clauses are worded so remove both the power and duty of supervision expressly, then the trustee is absolved from any responsibility in regards to investment of trust property.

While such retention appears contrary to orthodox purposes of trust law, it will not invalidate the settlement for it will not preclude the trustee's minimum fiduciary duties to the beneficiaries. Millet LJ, as he was then, explained in *Armitage v Nurse*,²¹² that there "is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust".²¹³ The trustee must perform honestly and in good faith and therefore must hold an independent mind in the exercise of discretion. There is also a duty to account for the stewardship of the trust property so to enable liability for related losses to be established. It must be asked however, what value these this core of duties offers if the settlor has retained such powerful duties as those of investment, appointment of income, and appointment and removal of trustees and beneficiaries?

Deeds of settlement that subtract the duties of accountability, honesty and good faith from the trustee do not create valid trusts. Jessica Palmer reasons that a clause that strips the trustee of the duty of accountability to the beneficiaries, by allocating such a degree of control of the trust's affairs to a third party, will indicate the absence of a valid trust.²¹⁴ The duty of accountability to the beneficiaries is imperative to the validity of a trust because the duties of honesty and good faith, the irreducible core of the trust in *Armitage v Nurse*, cannot be enforced if the trustee is exempted from liability. There will be no way for the beneficiaries to enforce the duties of good faith and honesty if they cannot hold the trustee accountable. Hayton suggests that any trust deed that purports to exclude beneficiary access to trust documents essentially undermines the trustee's fundamental duty of accountability.²¹⁵ In such instances the term would either be ignored, or the trust be held in favour of the settlor, as where the "trust instrument effectively precludes this 'irreducible core' of trustee duties, the law

²¹¹ At 911.

²¹² *Armitage v Nurse* [1998] Ch 241

²¹³ At 253.

²¹⁴ Palmer, above n 186, at 480.

²¹⁵ David Hayton "The Irreducible Core of Trusteeship" in A. J. Oakley (ed) *Trends in Contemporary Trust Law* (Oxford University Press, New York, 1996) at 53.

would hesitate from holding the transferee was acting as a trustee and correspondingly, from holding that there was a trust created.”²¹⁶

A trustee must also distribute trust property either to, or in a way that benefits those entitled to it.²¹⁷ However, the duty can be lessened if the trust distributions are fixed as to amount and time. The trustee may then appear an intermediary in a property transfer structure, rather than a trustee with meaningful obligations within a valid trust structure. Nevertheless, the fact the distributions must be effected correctly means the trustee will be held liable for any incorrect distributions.²¹⁸ It is this aspect of the fiduciary duty of accountability that allows trusts to survive sizeable interference with the irreducible core of obligations.²¹⁹

Arguably what should be an additional consideration when looking at the core obligations of a trustee is whether the beneficiaries are practically likely to hold the trustee accountable, rather than just legally entitled. If the discretionary beneficiaries of a ‘settlor-heavy’ trust structure are for example, the children of the settlor, they may be unlikely to challenge the structure. This makes the irreducible core though existent, meaningless, and therefore weakens the argument for using it to define a valid trust.

In a practical sense, although the trust will be held legally valid, the retention of control in this manner shows a lack of intention to divest beneficial ownership of the property, and the court ought to find the trust lacks the requisite certainty to create a valid trust. The test of the irreducible core can therefore be seen as an evidentiary test for the intention of the settlor. Such retention of control could also potentially be found as a breach of the maxim of *donner et retenir ne vaut* as described above, for the retention of the power would be evidence of a subjective intention to retain the “power to control the ultimate destination of the gifted assets”.²²⁰

The inclusion of large measures of trustee discretion within settlements has increasingly shifted the focus of trusts away from the beneficiary principle at the core

²¹⁶ Tsun Hang Hey "Settlor's reserved powers" (2009) 23(4) Trust Law International 183 at 193.

²¹⁷ Mowbray and others, above n 25, [26-01].

²¹⁸ At [26-04].

²¹⁹ Along with the fact a fixed interest gives the beneficiaries a beneficial interest rather than merely a discretionary expectation.

²²⁰ *Abdel Rahman v Chase Bank*, above n 35, at 105.

of the traditional trust structure.²²¹ The creation of a valid trust depends on certain trust objects, and the exercise of the trustee's discretion ought to occur with these beneficiaries in mind.²²² However, extreme discretion can be structured into a trust, including the abilities to both add and remove beneficiaries, resettle trust property and dispose of income, all the while having no vested or final beneficiaries. Hayton argues the core of the trust is the "beneficiaries' rights to enforce the trust and make the trustees account for their conduct", but the focus has shifted to the exercise of discretion over the assets, rather than on fulfilling duties owed to the beneficiaries.²²³ Smith suggests that the wider the dispositive discretion of the trustee, the more frequently the trustee will be required to have regard to the purposes for which his powers were granted. This therefore, "comes very close to saying that he must run the trust according to what he thinks the *settlor* would want in any situation".²²⁴ The general action of reference and deferral to settlor intention demonstrates a transformation of the trust into a property holding mechanism of the settlor. Rather than considering harm to beneficiaries when looking to invalidate a trust, the focus should instead be on the settlor and whether they intended to maintain control over their property to such an extent they did not form a valid trust.

E. Summary of Settlor Intention

A strong argument can be made for strengthening the test for certainty of the settlor's intention when looking at the formation of a trust. By attacking suspect trusts at the point of formation and looking to the settlor's true intention in regards to the property, there is no need to resort to the doctrine of sham.

The tools of *donner et retenir ne vaut*, alter ego, and the test of the irreducible core, are good examples of methods of interpreting a settlor's intention. The maxim looks to the subjective intentions of the settlor, while the doctrine of alter ego assesses the control had by the settlor over the trust property. The irreducible core, although a legitimate way of assessing a trust's validity in itself, is useful to illustrate both the level to which a settlor has retained control and the degree to which they chose to limit the trustee's influence over the trust. It therefore demonstrates the degree of

²²¹ O'Hagan, above n 209, at 912; Smith, above n 74, at 756.

²²² *Knight v Knight*, above n 23.

²²³ Hayton, above n 215, at 47.

²²⁴ Smith, above n 74, at 756 (emphasis the writer's own).

intent had by the settlor to retain control of the property and the lack of intent to give up beneficial ownership. As a trustee will always have a duty to distribute property, many suspect trusts will likely be upheld under the test, however large retention of control through the deed may infer the settlor did not have requisite intent to divest beneficial ownership.

The law of trusts as it presently stands does not consider settlor control an issue, for the principles and duties holding a trustee accountable to the beneficiaries are seen as sufficient to make good any wrongs. Parties outside the trust structure are not considered, and once a trust is validly created, it will not be lightly undone.

III. Reconceptualization of the Trust

Settlor control is not currently held a conceptual problem of the trust structure as evidenced by the lack of ability to address it under orthodox equitable principles. However, if such control is undermining the integrity of the trust structure, and trusts are becoming “perceived as a mean by which people shelter their true wealth and avoid liabilities”, then perhaps reconfiguration of the trust structure may be required, at least within the context of securities regulation.²²⁵

A radical solution may be to conceptualize a trust as an entity with a separate legal personality, shifting away from the traditional paradigm of a relationship between the parties. This would fit with the alternate view of a trust as a property transfer device, dependent only upon the unilateral intention of the settlor for valid creation.²²⁶ While the equitable jurisdiction to enforce the trust obligations against the trustee would only arise once the trustee became aware of the intention that he is to hold property for another, the trustee’s participation in establishing the trust would not be determinative of validity.²²⁷ The terms of the trust would not be a matter of agreement between the settlor and trustee, but rather terms dictated by the settlor that

²²⁵ Law Commission, above n 16, at 5.

²²⁶ Palmer, above n 30, at 93.

²²⁷ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*, above n 174, at 705. This would allow adherence to the principle that equity operates on the conscience of the legal owner of the property.

run with the property.²²⁸ However, as with a company, the structure itself could be used as a sham, which would allow for consideration of control exercised over it.

A. The Shift as a Natural Progression in the Use of Trusts

Viewing a trust as a separate legal entity is not as extreme as it may seem, for as Wadham puts it, “[h]ow often have you heard, or perhaps said, ‘I have a trust?’”²²⁹ Smith holds the “tendency to treat a trust as an entity” is a common mistake however, the fact this mistake is ‘common’, suggests a change in the law to reflect this perception would not be disruptive.²³⁰ Trusts share a number of commonalities with companies suggesting trusts may sit comfortably with the doctrine of separate legal personality as upheld in *Salomon v Salomon*.²³¹ The perpetual succession of a company, which can survive the death of both its directors and shareholders,²³² can be compared with the continuance of a trust following the death of its settlor, along with the well-established equitable principle a trust will not fail for want of a trustee.²³³ The ability of a company to own its own assets can also be likened to the ability of a trust to acquire assets, which, although legally owned by the trustee, are separate to the trustee’s estate due to the fiduciary obligations owed by the trustee to the beneficiaries. The fact shareholders of a company do not have rights in company property is also comparable to the lack of proprietary rights enjoyed by beneficiaries under a trust.

The use of trusts to avoid obligations to creditors, or by doctors to avoid negligence claims (as claimed in *Penny and Hooper*) is also similar to using the separate legal personality of a company to limit the personal liability of shareholders.²³⁴ Another strong factor of comparison is the role of modern trustee. The trustee must manage trust assets prudently and with due diligence, and these property-focused fiduciary

²²⁸ Palmer, above n 44, at 542.

²²⁹ James Wadham *Willoughby's Misplaced Trust* (2nd ed, Gostick Hall, Saffron Walden, 2002) at 20.

²³⁰ Smith, above n 74, at 758.

²³¹ *Salomon v Salomon* [1897] AC 223. The House of Lords unanimously upheld the doctrine of separate legal personality so that creditors of an insolvent company could not seek repayment from the company’s shareholders.

²³² John Farrar "Corporate Personality" in John Farrar (ed) *Company and Securities Law in New Zealand* (Brookers, Wellington, 2008) at [5.4].

²³³ *Re Lysaght* [1996] Ch 191.

²³⁴ *Penny and Hooper v Commissioner of Inland Revenue*, above n 133 at [16].

obligations of the trustee have begun to reflect those of a corporate director.²³⁵ However, a significant difference is while a company director is an agent of the company, a trustee is a principal and cannot be instructed to take specific action by the settlor or beneficiaries unless required so under the deed.²³⁶ Nevertheless, the ability of the settlor to retain the power to appoint and remove trustees is very similar to the ability of shareholders to hire and fire directors.

Viewing a trust, as a separate legal entity in itself would allow for the application of the doctrine of alter ego, in the same way it is applied to companies.²³⁷ Examination would be made of the factual control exercised by the settlor to determine whether actual ownership of the trust property could be attributed. This would therefore enable the reality of the control and enjoyment of assets to be acknowledged. As I will discuss below, this conceptualization would additionally give room to establish an objective bright line test to determine the acceptable threshold level of control a settlor may exhibit over property which has been purportedly settled on trust.

B. An Inference of Judicial Acceptance in KA No 4 Trustee Ltd v The FMA

The Court of Appeal has recently indicated in *KA No4 Trustee Ltd v The FMA*²³⁸ (the most recent chapter of the *Hotchin* litigation), a degree of acceptance of the construction of trusts in this manner. This was evidenced in the response to an argument put forward by counsel for the appellants.

In submitting that the sham pleading should be struck out in regard to the KA4 Trust, Dr Farmer, counsel for the KA No 4 Trust, argued that if a sham could be established at the point of settlement it was “effectively removed by the introduction of independent trustees.”²³⁹ This would mean when a settlor is also the sole trustee at the time of settlement and had a sham intention, for the sham to continue upon the introduction of a new trustee, the new trustee must share the settlor’s intention that the trust not really be a valid trust.²⁴⁰

²³⁵ The duties of due diligence and prudent investment are both equitable duties, and statutory ones under the Trustees Act 1956.

²³⁶ *Mowbray and others*, above n 25 at [1-18].

²³⁷ See *Gifford Motor Co Ltd v Horne*, above n 202; *Jones v Lipman*, above n 202; *Adams v Cape*, above n 202. Also discussed in *Hayton*, above n 202 at [7].

²³⁸ *KA No 4 Trustee Limited v The Financial Markets Authority* above n 2.

²³⁹ At [48]

²⁴⁰ At [50]

What was being advocated was effectively the inverse of an emerging sham.²⁴¹ However emerging shams do not fit within the traditional model of a trust, as discussed in chapter I, for it is the act of settlement that establishes the trust and the subsequent intentions of the settlor and trustee are irrelevant. Yet Dr Farmer was submitting that from a sham trust a valid trust could emerge upon appointment of a new and independent trustee. In other words, counsel argued the validity of a trust is not fixed at the point of settlement, and could change depending on the appointment of a new trustee.²⁴²

Because the Court of Appeal in *Wilson* rejected as a matter of law in New Zealand the emerging sham in the context of a trust, it can be contended that this argument by Dr Farmer should have held little chance of success too. Yet, although the Court in *KA No 4 Trustee Ltd* stated that while the argument could not automatically follow and that post-settlement actions could not transform a sham into a valid trust, the matter was left to be resolved at trial and the Court refused to rule definitively on the matter.²⁴³ The Court held that.²⁴⁴

... we would not be prepared to say that the opposite contention, that a sham remains a sham notwithstanding the introduction of an uninvolved trustee in the absence of a fresh declaration of trust, is so unlikely to succeed that a claim relying on that proposition should be struck out.

For a claim to be struck out “the cause of action must be so untenable that it cannot possibly succeed”.²⁴⁵ Therefore, it appears Dr Farmer’s argument was sufficiently sustainable that it could potentially succeed, an unexpected result under the supposedly settled law. It must be stated at this point that this argument may yet fail at trial, however the court’s willingness to hear the full substance of the argument is

²⁴¹ At [49].

²⁴² At [50].

²⁴³ At [48].

²⁴⁴ At [50].

²⁴⁵ At [13]. The Court refers to *R v Lucas and Son (Nelson Mail) Ltd v O’Brien* [1978] 2 NZLR (CA) at 294-295.

unexpected and may infer a readiness to deal with the issue of settlor control in an innovative manner.²⁴⁶

The importance of the argument as put forward, and tentatively accepted, in *KA No 4 Trustee Ltd* is that the ability to have an emerging sham trust or an emerging valid trust means the traditional paradigm of a trust as a relationship is not being strictly adhered to. In allowing a new trustee to influence the validity of the trust, the trust is not being viewed as a relationship with terms set at the point of settlement. Rather the trust is being treated as an entity with each new trustee influencing its validity. This view of a trust would additionally allow for a comparison of companies and trusts. Both companies and trusts are essentially legal fictions, as discussed above. The idea of using a valid company as a sham could therefore be imported into trust law so a valid trust could be invalidated by the later sham intentions of the settlor and new trustee.

C. Instituting a Bright Line Test to Assess Settlor Control – Effective and Substantial Control

This paradigm of a trust as an institution would theoretically allow for the development of a clear test of objective control to be used to intervene or look through trusts. An appropriate test is suggested by counsel in the *Esteem Settlement* as one of ‘effective and substantial control’, which has its origins in the company law sham and alter ego frameworks.²⁴⁷ The test equates to the level of control required from a controlling shareholder when a court is looking to pierce the veil of a company.²⁴⁸ To ‘lift’ the corporate veil is terminology used when looking behind the corporate façade and identifying the real nature of the relationship and the reality of the relationships created.²⁴⁹ This is evidenced in aspects of taxation law, when the court is willing to look upon a group of companies as one economic unit. To ‘pierce’ the veil, however is to take the enquiry one step further and was held in the *Esteem*

²⁴⁶ The Court additionally stated that it was likely that if the trust were found to be a sham, the trust property would be held on resulting trusts for the contributors of the property. This supports the analysis of a trust as a separate entity into which property can be added by third parties. If a trust were a relationship, then the property would be held on resulting trust for the settlor.

²⁴⁷ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 249.

²⁴⁸ At 249.

²⁴⁹ *Attorney General v Equiticorp Industries Group Ltd (in stat man)* 1996] 1 NZLR 528 at 541.

Settlement to be an expression reserved for considering the property, rights or liabilities of a company as those of its shareholders.²⁵⁰

1. The test for control

The English High Court at an earlier stage of the *Esteem* litigation, in considering whether the court could pierce the veil in order to achieve justice, held:²⁵¹

The ultimate issue is ... whether it is necessary, in order to achieve justice to lift the veil of the structure and... a key question is likely to be whether it was in practice a vehicle over which the defendant exercised substantial or effective control.

‘Effective and substantial’ control of the property could be defined for this purpose as occurring when a settlor exercises sufficient control to achieve the genuine benefits equivalent to property ownership. A manifestation of this could be leveraging the property as security for a loan, or enjoying the benefit of such property to the exclusion of others. The real advantage of viewing a trust as an institution is it would allow for application of the alter ego concept to help evaluate the control exercised by the settlor.

2. Requiring more than mere control

The Royal Court of Jersey went on in the *Esteem* litigation however to state no defining level of control will suffice as a bare justification to pierce the veil, as control will not create rights of beneficial or legal ownership. There must be additional impropriety, or fraudulent behaviour, either criminal or equitable, before the courts will be prepared to disregard the separate legal identities held by the parties.²⁵² While criminal fraud is definable under the Crimes Act, and requires an element of dishonesty, equitable fraud has a fluid definition based on the premise of unconscionability. The veil can also be pierced where the company structure itself is used as a sham; for it is being used as a fraud.²⁵³

²⁵⁰ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 249.

²⁵¹ *Grupo Torras S.A v Sheikh Fahad Mohammed As-Sabah* EQBD, July 29th, 1994, unreported.

²⁵² See Farrar, above n 232; *Gifford Motor Co Ltd v Horne*, above n 202 ; *Jones v Lipman*, above n 202.

²⁵³ *Chen v Butterfield* (1996) 7 NZCLC 261,086 at 261,092.

Equitable fraud will be found in circumstances where the settlor has unauthorized control over trust assets, and has therefore denied beneficiaries their rights. Using this test, equitable fraud could also be found where a settlor has disposed of property into trust to avoid the rights of creditors. This may appear as circular reasoning, as the settlor's control over the property is used to justify attributing the property to the settlor. However, equally, the use of 'unconscionability' in the framework would allow for the courts to have discretion over the issue, and may allow for justice on the facts. The unjust enrichment of the settlor occurring from their control may be a factor to be taken into consideration.

Given the growing concern over the use of trust structures to avoid statutory obligations and debt repayment, it is arguable that regarding a trust as an institution, with a veil capable of being pierced, may be an attractive solution. The avoidance of obligations by a settlor, through placing assets into a trust, could be argued as factually similar to *Jones v Lipman*. The case involved a defendant who sold his property but then sought to avoid the obligation of sale and transferred the property to a company. It was held the company could be subject to an order for specific performance and that the obligation could not be fraudulently avoided. The company was held as "the creature of the first defendant, a device and a sham, a mask which [he] held before his face to avoid recognition by the eye of equity".²⁵⁴ This principle could theoretically be applied to assets held on trust. Where the court finds the settlor has simultaneously and unjustly avoided an obligation (or more specifically committed a breach of the Securities Act) and has used a trust as a façade or mask to hide the avoidance, the assets should be attributed back to him to allow distribution in line with the avoided obligation.

C. Affirmation of a Breach Through Attribution of Ownership

The main issue of remodelling trusts on the form of companies, with separate legal identity, stems from the fiduciary duties owed by the trustee. In recognizing the trust is valid, tacit acceptance is given to the existence of duties owed by the trustee to the beneficiaries. One must remember, unauthorized control by a third party is likely to mean a breach of these fiduciary duties has occurred by the trustee, in allowing such control to occur. Therefore, the court would be effectively affirming the breach by the

²⁵⁴*Jones v Lipman*, above n 202, at 445.

trustee by warranting transfer of the trust property out of the trust to the benefit of the settlor. It is “wholly inconsistent with the recognition and enforcement of that trust to order the transfer of those assets to [third parties to the trust]”,²⁵⁵ because to give effect to the misconduct of both the trustee and a third party disregards the beneficiaries’ rights to have the trust property administered in accordance with the trust instrument.²⁵⁶ The “nature of a true trust of property cannot be changed just because the trustee wrongfully permits the settlor to have de facto control of such property”.²⁵⁷

It was confirmed by the House of Lords in *Target Holdings Ltd v Redferns*²⁵⁸ that the basic rule of personal liability of a trustee is to make good or restore to the trust estate the assets, which have been lost by reason of the breach of trust or failure to account properly for the trust fund.²⁵⁹ The test for loss was reaffirmed as one of ‘but for’ causation.²⁶⁰ It could be tenuously argued that if a trust could be thought of as an institution, the veil could be pierced so the ‘loss causing action’ of the trustee could be attributed to the settlor under the principles of agency. Therefore, the trustee would not be in breach of obligations owed to the beneficiaries and the assets could more be more credibly seen as those of the settlors. This could occur comfortably in the context of a discretionary family trust, where the beneficiaries are those related to the settlor and are therefore unlikely to complain of a breach. However, the same problem occurs, with the settlor now liable for the breach and associated loss suffered by the beneficiaries, and yet ‘rewarded’ for it by having the assets transferred in their favour.

The issue as to why the creditors of the settlor should be favoured over the beneficiaries is not addressed by seeing a trust as a separate entity. However, it is maintainable that this situation is similar to that of a voidable transaction or sham settlement, where the beneficiaries were never intended to actually obtain beneficial ownership of the property. Therefore, it would hardly be inequitable to deny the beneficiaries property they were never intended to receive. Going back to the first principles discussed in this chapter, attributing the assets to the settlor by looking at

²⁵⁵ *Grupo Torras S.A. and Culmer v Al.Sabah and four others*, above n 49, at 242.

²⁵⁶ The third party would be potentially liable for knowing receipt of trust property, or breach of knowing assistance.

²⁵⁷ Hayton, above n 202 at 9.

²⁵⁸ *Target Holdings Ltd v Redferns* [1996] AC 241 (HL)

²⁵⁹ Mowbray and others, above n 25, at [39-09].

²⁶⁰ *Target Holdings Ltd v Redferns*, above n 258, at 434.

their control and their purpose, could be considered a similar investigation to simply seeking to ascertain the true intentions of the parties to the transaction. Therefore the answer to the problem of settlor control may simply be taking a harder line, and requiring a greater degree of intention for a trust to be valid.

D. Summary as to the Reconceptualization of a Trust

The suggestion of reconceptualising a trust to be that of a separate entity is outside what is orthodox trust law. However, the willingness of the Court of Appeal to hear full argument on the idea of an emerging valid trust suggests this idea may not be overly controversial. Classing a trust structure as a separate entity would allow for the ‘veil’ of the trust to be ‘pierced’, and elements of control considered when looking at the structures validity. Assets of the trust could then be potentially attributed to the settlor. This would be a step in the right direction of addressing settlor control over trusts.

CHAPTER IV – BROADENING OF THE SHAM: LOOKING TO EFFECT RATHER THAN INTENT.

I. *Introduction*

The issue of settlor control both in the context of the Securities Act and in other areas in to which trusts extend, when not regulated by statutory provision, has been dealt with using the sham doctrine. The Court's primary weapon to deal with trusts that appear to be under the substantial control of a settlor is to look to the settlor's intention at settlement and make sure there is the required intention to create a trust. If an objectively valid trust is found, then the only method available to third party creditors of the settlor to access property of the trust is to refer to the sham doctrine and look at the subjective intention of both the settlor and trustee to determine whether they shared an intention to create a sham trust at the time of settlement.

The Securities Act 1978 does not regulate the use of trusts to shelter assets nor does it address the issue of settlor control of trust property. Additionally, the current test for objective validity of a trust is not sufficient to deal with problem cases, as evidenced by *Hotchin*. Therefore this chapter looks to the sham doctrine to see whether it is adequate to deal with the problem of settlor control.

Settlor control can be seen in instances when the settlor and trustee have intended to deceive third parties by creating the façade of a trust, and therefore the doctrine of sham is the appropriate means to provide a solution. But the sham doctrine does not address more common instances where the settlor is retaining the control and enjoyment of the property without holding any fraudulent intention. The settlor may have no contemplation of what a trust is, and continue to act with a free hand while the trustee is complicit acting as an agent.²⁶¹ This retention of control and benefit may induce a particular behaviour from third parties, for example, an investment or loan, or it may rile creditors who cannot access the property to make good debts owing.

²⁶¹ Law Commission, above n 16, at [58].

However frustrating the problem, “actual control alone does not provide justification for looking through/invalidating a trust”.²⁶²

It is its adherence to the core principles of trust law, which makes the sham doctrine so attractive. One core principle of trust law is that a trust is held objectively valid if the three certainties are present.²⁶³ One aspect, upon which this objective validity relies, is the core requirement of the certainty of intention. The sham concept fits neatly within trust law, as the doctrine is “merely part of a court’s general inquiry into the correct legal characterization of an act”.²⁶⁴ It is a process to allow, and justify, the revelation of the subjective intention of the settlor. A declaration of sham asserts that “there was no true trust intention as is required for the valid creation of a trust”,²⁶⁵ and the intention of the settlor was to “have an express trust in appearance only”.²⁶⁶ Essentially the sham asserts the settlor had a dishonest intent rather than a genuine intent to create a trust. One of the only legitimate grounds to invalidate a trust is proof of a lack of intention by the settlor and as the sham proves the settlor did lack this requisite intention, it does not interfere with the base premises of trust law.

The issue is that the sham doctrine as it stands, does not respond directly to the perceived problem of control, as if a trust is intended to be genuine at the time of settlement, and there is no intention to deceive, then it cannot be declared a sham.²⁶⁷ This chapter briefly questions whether the sham test could be altered to enable wider application, or whether the paradigm of the trust could be fashioned to address the problem of control over trust property

The sham doctrine is currently stable in its form and requirements. Therefore any redevelopment suggested would not be within the current sham framework.

A. Definition of a Sham

A sham is a transaction that appears on its face as one transaction and that appearance masks or conceals a different arrangement between the parties. There may be an

²⁶² *Official Assignee v Wilson*, above n 36, at [70].

²⁶³ Refer to chapters I and III.

²⁶⁴ Ben McFarlane and Edwin Simpson "Tackling Avoidance" in Joshua Getzler (ed) *Rationalizing Property, Equity and Trusts: Essays in Honour of Edward Burn* (Lexis Nexis, Edinburgh, 2003) at 139.

²⁶⁵ Palmer, above n 186, at 476.

²⁶⁶ *Official Assignee v Wilson*, above n 36, at [26].

²⁶⁷ Palmer, above n186, at 476.

alternate arrangement that the deed is attempting to cloak, as seen in *Marac Finance v Virtue*, where a conditional purchase agreement was held to be a sham and the true arrangement between the parties was a moneylending transaction.²⁶⁸ Alternatively, instances where the parties do not intend to be bound by the transaction will also qualify as shams. An alternate arrangement still exists, but it is that there will be no binding relationship between the parties. The settlement of a family home on trust in *Midland Park plc v Wyatt* was held a sham, as the trust was never intended by the settlor to be valid.²⁶⁹

However, there is a question whether a document, drafted in such a way that it does not have any perceived effect, allows for the finding of a sham. In the context of trusts, this would occur when the deed creates rights and duties in a manner that allows the day-to-day interactions between the settlor and the property to remain the same as prior to settlement. The situation could be termed a ‘factual nullity’, as the deed brings about no change in objective circumstances. The deed appears to third parties to create a trust and infers the settlor no longer enjoys the property, but it hides the fact nothing has changed in the way the property is managed or controlled. Such a situation could occur when a settlor retains the powers of investment, appointment of income, the appointment and removal of trustees and beneficiaries. Additionally the retention of day-to-day possession and the limiting of the core duties of the trustee would support this factual situation. This class could also include those instances where a settlor has settled a trust without knowledge of the ramifications, and continues to manage and control the property with a complicit trustee as before settlement. However the settlor has no fraudulent intent.²⁷⁰

It may be argued the traditional sham covers only first of the two situations and has a purposefully narrow definition. The “proposition that the courts will not wantonly interfere in ostensibly valid commercial transactions” emphasizes the perceived importance of upholding commercial certainty.²⁷¹ The first situation is dealt with currently both by sham, breach of trust and fraud on a power in particular contextual situations. Yet it is the second situation, where a factual nullity is created, which is arguably the new common problem.

²⁶⁸ *Marac Finance Ltd v Virtue* above n 70.

²⁶⁹ *Midland Park plc v Wyatt*, above n 35.

²⁷⁰ The Law Commission suggests this is a common situation. See Law Commission, above n 16, at 58.

²⁷¹ *Official Assignee v Wilson*, above n 36, at [52].

B. Comparable Treatment of the Two Scenarios

The two situations seemingly share the same outward manifestations. While in the second situation, the settlor has an objectively greater intention to create a trust, comparatively to the first; in both scenarios there is no subjective intention to divest beneficial ownership. It is merely that the ownership is retained in contrasting manners. In the first situation the settlor seeks to retain ownership by never actually settling the property on trust, while in the second situation, retention of beneficial ownership is achieved by a two-part mechanism. The property is settled on trust, which creates a front for the fact that control and enjoyment over the property is retained through the deed itself.

There is support for an expression of sham, which could fit both examples above. Turner J holds in *Bateman Television Ltd v Coleridge Finance Company Ltd* that a sham occurs when parties in conducting one transaction, have resorted to a form that does not fit the facts.²⁷² This is done to deceive a third party into the belief the transaction achieves something it does not.²⁷³ The notion of using a specific form of transaction to deceive a third party covers both scenarios above. While the first scenario deceives because a trust is used as a form to mask the real arrangement, the second deceives because the form of the trust has no practical effect on the control or enjoyment of the property.

On a similar note, Robertson and O'Regan JJ held in *Wilson* that a finding of sham does not 'invalidate' a trust. This is because the sham "intention goes to the non-creation of the trust," and therefore there is no trust to be a sham.²⁷⁴ It is the trust documentation that is the sham. Using a liberal interpretation, this too could be understood to cover both scenarios above. It would naturally include the orthodox sham, as the existence of an intention to not create a trust is seen the settlor's sham intent and corresponding intent to not divest beneficial ownership. In the alternative example, the documentation is executed with the explicit purpose of being relied upon. Robertson and O'Regan JJ's statement would also apply to the second situation if an 'intention to not create a trust', was interpreted broadly to be 'an intention to not create the true obligations that properly characterise a trust'. The rights and

²⁷² *Bateman Television Ltd v Coleridge Finance Co Ltd* above n 58.

²⁷³ At 813.

²⁷⁴ *Official Assignee v Wilson*, above n 36, at [48].

obligations created by the trust documentation do not represent those created by a traditional trust, because the settlor has retained the right to the control and enjoyment of the property using the deed and has not sacrificed its benefit. Therefore the settlor has exhibited an intention to avoid creating the obligations of a trust, so has shown an intention to not create a trust, while appearing objectively to do so. The fact the documentation has the effect of not creating what it purports to create, should allow for the documentation to be considered a sham.

A sham concerns creating the appearance of something inaccurate or fabricated. Therefore, documents that appear to affect property rights or the circumstances of the parties to the transaction, but instead have no effect on either, should also be considered shams. For these scenarios to be included, a new test without any focus on sham intention would be needed. It is this requirement that inhibits the instances of factual nullities from being caught as sham trusts, as parties to shams in the form of factual nullities intend to be bound by such documents, as they provide asset protection without changing the reality of the control or benefit of the property. Additionally they may be well intentioned in executing the deed, but not understand the consequences of the settlement. The most convincing shams are those done through the retention of control, and either where the trustee is deceived or alternatively inhibited by the deed from interfering.

II. A New Test – Looking to ‘Effect’, Rather Than ‘Intent’.

The current sham formulation is dependent on finding a mutual sham intention, as discussed in chapter I. If the settlor has the intention to create a genuine trust at settlement then the sham doctrine will not be applicable. The purpose of the transaction is of no relevance, and “if what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it”.²⁷⁵

The sham test, as another form of inquiry into the intent of the settlor, rehashes covered ground. A sham finds no requisite intention to create a trust, which could theoretically be identified when the court looks the validity of the trust at

²⁷⁵ *Miles v Bull* [1969] 1 QB 258 at 264.

settlement.²⁷⁶ A stiffer test for certainty could be introduced if it was emphasized the court had no need to “to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs.”²⁷⁷ The current formulation of sham would offer limited value when applied to instances of settlor control upon the introduction of a more demanding test of settlor intention.

To address the issue of settlor control a wider sham formulation could look instead at the outcome of the settlement, rather than the subjective intent of the settlor. What could be asked is, ‘what does the transaction achieve?’ rather than, ‘what is it intended the transaction hide?’. To achieve this, rather than looking for an intent to disguise transactions in the cloak of another, a sham could be found instead where the settlor uses documents to create an apparent burden, in exchange for the benefits gained from settling the trust. The test would address the issue of the misuse of trust. It could look at whether the purpose of the settlement is to avoid obligations while enabling an undeserved gain of the benefits of the trust. The fiction of the settlor divesting beneficial ownership could be addressed, respecting equity’s preference of substance over form.

A. Rephrasing the Claim –A Wider Test for Sham

The claim of sham originated when one party claimed a transaction was really a façade, or was masking another. However, the statement was not simply that,

this transaction is not a trust.

Rather, the claim was representative of,

this transaction is hiding another. This can be evidenced by the fact that this transaction, which purports to be a trust, does not fulfil the requirements of a valid trust. The requirement it lacks is the settlor’s intention, as he did not intend it to be an actual trust. The settlor instead shared an intention with the trustee to deceive third parties, using the transaction as a façade.

To refocus the sham on the effect of the settlement of the trust, the claim could be reframed, to state,

²⁷⁶ For the courts to find a valid trust there must be the certainties of intention, subject matter and object (*Knight v Knight*, above n 23). See also Chapter III.

²⁷⁷ *WT Ramsay v Inland Revenue Commissioners* [1982] AC 300 at 323.

this transaction is hiding another. This can be evidenced by the fact the parties entered the transaction to cloak the reality of the situation.

In the context of a trust, this new wider sham claim would be that the effect of the settlement allows obligations to creditors to be avoided without any corresponding loss in control and enjoyment of the property. This avoidance of the obligations infers, that the benefits from the assets have also been sacrificed. However, the benefits under a settlor-controlled trust have not been sacrificed and therefore the transaction is a sham.

This rephrasing of the sham test, to focus on the outcome of the transaction, would make the evidence of factual control by the settlor the primary focus of the investigation. Such control could be either direct, or indirect, authorized or unauthorized. Direct control would be such instances where the trust property was in possession of or under authority of the settlor. Indirect control may be evidenced by instances of de facto alter ego, where the trustee is a puppet for the settlor. Authorized control may occur through legitimate retention of powers through the deed. Such retention may be so excessive that the irreducible core obligations of the trustee have been limited in such a way so the trustee no longer has any duty other than correct distribution. Unauthorized control would cover instances where a breach of trust by the trustee has enabled the control to occur and be maintained, and would cover instances not sanctioned by the deed.

B. Avoidance of a Burden

An important evidentiary indication would be the lack of burden suffered by the settlor to correspond to the gain of benefits enjoyed through the establishment of the trust. This is a similar criterion to that within the context of tax avoidance, where an arrangement will appear to be avoidance where expenditure is neither borne nor loss suffered to balance out the enjoyment of the reduction in tax liability.²⁷⁸ Lionel Smith summarized Peter Willoughby's thoughts on this common situation, stating, "[y]ou cannot expect to get the tax advantages that come with a certain kind of trust without actually creating a trust of that kind; and such trusts have certain requirements that

²⁷⁸ *Challenge Corporation Ltd v Commissioner of Inland Revenue*, above n 130. See Chapter III, "Income Tax".

cannot be avoided”.²⁷⁹ This relates to the idea of misusing the trust structure in a way in which it was not intended, so to secure a benefit (including avoiding an obligation) without sacrificing any of the benefits of ownership previously held.

It could be suggested Lord Templeman was supporting a wider concept of sham when he warned in *Street v Mountford*²⁸⁰ that, “the court should be... astute to detect and frustrate sham devices and artificial transactions whose only object is to disguise the grant of tenancy and evade the Rent Acts”.²⁸¹ Susan Bright argues this reflects his Lordship’s attempt to create a flexible doctrine to apply wherever an agreement or document has been artificially constructed to avoid a statutory obligation under the Rent Acts.²⁸² Lord Templeman additionally referred within *Street* to the case of *Somma v Hazlehurst*,²⁸³ as being one of sham, yet in the case of *Somma* there was no shared intent to mask the true arrangement, rather the arrangement was intended to be effective but was done with the purpose of avoiding statutory obligations.²⁸⁴ This notion of sham could be taken out of the framework of the English Rent Acts and applied wherever a statutory or personal obligation is avoided.

If the effect of the settlement is to deprive creditors of repayment, and the settlor experiences no change in enjoyment of the property, which is apparently held on trust, then arguably the integrity of the trust has been compromised. Alternatively, the problem may just be the general public no longer believes the law should allow a settlor to retain control and benefit of property to the extent that avoidance of public policy occurs. There is an argument that trusts are used primarily as a method of protection for a businessman’s assets and they have become too far removed from the accepted principles of equity.²⁸⁵ The Law Commission acknowledges that other jurisdictions hold trusts must not be used to defeat public policy yet New Zealand has not introduced any regulation as to the purpose of trusts.²⁸⁶ A method to pull trusts

²⁷⁹ Smith, above n 74, at 751.

²⁸⁰ *Street v Mountford* [1985] AC 809

²⁸¹ At 825.

²⁸² Susan Bright "Beyond Sham and into Pretence" (1991) OJLS 136 at 139.

²⁸³ *Somma v Hazlehurst* [1978] 1 WLR 1014.

²⁸⁴ *Street v Mountford*, above n 280, at 825; Bright, above n 282, at 139.

²⁸⁵ Sue Tappenden "The family trust in New Zealand and the claims of 'unwelcome beneficiaries'" (2009) 2 Journal of Politics and Law 17 at 17, cited in Law Commission, above n 16, at 13.

²⁸⁶ Law Commission, above n 16, at 15. American Dr Austin Scott wrote in the Fifties that “a trust can be created for any purpose which is not illegal, which is not against public policy” (A W Scott *The Law of Trusts* (2nd ed, Little Brown and Co, Boston, 1956 at 1).

back from the precipice may be to require that for the benefit achieved by a trust, there should be an identifiable corresponding loss.

The factual scenario from the case of *Penny and Hooper* is a good example that would fit this form of sham. The Supreme Court held the arrangements in question, which diverted the taxpayers' income into trusts and then dispersed it back to them in the form of distributions, constituted tax avoidance. This was primarily because "the taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had".²⁸⁷ Additionally, the control of the trustees was suggested as pivotal to the successful implementation of the arrangement.²⁸⁸ Both elements of the new notion of sham as advocated in this paper would be therefore present: the avoidance of an obligation but no reduction in the enjoyment of the property or corresponding loss, and control held over the property.

III. An Alteration to the Traditional Paradigm of the Trust

An alternative solution to the issue of settlor-controlled trusts is to introduce a new form of emerging sham. Traditionally the trust is theorized as a relationship determined at the time of settlement of the property in question,²⁸⁹ and as explained in chapter I, the structure of a trust as a relationship does not sit compatibly with the notion of an emerging sham.²⁹⁰ For unlike a contract where it is possible for "transacting parties may later agree to something different than what appear on the face of the transaction",²⁹¹ and the document therefore becomes a façade for the new agreement, the rights and obligations of a trust are established at settlement and unable to be altered during the life of the trust (except via the powers of amendment or variation in the trust deed, or subject to the courts' jurisdiction).²⁹²

The difficulty in finding a sham trust is often that the trustee will have changed since settlement. The sham intention of a trustee is inferred from behaviour including deference to settlor requests, or allowing the settlor to have de facto control. If a

²⁸⁷ *Penny and Hooper v Commissioner of Inland Revenue*, above n 133, at [47].

²⁸⁸ At [35].

²⁸⁹ Palmer, above n 186, at 474.

²⁹⁰ *Official Assignee v Wilson*, above n 36, at [57].

²⁹¹ Palmer, above n 30, at 105.

²⁹² At 106.

change in trusteeship has occurred since settlement, but the current trustee acting in an inappropriate manner, it will be challenging to find such sham intention. As discussed in chapter III, the remedy will then be a claim of breach of trust against the trustee, but this does not address third party claims.

A solution may be to see a trust as a series of relationships, between the settlor and each trustee as they are appointed. Therefore, the emerging sham could be introduced as an action into the trust context and be available as against every separate trustee post settlement. In a context where the settlor often retains the power to both appoint and remove the trustee this may be a valid extension. The introduction of the emerging sham would also allow for the test of the irreducible core of duties of the trustee to be expanded.²⁹³ Evaluation of the core duties of each trustee in office could be had, in the context of the individual relationship with the settlor, and with the trustee's specific intent in mind. As discussed in chapter III, a trust may be held invalid where the irreducible core of duties has been diminished to such a degree that the trustee no longer owes any fiduciary duty other than ensuring distribution. An extended emerging sham test could take into account not only legitimate and authorized control by the settlor, but instances where a particular trustee has shown to abdicate his discretion to allow the settlor to step in. This formulation would also support the interpretation from *Abdel Rahman* a breach of the maxim *donner et retenir ne vaut* may occur through de facto control by the settlor. If the particular subsequent trustee allowed the settlor to obtain dominion and control at the time of their appointment post settlement, it may evidence a breach of the maxim at that time.

While *Hitch v Stone* held that departure from an agreement is not necessarily evidence that the agreement was never intended to be binding,²⁹⁴ this amalgamated combination of assessment would provide a more comprehensive structure to find a sham, and mean no factor would be individually decisive.

However this formulation would allow for beneficiaries to lose out. A transfer of a power by a trustee to the settlor would potentially be itself a breach of trust, although factual analysis of the trust deed could allow the courts to assess whether realistically there are beneficiaries to suffer loss. Within the context of a discretionary family trust,

²⁹³ See Chapter III for full explanation.

²⁹⁴ *Hitch v Stone*, above n 32, at [68].

the issue is that there are usually no beneficiaries to complain when the head of the family abuses the family trust structure. Alternatively the beneficiaries could be merely ‘nominees’, and named only for the purpose of the sham trust, unaware of their rights. If a sham is found, then arguably there are no beneficiaries to lose their rights for the trust is void at settlement. But if the test becomes one of invalidation, then the fact the beneficiaries are volunteers should remain at the forefront of the courts’ minds.

IV Conclusion

The current formulation of the test for a sham is not responsive to the issue of settlor control over a trust. The sham test as it stands focuses on the intent of both the settlor and trustee at the time of settlement. This means settlements that occur without fraudulent intent escape the jurisdiction of the sham. Furthermore, settlements can be drafted in a way to enable a settlor to retain effective control and benefit over the property while allowing avoidance of personal and statutory obligations. While these settlements may appear objectively valid, the subjective intention of the settlor is to retain beneficial ownership. However, the settlor, through intending to be bound by the deed, escapes a finding the sham.

A broadening of the sham doctrine, to include a test for effect and misuse of the trust structure, could allow for capture of these instances of settlor control. By requiring a burden be born in return for the benefit achieved by the settlement of the trust, it could be ensured the trust structure is not used merely as a tool for avoidance.

An alternative solution would be to reconceptualise a trust as a series of relationships between the settlor and each trustee as appointed, rather than as one relationship defined at settlement. This would allow for the application of a test for an emerging sham and would therefore remove the difficulty of requiring a mutual sham intention at settlement.

CONCLUSION

This paper set out to examine the issue of settlor control over trusts and trust property, and answer the question whether a settlor can ever be said to have exerted so much control over trust property he has crossed the threshold from control into beneficial ownership.

Chapter I established the context in which the issue is currently appearing. Reform within the area of securities market regulation has led to an increased capability to hold directors of financial institutions accountable for breaches of the Securities Act 1978. However, the common occurrence of personal trusts among such directors means upon liability being held, the defendants are often adjudicated insolvent and unable to pay compensation or pecuniary fines under the Act. Concern is evoked when the defendant exercises significant control over the trust property, yet the property is shielded from claims of third parties by the structure of the trust. The defendant is able to control and benefit from the property while unrestricted by the burdens of ownership. In such instances, the common claim is that the trust is a sham, void at settlement due a mutual deceitful intention of the settlor and trustee. However the sham doctrine has proved ineffective at addressing the problem of settlor control, due to its focus on the subjective sham intent of the parties to the transaction. There is a difficulty in proving the mutual intention, compounded by the illusory nature of the subjective evidence sought. The paradigm of a trust as a relationship impedes the implementation of the 'emerging sham', which consequently means the intention of subsequent trustees post-settlement is irrelevant.

Chapter II examined a range of statutory contexts in which Parliament has instituted provisions to deal with the use of trusts. The provisions of the Insolvency Act 2006 and the Property Law Act 2007 are effective in indirectly regulating the control of trust assets by controlling dispositions into trusts. However both do not directly address the control of trust assets. The Acts allow for direct access to the property through the cancellation of transactions, reattributing ownership back to the settlor. The Income Tax Act 2007 and Legal Services Act 2011 look holistically at the realistic economic situation of the parties involved. Both Acts allow for trust property controlled and enjoyed to be notionally attributed to the party in question for the purposes of the respective statutory calculation. However, the void between control

and ownership is not breached and ownership is never attributed, so third parties do not gain any ability to access the property.

Each statutory context offers a viable structure for implementation within the Securities Act. The provisions within the Insolvency Act and Property Law Act operate easily and look objectively at the dispositions of property, rather than any element of control. However, they do not themselves address the problem of settlor control. The taxation and legal aid regimes offer better structures to analyse settlor control over a trust, however there is a big gap between saying property would be likely to be attributed to a settlor if distribution was effected immediately, and allowing third parties access to the property due to control of the settlor.

Chapter III is where the core of the discussion regarding the importance of settlor control can be found. Chapter III analyses the possible equitable alternatives to deal with the issue. The primary opportunity to address settlor influence is through the requirement of a certain intention of the settlor to divest beneficial ownership at settlement. It is argued a stiffer test for certainty of intention would capture trusts where the settlor has objectively settled a trust but continues to exert a sizeable degree of control over the trust. This is argued as inferring an intention to retain beneficial ownership.

Chapter III examined a set of equitable principles, which evaluate settlor control of trust property in terms of identifying the settlor's true intention in relation to the trust. The equitable doctrine of *alter ego* is explained as an important evidentiary tool for the test of sham. The doctrine however is inappropriate as a cause of action on its own because control alone cannot justify the attribution of ownership of property to the controller. Additionally, its requirement separate legal personalities means it cannot be applied coherently to trusts. The maxim of *donner et retenir ne vaut* is a viable alternative, dependent only on the subjective intention of the settlor. It holds a gift or transfer into trust will not be completed where the settlor has intended to retain beneficial ownership of the property, or where the revocation of the gift or transfer has been allowed for. The test of the irreducible core of trustees' duties is sufficient in itself to measure trust validity, however the analysis also offers insight into the intention of the settlor. Attempts by the settlor to limit the powers and duties of the

trustee may infer an intention of the settlor to retain control and beneficial ownership of the property.

Chapter III also explores the contemporary idea of reconceptualising the trust as a separate entity, rather than the traditional relationship. This paradigm fits with the notion of a trust as a property transfer device. It allows for elements of control, through the doctrine of alter ego, to be used to justify piercing the veil of the trust and permits attribution of trust assets to the settlor. The rights of the beneficiaries are however infringed by this principle, for breaches of trust by the trustee in allowing the settlor to obtain control, are affirmed in the attribution of property. It is however argued that the finding of an alter ego in this form, is equivalent to finding the settlor never intended to vest beneficial property rights in the beneficiaries and this justifies the abrogation of these rights.

Chapter IV is innovative in its response to the failings of the doctrine of sham in addressing the issue of settlor control. Broadening the test for sham to assess the effect of the settlement rather than the intent of the settlor allows for trusts, which have a primary purpose of obligational avoidance, to be captured. Settlements drafted in a manner allowing the settlor to gain protection from third party claims without sacrificing any enjoyment of the property also fall under the ambit of the wider sham doctrine. Alternatively this chapter suggests reconceptualising the trust as a series of relationships between the settlor and each individual trustee to allow for the application of the doctrine of the emerging sham. This would bypass the constrictive requirement of having to ascertain a mutual intention at settlement and instead allow for a mutual sham intention to be found at the time of appointment of a new trustee.

In summary the issue of settlor control is difficult to address because equity itself does not consider settlor control an issue affecting the integrity of trusts. Statutory provisions go some way to address the disposition of assets into trusts however there is still inadequate provision for dealing with instances of third party control over trust property. So long as control is held to be an insufficient justification for granting property rights, it will be difficult to placate third parties to whom obligations have been avoided by the settlement of the trust, and who are aggravated by the continued enjoyment of such property by the settlor.

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